Industry Canada Industrie Canada

Self-Study Guide

STEP 9:
Close the Deal

Canada

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9.1 Close the Deal - Introduction

At this stage you and the investor have probably negotiated a final draft of the investment agreement. But a few issues, such as the due diligence review, need to be resolved before you sign on the dotted line. This review is the investor's last opportunity to take a serious look at this deal, to see management in action and to get a hands-on feel for the company. This stage is also your last chance to reconsider. After all, this deal is probably not quite what you first envisioned. It's time to reassess your initial needs to ensure there is still a good match.

In This Step
You will learn to take a careful, last look before committing yourself to a negotiated deal. As well, you will find out more about the due diligence review and get some tips about how to handle it. This Step will provide you with strategies for conducting your own review of the investor. Finally, you will explore how to maintain a good relationship with the investor.

- Take a Good Look at the Deal
- Scrutinize Legal and Other Obligations
- Prepare for Due Diligence
- Conduct Your Review of the Investor
- Build Good Relations With Investors
- Action Items

The New Tech Story
Follow the fictional company New Tech Distributors Corp. (New Tech) as it pursues venture financing. This case example gives you a feeling for the "real" data and strategic decisions you'll be facing.

9.2 Take a Good Look at the Deal

After all your preparations and negotiating, the deal is finally starting to take shape. But is it still in line with your needs? Maybe the investor thinks you have overestimated your needs and has lowered the amount of the investment. Maybe the type of investment instrument has changed. Maybe the investor's involvement in your company will be more hands-on than you anticipated.

The decision you are about to make will have a significant effect on your business and personal future. As the deal comes closer to reality, take some time to collect your thoughts and compare your initial proposal with the way things are actually turning out. At this point too, seek out the advice and opinions of your business advisors, key members of your management team, and your board of directors.

Take a good look at the deal from these standpoints:

- Your Company's Future
- Financial Needs and Goals
- Trust and Chemistry

Your Company's Future

It's time to make a hard decision based on what you believe is best for you and the company, both now and in the future. So step back and think of the big picture.

- Are there any reasonable alternatives? If not, what position will your company be in if you don't go ahead with your plans?
- Can your company afford the management team under present circumstances?
- Will the company continue to be viable without this investment?
- Are you prepared to give up a greater share of the business in order to close this deal?
- On the other hand, are you giving up so much to make a deal that you're risking your company's survival?

Financial Needs and Goals

Consider again whether this deal is a good one for the financial health of your business.

- How will the deal affect your cash flow? Will your cash flow meet your current needs under the new arrangements with the investor?
- Are the proposed changes too restrictive from an equity standpoint? Will you be able to obtain additional equity financing in future without jeopardizing this agreement?
- Can you still meet your goals?

Trust and Chemistry

Trust and chemistry are the key elements of this process. You and the investor may be partners for a long time, so make sure the relationship begins properly. If it comes to light that you haven't provided full disclosure, or if you try to introduce new information that effectively blindsides the investor, you run the risk of destroying your credibility and the trust you have established. If the investor loses faith in you, the deal will not close.

Tip
Recruit a Devil's Advocate

As you've seen in previous Steps, it takes time and effort to prepare for and work out a deal with an investor. When you've put so much hard work and valuable time into the process, it's natural to just want the deal to get done. As you review the terms of a potential agreement, therefore, it's a good idea to recruit someone to act as the devil's advocate. This person's role will be to question you and challenge your assumptions.

Provide your challenger with the points and questions we've included on this page. Set aside an hour or so for the two of you to go through the items. Ask the devil's advocate to keep an eye out for any points about which you seem hesitant or uncertain, and to note these down for you.

When you've gone through all the items, return to the challenger's notes and dig more deeply into the areas of concern. Do these represent aspects of the deal that make you uncomfortable? Are there good reasons for you to have doubts over these points? Do you need more discussions or negotiations about these areas?

Key Question
When to Walk Away

If you and the investor find yourselves in real conflict over terms, it may be better to walk away than try to resolve it. Don't talk yourself into a bad deal just because you've worked hard to arrive at an agreement. If you feel really uncomfortable, it's probably an indication that you're subconsciously aware of issues that could give rise to serious problems in future. Keep in mind that the purpose of finding funding was always to make your company better and stronger. If the deal you've reached doesn't do that, it's not the right one for you.

