Navigating Disclosure Options for Private Placements: What Issuers Need to Know

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When a company is thinking about launching a private securities offering, one of the first questions that arises is what disclosures are required to be provided by the company to investors. The answer to this question can depend on a number of factors, including 1) the number and type of investors the company is soliciting for the offering, 2) the risk tolerance of the company, 3) the company's budget for the capital raise, and 4) the size of the offering. This article explains the disclosure options available to companies for private placements and key factors management needs to know when deciding which option is best for them.

Securities Law Requirements for Private Placements

State and federal securities laws require issuers to provide investors with full, fair, and complete disclosure of all "material" facts about the offering and the issuer, its management, business, operations, and finances. Information is deemed to be material if a reasonable investor would consider the information important in making an investment decision. While materiality is a difficult concept to define precisely, at a minimum, a fact is "material" *if you do not want to disclose the information because if the investors know about it, they would not buy the securities*. Facts that are disclosed must be developed fully.

Even though a securities offering may not be required to be registered with the SEC, the issuer and its control persons must comply with state and federal anti-fraud provisions. The federal anti-fraud provisions arise primarily from the well-known Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 as well as the lesser-known Section 12(a)(2) of the Securities Act of 1933. Failure to comply with these provisions can result in civil liabilities (i.e., money damages) and, in some instances, criminal liability. The liability can be personal as to the issuer company and its officers, directors, managers, principal equity-holders, promoters, and others associated with the offering. These anti-fraud provisions collectively prohibit any person in connection with the purchase or sale of any security from misrepresenting or omitting a material fact or engaging in any act or practice that constitutes a "fraud" or deceit upon any other person.

Fraud, for securities law purposes, is a much broader concept than it first appears – it includes omissions in disclosure (sometimes even unintentional ones) rather than just deliberate misrepresentations. Therefore, regardless of whether an issuer intends to defraud an investor, should the issuer and its management and principals fail to disclose a material fact, the issuer, as well as its management, promoters, and control persons, may be liable.

If the securities will only be sold to accredited investors under Regulation D of the Securities Act, there are no absolute disclosures that the SEC requires issuers to make in writing to investors. The rationale is that accredited investors are deemed to be sophisticated enough to know the right questions to ask and presumably have the economic leverage to obtain such information. If the issuer is offering and selling securities to non-accredited investors, the issuer may be required to provide certain specific written disclosures that contain substantially the same information as disclosure statements from companies that are registering their securities offerings with the SEC, including audited financial statements. To satisfy these disclosure requirements and comply with the anti-fraud provisions of the securities laws, a disclosure document in the form of a Private Placement Memorandum (PPM) or Offering Memorandum is usually prepared that would resemble a prospectus for an initial public offering.

That said, many issuers do not want to go through the time, effort, and cost of producing a PPM for their offering, either because they feel they need to get to market quickly for the offering and they have investors waiting to contribute capital, or the offering amount is low enough where the client does not perceive the utility in preparing and distributing a PPM. In this case, there are other disclosure options available to clients providing varying levels of protection from securities law liability. Following is a summary of the disclosure options available to an issuer for a private securities offering, depending on how much legal protection the issuer wants and how much money and effort the client wants to expend in producing disclosures for investors. These options are presented based on a "continuum" of legal protection, starting with the least protective and moving up to the most protective, which is a PPM.

Continuum of Disclosure Options

- **No Disclosures and No Subscription Agreement** – Under this option, the issuer provides no written disclosures of any nature to investors. The investors sign the operating agreement, partnership agreement, or similar organizational document of the issuing company and make their capital contributions. *This provides no legal protection to the issuer or its control persons for securities fraud liability.*
- **Subscription Agreement** – The issuer prepares a subscription agreement containing the principal terms of the purchase and sale of the securities, and various reps and warranties from the investor, including a representation that the investor has been given a full opportunity to ask questions and receive materials from the issuer regarding the company and the offering. No separate disclosure document is provided to investors. *This option provides little legal protection to the issuer and its control persons, but more protection than providing no disclosures or subscription documents.*
- **Subscription Document Package** – The issuer prepares a short disclosure document containing summary descriptions of the offering, company, use of proceeds, capitalization, and rights of the offered securities, along with risk factors. A full subscription agreement and confidential purchaser questionnaire is attached to the disclosure document to establish the investor's suitability to invest in the offering. *This option provides greater legal protection to the issuer and its control persons than the first two options above.*
- **Stock/Securities Purchase Agreement w/ Full Due Diligence Opportunity** – The issuer does not provide a disclosure document to the investors, but rather prepares and enters into a detailed stock/securities purchase agreement with the investor(s) with detailed reps and warranties regarding the investor's investment intent, suitability, accredited investor status,

and other matters. The issuer also opens up a data room and provides the investor(s) with a full due diligence opportunity to review company documentation, have meetings with the company's board and executive officers, and receive full answers to questions. This option is frequently used by more sophisticated private equity and venture capital investors who are confident in their own due diligence processes and would rather rely on those processes to determine whether to invest, rather than receiving a disclosure document that may not provide them what they desire to know about the company and its business. *This option provides a high level of legal protection to the issuer and its control persons.*

- **Full PPM** – The issuer prepares and distributes a full, detailed PPM to prospective investors providing fulsome disclosures regarding the offering, the company's business, management, capitalization, organizational documents, risk factors, competitors, and other disclosures. *This option provides the highest level of legal protection to the issuer and its control persons.*

Many times, deciding the best disclosure option for a company can mean the difference between a successful and unsuccessful private offering. Any company considering launching a private offering should evaluate its options carefully and seek the assistance of experienced counsel.

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