9.3 Scrutinize Legal and Other Obligations

As you know, the fine print can often include some surprises. This investment deal is one of the most important you will ever make for your business, and it's vitally important that you know and understand every detail of the commitment you will be making. Take the time to comb through the details and to ensure you're aware of how the deal fits with new and existing obligations. Be sure to consider:

- Legal Issues
- Government Regulations
- Existing Contracts

Legal Issues

Keep Actively Involved in the Legal Agreement

Reviewing and negotiating the various elements in your legal agreement is time consuming. But it's critical for you to do so before closing the financing. Don't rely on your legal counsel to take care of the legal issues for you. Read all sections of the agreement and make sure that you understand them. Why? Because you'll have to be involved in decisions affecting the agreement, such as what representations and warranties the company is prepared to give, the composition of the board of directors, the dividend policy, compensation arrangements, positive and negative covenants, and so forth. Don't underestimate the importance of these issues.

Work With a Specialist

It's critical that you continue to work with a lawyer throughout the final closing of the deal. At this stage you need a lawyer who is a specialist with investment contracts and shareholder agreements. Your existing lawyer may not have the necessary experience to guide you properly, and if so, should refer you to a specialist practising in this sector of the law.

Retain* Your *Own Lawyer

No matter how much you trust the investor and the investor's lawyer, always remember that they have the investor's interests in mind, not yours. Although many of your interests coincide (e.g. to have your business succeed), many will conflict (e.g. who has effective control over the business). Without independent legal counsel protecting your interests, you allow the investor to control the agreement.

Get Advice Before Signing Anything

In particular, don't sign agreements that the investor says are used "with all the other companies" that the investor finances, without having your own legal expert check them over. And don't try to save on legal fees by signing an agreement in which only "minor" changes were made. Your lawyer should always review the final version. Changes that you regard as minor could have major repercussions in terms of the documentation to be filed or the impact on your business. Besides, if your lawyer reviewed the first draft, it shouldn't take much time or money to review the changes.

Government Regulations

Financing arrangements are governed by provincial statutes. These statutes establish regulatory requirements that vary according to the type and amount of the investment. Each province has legislation that covers various aspects of business transactions and the issuance of securities by companies. In Ontario, for example, the *Ontario Business Corporations Act*, the *Ontario Securities Act* and the *Personal Property Securities Act* may all contain regulations that may apply to your particular financing arrangement.

You should consult with your lawyer to ensure that all applicable regulations, restrictions and registration requirements are considered. And your lawyer should review every document to ensure that the investment agreement conforms to the negotiated terms.

Once all the documents are signed, you'll find it very difficult, if not impossible, to change, delete or add clauses.

For more information on legal issues and government regulations see the *Legal and Regulatory Overview* in the Appendix.

Existing Contracts

Think ahead. Once your agreement is signed, your company's capital structure and ownership will have changed, perhaps dramatically. What effect will this have on existing contracts? For example, if you have a bank loan, you may have agreed in writing to notify the bank and get its approval before you change the ownership structure.

Before the deal is finally closed, ensure that there are no loose ends that could turn into problems down the road. Your lawyer will be able to guide you on these matters. Here are some items that you should consider.

- Do any options or other agreements exist that were negotiated earlier in the company's life that would be unreasonable after the financing? For example, options to purchase shares that may have very low exercise prices in light of the new size of the company.

- Are there any contracts (licences, employment contracts, supplier contracts, etc.) that will soon expire? Should they be renegotiated early or allowed to lapse? For example, a supplier may demand increased prices knowing that the product is vital to your expansion or, alternatively, if you will be producing more items in-house, you may need to cancel some contracts.

- Do any existing contracts restrict your ability to enter into new contracts, open up new markets, etc.?

- Do employment contracts and confidentiality agreements (especially with respect to intellectual property) cover all key employees? Key employees may include not only the management team but also scientists, engineers, plant managers, etc.

- Did you enter into any related party transactions that, while appropriate when you were the sole owner, may no longer be appropriate? For example, payments to management companies, special dividends or shareholders loans may need to be attended to.

- What about any potential or contingent liabilities (i.e. lawsuits)? You may wish to settle these before your company grows because an award granted after the financing may be larger simply because your company is larger.

- Are you satisfied with your current auditors and legal counsel? Changing advisors may be more difficult later on with additional owners who must consent.

- Are there any agreements, contracts, etc., that will end or materially change as a result of a new share issue, share dilution, the assumption of subordinated debt or a change of control?

- Ensure that all banking arrangements reflect the new financing structure and that there are no outstanding issues regarding security documentation, required notice or forced repayments.

This list adapted from Public and Private Financings: A Legal Perspective. Jay Lefton, Aird and Berlis, Barristers and Solicitors, Toronto: November 21, 1994.

9.4 Prepare for Due Diligence

Up to this point in the financing process, the investor has relied mostly on the information you have provided. But before committing to the deal, the investor will conduct a due diligence review to verify your information and to obtain more data, if necessary.

Every investor will perform the due diligence review differently. Some will have advisors (usually from large accounting firms) perform the task, whereas others, often angels, will handle it themselves. A due diligence review will usually include a detailed look at these main elements:

- **Legal review** — your corporation's legal documents, contracts and other legal issues;
- **Financial Review** — your company's financial status;
- **Management Review** — your management team's capabilities;
- **Marketing Review** — your marketing plan and activities; and
- **Operations and Technical Review** — your equipment, plant and processes.

The information the investor wants is usually drawn from two sources: interviews and documents. Interviews may be conducted with any or all of the following: your management team; your banker, lawyer and accountant; major clients or suppliers. Give these people advance notice that they may be called on to talk with the investor

Documents You'll Need to Have Ready

Do some groundwork in advance, and make sure that all the following documents are readily available when needed. Assign responsibility for ensuring good copies are prepared, and keep track of where they are located in case a key person is out of the office when the information is requested. Here are some documents you'll probably need. For operations and technical review, consider what is appropriate in your case.

Document Type	Responsible	Located/Ready
Financial Review • published financial statements for the last four or five years • company-prepared interim financial reports and analyses • recent business income tax returns and payment schedules • auditors' working papers and all pertinent correspondence with the auditors • recent appraisals of tangible assets		
Management Review • a strategic plan that focusses on the big picture for the next 5 to 10 years and incorporates your vision of the company • historical and future forecasts, along with actual figures, to assess management's ability to produce accurate forecasts and to determine future expectations • all key management biographies and résumés • an organization chart and copies of any employment, consulting and confidentiality agreements with key employees • a list of primary and backup suppliers (especially if you buy a speciality product or service)		
Legal Review • corporate minute books and documents (e.g. articles of incorporation, by-laws) • summary (and copies) of the main contracts in place (e.g. shareholders agreements, employment contracts, leases, patents, insurance policies, mortgage documents, and sales or supply contracts) • a summary of all outstanding or pending litigation with an accompanying opinion letter from your lawyer explaining the expected outcome of each lawsuit		

Marketing Review • press releases, speeches by management and marketing materials released in the past few years • a list of key customers with historical and projected sales data and order backlog, if available • market due diligence		
Operations and Technical Review • if your company is a manufacturer, returns and warranty data to assess the quality of the product and to assess any contingent liability related to your products • other		

Take a Closer Look

Due Diligence is Not Just a Formality

More than one entrepreneur has lost key financing because of inadequate preparation. See the Appendix for information about *the elements of due diligence*.

FAQ

Who Pays for the Due Diligence Review?

Sometimes the investor will require the business owner to pay for the legal and due diligence costs. There are no laws or regulations preventing the investor from asking this of you. Although every investor operates differently, the bottom line is that you need the investor's money, so you may decide to agree to pay if refusing could mean the end of your financing negotiations. If you do decide to pay, agree on a time budget and maximum amount before the work begins.

9.5 Conduct Your Review of the Investor

It's hard to resist an investor who is willing to inject capital into your business. But the risks of being associated with an incompatible partner can quickly be outweighed by any benefits. So before you sign the deal, whether you're courting one investor or several, you owe it to your business to take one last objective look at your partner-to-be.

Many entrepreneurs look only at the amount of money an investor is offering, but it's just as important to consider the investor's contacts, experience and expertise. If your business does encounter difficulty, an experienced, committed investor-partner could make the difference between success and failure.

Issues for Your Due Diligence Review

Look over the following checklist - it contains a list of issues you should consider when assessing the prospective investor. Think of it as your due diligence review. Do some investigation and analysis on each of the items and rank your comfort level with the investor on each of them.

Scale:

1. uncomfortable 2. somewhat uncomfortable 3. comfortable 4. very comfortable

What to Check Out	Based on what you learn, how comfortable do you feel about the investor? Uncomfortable Very comfortable
Honesty and Integrity Can you trust this person to keep his or her word and honour verbal commitments? Will you need signed contracts for every matter?	1 2 3 4
Past Track Record Is this person usually involved with successes or failures?	1 2 3 4
Typical Investment Philosophy Will this person be an active or a passive investor?	1 2 3 4
Size Does the investor have sufficient capital to provide you with a second round of financing if you need it in the future?	1 2 3 4
Stability Has the investor been in business for a long time and, if so, what is included in the investment portfolio? Is the investor financially stable? If the investor goes bankrupt, your financing may belong to one of the creditors, who may not share the investor's enthusiasm for your business.	1 2 3 4
Expertise and Experience Does the investor have industry expertise related to your business? Will the investor be a useful addition to your board of directors? Does the investor have management skills that compensate for weaknesses in your current management team?	1 2 3 4
Network Does the investor have a large network of contacts that you can use to find management expertise, potential customers, or suppliers?	1 2 3 4

Problem Investments What does the investor normally do with investments that under perform? Does this person exit from the financing arrangement, take over the company or arrange to work it out with the entrepreneur?	1	2	3	4
Personality Is this investor someone you feel comfortable working with?	1	2	3	4
References What do other businesses, bankers, business associates, financial newspapers, magazines and your own business advisors have to say about this investor?	1	2	3	4
Other Investigate any additional factors that are important to you and your business.	1	2	3	4

9.6 Build Good Relations With Investors

Your relationship with your investor began the moment you first made contact. Make sure every experience thereafter is a positive one. The key to a successful relationship is honest and open communication. Check out our Tips on Keeping a Good Working Relationship.

Once you've agreed to a deal, it's even more important to continue to be honest and open. You have to make the investor aware of all significant developments, even unfavourable ones. Remember that it's always better for you to break the bad news than for the investor to learn about it from outside sources. If you raise the issue first, you'll have an opportunity to discuss your plans to address the situation or to seek the investor's advice.

If you don't keep the investor informed and involved, he or she may pull the money out (under exit clauses) or be less willing to help you work out problems when they occur. As well, most investors and angels know each other reasonably well, and if you lose your credibility with one, you may find it hard to access this type of financing in the future. On the positive side, if the investor experiences you as trustworthy and straightforward, this may lead to further investments as your business grows.

Tips on Keeping a Good Working Relationship

Most investment agreements require some sort of ongoing formal reporting, such as the completion of a monthly financial reporting package. But you should strive for a higher level of communication with your investor that includes the following ideas:

- Reliability — ensure that the investor receives requested information (i.e. monthly financial statements) on time, according to the schedule contained in the agreement.
- Provide a meaningful management overview that explains the numbers whenever providing monthly or quarterly financial reports to the investor.
- Keep the investor aware of market trends and developments by inviting the investor to strategic sessions or industry seminars presented by external experts.
- Ensure that the investor feels comfortable in joining board of directors' meetings.
- Make sure the investor is aware of all major decisions. This policy not only keeps the investor up to date on developments, but also tends to remove potential conflict down the line. Keep in mind that the investor is your partner and not your boss. Follow your normal operating procedures and involve the investor in those decisions that are required by your investment agreement or shareholders agreement. Accept the investor's input as a positive contribution, but don't follow it blindly.
- Regardless of what you have to do to maintain the relationship, ensure that you have a common trust. If the investor feels you're not forthcoming and loses confidence in you, the remainder of your relationship will be very difficult. Conversely, if you have similar concerns about the investor, you should re-evaluate the situation. Ask yourself if it is advisable to continue the relationship? After all, you want to spend more time managing your business than managing conflict with the investor.

Tip
Are you just looking for the money? Or are you looking to grow your relationship with the investor?

It Takes More Than Money to Build a Good Partnership

Credibility, honesty, trust and confidence are the most important elements in a successful partnership. You must ensure that these elements exist throughout your relationship with the investor. Cultivate and nurture them, and your relationship with the investor will grow. Ignore them, and your relationship will dissolve.

9.7 Action Items

In this Step you looked at the activities that lead up to the closing of an investment deal, and considered the importance of proceeding carefully before committing yourself. As well, you have seen how to prepare for the due diligence review the investor will conduct. Finally, you have looked at ways to ensure that your relationship with the investor continues to be a beneficial one for all parties.

The following checklist will help you to:

- assess your understanding of the ideas covered in this Step;
- gauge your progress; and
- plan your company's approach.

Checklist

	Status	Target Date	Responsibility
Take a careful look at the deal that is on the table, considering: • your company's future; • the financial arrangements and their effect on your company; and • the level of trust and positive chemistry you feel underlie the deal.			
Have an outside expert or advisor review the deal with your interests in mind.			
Review legal and contractual obligations: • go through the legal agreements with a fine-tooth comb, and with expert advice; • review government and regulatory requirements; and • consider the effects of the deal on existing contracts.			
Prepare for the due diligence review, assembling necessary documents and support for: • financial review; • market review; • management review; and • operations and technical review.			
Conduct your own review of the investor.			
Work toward establishing a good ongoing relationship with the investor.			

Appendix

Take a Closer Look - Due Diligence (see section 9.4)

Financial Review

A due diligence review will always include a detailed look at the financial status of the company. The investor will want to verify the information contained in your investment proposal against the financial records of the company. When the investor is confident that your financial records are accurate, the credibility of your forecast data is enhanced.

Your financial advisor should have updated your financial information when you prepared your forecasts. If this review hasn't taken place, do it now. It's essential that you're aware of all weak areas in your financial material so you'll be properly prepared to explain them to the investor.

A strong balance sheet makes an investment more attractive. A certain amount of debt is expected; however, if the company's debt load is excessive, the investor will be concerned about your real intent for the funds generated from the investment. Do you really intend to expand, or will you simply retire existing debt?

The investor typically wants to ensure that your capital structure will sustain the business through its growth period. A company with an unbalanced financial structure (too much debt or equity) is likely to encounter difficulties ranging from a lack of liquidity to poor rates of return. These types of problems often ruin a business.

Marketing Review

All aspects of your marketing plan that were included in your investment proposal will be thoroughly examined at this stage. You'll need to provide support for the assessment of your position in the marketplace with respect to your present and future competitors. Be realistic. Investors tend to be wary of anyone who either claims there is no competition or completely discounts the competitors' ability to challenge the entrepreneur in the marketplace.

The investor will probably want to review the underlying market research data that you summarized in your investment proposal. The information required will vary depending on the type of market. In any case, be prepared to disclose your market research data, questionnaires, responses and analyses. If you operate in an existing market, you'll need to provide market demographic studies. If you expect to create a new market, you'll need to produce a detailed analysis of the potential for the market, future demographics and how you will develop your share in that market. Reports prepared by outside consultants (particularly those recognized as experts in their field) will add significant credibility to your estimates of the market size and how your product will serve the target market.

Management Review

The investor is buying not only a business, but also you and your management team. Evaluating your management team's capabilities will therefore be an integral part of the due diligence review. Always be open and honest with an investor about management shortcomings or past failures. Most investors look for people who have learned from their mistakes (and can avoid them in the future) rather than people who claim to be perfect. Besides, experienced investors, through their own skills or their extensive network of contacts, can probably fill the gaps in management - but first they have to be aware that those gaps exist.

The following list provides an example of the issues that may need to be addressed in this very important part of the due diligence review.

- The investor will review the background and employment history of key employees very carefully, so if there are any unexplained gaps or blemishes, be prepared to explain them.
- The investor may ask for business and personal references for each key member of management.
- Do you encourage your management team and staff to improve their skills and knowledge? Do you offer to pay for courses or seminars?
- Do you use the services of external consultants to ensure that your product or marketing strategies are leading edge? For example, are you affiliated with a university or college program? Do you bring in external expertise to keep your management team up to date?
- Is the chemistry within the management team positive? The investor will want to see a good cross section of skill sets, complementary personalities and a cohesive approach to problem solving. The investor will also look for a team with demonstrated strengths that compensate for any identified weaknesses.
- Is there a natural leader and will this be apparent beyond the share structure? The investor may want to meet with the management team in your absence, so be prepared for this.

Operations and Technical Review

The investor may have already visited your premises and will likely return as part of the due diligence review. Many investors develop a gut feel for the type of people they are investing in by walking the plant floor. You should ensure that everyone on staff, including people in the factory and office, is aware that an investor will be touring the facility, so they can put their best foot forward.

The investor may have unique industry knowledge in the operations area and may critique the manufacturing layout. This could be a positive development.

Some investors prefer to make surprise visits during the financing process to ensure that the employees are not just "acting" while visitors are present. Although you should encourage your employees to welcome the visitors, exaggerated behaviour is easily

spotted and may suggest that the day-to-day reality is being hidden. Ensure that your business is ready for such a visit any time during the process.

Here are some thoughts to keep in mind when the investor is conducting a plant tour.

- Make sure your premises are neat and tidy, but also look like an ongoing operation.
- Ensure that you have appropriate safety equipment available for the visitors, if necessary, and that it is properly used.
- Encourage your employees to act naturally. The investor will be looking at the people to get a flavour of the culture and the communication within the company.
- Remind employees that if the investor stops and talks to them they must take appropriate safety precautions, such as shutting down equipment that requires constant monitoring.
- Have members of your management team who are specifically involved in each process on hand to provide an overview during the visit. For example, your production manager should accompany the visitors on a tour of the production line.
- Make sure your team is prepared for on-the-spot requests from the investor, such as showing the order book.

If the business depends on specialized technology, the investor will typically want to exercise extensive due diligence in this area. If investors don't have a technical expert on staff, they can generally hire a consultant with such expertise. For example an expert could be brought in to review a software company's software source code.

Tool – Legal and Regulatory Overview (see section 9.3)

Overview of Prospectus-Exempt Financings: A Legal Perspective

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**The issues addressed in this paper are complex and fact specific, and may vary in application from jurisdiction to jurisdiction. This paper is intended to provide only an overview of the concepts introduced here, and does not offer professional advice for any particular situation, nor does it address the issues completely or address all legal issues which may be related to the matters described here. The reader is urged to consult with an advisor who is knowledgeable in the area of the legal implications of conducting financings and, moreover, is familiar with the requirements of the specific provincial jurisdictions which apply to the offering.*

Introduction and Overview

There are three fundamental principles of securities legislation: the efficiency of capital markets, the integrity of capital markets and investor protection. These principles are very much interrelated in that the integrity and efficiency of the capital markets are fostered, if not maintained, when investors are entitled to rely upon adequate and appropriate safeguards in making their investment decisions. The method and extent of these safeguards vary somewhat, depending upon the route taken by an issuer in gaining access to the capital markets. Under no circumstances, however, does the maxim "let the buyer beware" have any application. The questions, rather, are what is the appropriate gaining in the circumstances of the particular offering, and how to balance an investor's ideal wish for a guaranteed winner and the issuer's desire to raise capital without being exposed to liability in the event things do not turn out as hoped.

Securities legislation in Canada essentially provides three ways of distributing securities:

> (a) pursuant to a prospectus which is filed with, and cleared by, the securities regulatory authority (typically a securities commission) in the relevant jurisdiction;
>
> (b) by relying upon one or more statutory exemptions from the prospectus requirement (generically referred to as "private placements") in circumstances where the disclosure document, if any, is not required to be reviewed by the securities regulators (but is required to be filed); or
>
> (c) by obtaining exemptive relief from the relevant securities regulator.

Securities regulation in Canada is a matter of provincial jurisdiction and, accordingly, each province of Canada has its own legislation regulating securities-related matters. Nevertheless, many of the principles and substantive provisions of the legislation in the various provinces are similar in approach.

The Concept of Trading or Distributing Securities
A "trade" in securities is defined broadly and includes any sale or disposition of securities for valuable consideration—but does not include a purchase of securities. In this way, the applicable securities legislation regulates the vendor of securities, but does not regulate the purchaser of securities. Trade is also defined to include any act, advertisement, solicitation, conduct or negotiation directly or indirectly in connection with a sale of a security. For the purposes of the applicable securities legislation, "distribution," where used in relation to trading in securities, includes a trade in securities of an issuer by that issuer (e.g., from treasury).

Commonly Used Exemptions from Prospectus Requirements
In describing a distribution of securities effected pursuant to a prospectus exemption, the term "private placement" is often used. While these different types of offerings are frequently referred to, collectively and generically, as private placements, the different prospectus exemptions result in different practical implications.

The policy behind certain exemptions from the prospectus requirements being permitted is that in certain situations investor protection does not require the detailed disclosure of the proposed investment or it's prior review by the securities regulators. This is frequently because the sophistication of the investor (or the "deemed" sophistication of the investor arising from the size of the investment) suggests that the investor does not "need to know" the information which would ordinarily be contained in a prospectus (i.e., that such an investor is in a position to dictate what protections are appropriate to, or necessary for, that particular person).

The use of certain prospectus exemptions can be beneficial for a number of reasons. First, the delay and the costs inherent in preparing a prospectus can often be prohibitive. Second, in certain circumstances a disclosure document may not need to be prepared. Third, even if such a document is required, the information to be provided in an offering memorandum is generally left to the discretion of the issuer and its counsel, provided that anything included or omitted does not amount to a "misrepresentation." Nevertheless, in some jurisdictions reliance upon certain prospectus exemptions necessitates the preparation of an offering document containing prescribed information.

Statutory exemptions are essentially self-policing, and each element must be reviewed to be satisfied that the issuer is entitled to rely upon a particular exemption. Since many exemptions are based upon the type of investor or facts which relate to the investor, part of this review typically includes obtaining statutory declarations or representations and warranties from the investor as to such facts. Issuers should not, however, blindly rely solely upon such declarations and representations (particularly if the circumstances of the situation suggest that the issuer knows or ought to know that they are likely to be incorrect), but should make reasonable enquiries and investigations to ensure that this reliance is appropriate.

Private Company Exemption
For very early stage financings where the promoter is relying exclusively on family, close friends and pre-existing business associates, one frequently relies upon the prospectus exemption under the applicable securities legislation which exists when one is issuing securities of a "private company" to persons who are not considered to be members of the "public" for the purposes of securities legislation. A "private company," which is defined more specifically in the particular province's securities legislation, is generally considered to be one which has, in its articles of incorporation restrictions on the transferability of its securities, a provision limiting the number of security holders to not more than 50 (not including employees and certain former employees) and a prohibition against inviting the publicto subscribe for its securities. There is generally no definition in the legislation as to which investors are considered to be members of the public for these purposes, and the courts and securities commissions have developed an extensive body of case law and precedent addressing the issue. A number of factors will be considered in making the determination, including the number of persons to whom the issuer tried to sell securities, the number of ultimate purchasers, the sophistication or investment expertise of the purchasers or their access to advice (including their capability to evaluate the merits and risks of the prospective investment), the net worth or ability of the purchasers to risk a complete loss of their investment, the relationship of the purchasers to the vendor, the manner in which the offering is made, the purpose of the offering and the circumstances relating to the vendor. In many cases, the courts and securities commissions have applied the "need to know" rule, whereby they consider a person not to be a member of the public if he or she does not need the type of knowledge about the issuer and the security ordinarily available in a prospectus. No one of the foregoing considerations will be determinative but, rather, the overall circumstance will be evaluated. The determination of who is or is not a member of the public is plagued with uncertainty, and the ultimate determination will be based upon a review of the salient facts—which determination and examination will always be viewed in hindsight often having regard to the views of the judge or the regulators as to whether protection should be extended to the investor.

If an investor is considered to be a member of the public (and, therefore, entitled to the more detailed protections of securities legislation), the trade to such person must be conducted in a manner which allows it to be exempt from the general prospectus requirements of the applicable securities legislation.

Seed Capital Exemption
The "seed capital exemption" is generally used in the relatively early stage of financing of companies in circumstances where the private company exemption is considered to be unavailable (because, for example, the offering is being made to members of the public). The applicable securities legislation should be reviewed to determine the specific eligibility criteria, including whether there is a minimum subscription required (which, for example, under a specific exemption in the British Columbia legislation, requires a minimum subscription of $25,000), whether a specified form of offering document must be prepared, the number of persons to whom an offer may be made, the sophistication requirement of the purchasers, the number of persons who may purchase in reliance upon the exemption and the period of time during which the offering may be made. For

example, in Ontario some of the conditions imposed under that province's securities legislation are that:

> (a) solicitations may be made to not more than 50 prospective purchasers and result in sales to not more than 25 actual purchasers, each of whom must purchase as principal (such numbers being in respect of solicitations and sales in all jurisdictions, including Ontario); and
>
> (b) each purchaser must have "access to substantially all the same information concerning the issuer that a prospectus" filed under that province's securities legislation would provide and must either be:
>
> > (i) an investor who, by virtue of net worth and investment experience or by virtue of consultation with, or advice from, a person who is not a promoter of the issuer and who is a registered advisor or a registered dealer, is able to evaluate the prospective investment on the basis of information respecting the investment presented by the issuer; or
> >
> > (ii) a senior officer or director of the issuer, or the parent, brother, sister, child or spouse (common-law or otherwise) of a senior officer or director.

Clearly, the policy behind the seed capital exemption is that an investor who is sophisticated, as evidenced by net worth, business experience, independent advice or close personal bonds of association with the issuer, is deemed to be capable of protecting his/her own interests and, by implication, is not in need of the same kind of investor protection as other investors.

Minimum Subscription Private Placement Exemption
The private placement exemption which is frequently referred to specifically as a "private placement" is based upon a minimum amount of the securities purchased by the investor which, depending upon the particular jurisdiction, varies from $97,000 to $150,000. Since it may be relied upon any number of times without a specific need for the investor to be provided with, or even have access to, any documentation or information, it is one of the most popular exemptions available. Under the applicable securities legislation, the only qualification of the exemption that generally applies is that the purchaser must purchase, as principal, securities having an aggregate acquisition cost of at least the specified amount. Certain securities commissions are of the view that neither corporations or syndicates, nor partnerships or other forms of unincorporated organizations should be created solely to permit purchases by groups of individuals whose individual share of the aggregate acquisition cost is less than the specified amount.

Disclosure Considerations: Documents and Concerns

Exempt Offerings: Offering Memoranda
There are no requirements governing disclosure documents for use in connection with securities issued in reliance upon the private company prospectus exemptions. Moreover,

no filings must be made with applicable securities regulators in respect of such financings.

Written material delivered to investors in connection with the seed capital exemption and the minimum subscription private placement exemption will frequently constitute an "offering memorandum" for the purposes of the applicable securities legislation. Business practice often dictates that comprehensive material be prepared for delivery to prospective investors to induce them to acquire offered securities. Each province's securities legislation should be reviewed to determine what the specific requirements within that province are as to the need to prepare an offering document and what, if any, are the required contents of such a document. Moreover, the specific legislation should be reviewed to determine what, if any filings must be made with, and fees paid to, the applicable securities regulator as a result of the financing.

For the purposes of the Ontario securities legislation, for example, an offering memorandum is a document which:

(a) purports to describe the business and affairs of an issuer;

(b) has been prepared primarily for delivery to and review by prospective investors to assist those investors in making an investment decision; and

(c) is prepared in connection with a distribution being conducted in reliance on particular statutory prospectus exemptions, including that province's $150,000 private placement exemption and the seed capital exemption.

A document does not need to be identified as an offering memorandum in order to be treated as such for the purposes of the applicable securities legislation. It could be identified as business plan or an investment proposal or otherwise. Technically, each separate document which fits the foregoing definition constitutes an offering memorandum for the purposes of the Ontario legislation (or, at least, all documents taken together will constitute an offering memorandum). Excluded from the definition of offering memorandum are documents setting out current information about an issuer for the benefit of prospective investors "familiar with the issuer through prior investment or business contacts." Also excluded from the definition, in certain cases, are the annual reports, information circulars, prospectuses and other documents the contents of which are prescribed by statute or regulation. These exceptions will not be discussed here.

When a security is distributed in conjunction with an offering memorandum in reliance upon the Ontario $150,000 private placement exemption or the seed capital exemption, it is generally required that the purchase be given a contractual right of action for rescission or damages in respect of any "misrepresentations" contained in the offering memorandum. These rights are to be described in the offering memorandum and generally correspond to those which a purchaser of securities under a prospectus would have. Moreover, in situations where one is relying upon the seed capital exemption in Ontario, the Ontario legislation requires that the investor have access to substantially the

same information concerning the issuer that a prospectus filed under the Ontario securities legislation would provide; this is frequently satisfied by including such information in an offering memorandum.

In some jurisdictions outside of Ontario, the legislation prescribes what must be contained in an offering memorandum delivered in reliance upon certain of the prospectus requirements in such legislation. Neither the Ontario securities legislation nor the Ontario Securities Commission prescribes what an offering memorandum should contain. Given the self-policing nature of offerings pursuant to the seed capital exemption and the private placement exemption, such a decision is thought to rest more appropriately with issuers and their advisors.

The prohibition on an offering memorandum containing a "misrepresentation" implies, having regard to the definition, that the offering memorandum cannot:

(a) contain an untrue statement of a material fact; or

(b) omit a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

The term "material fact" means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the securities being offered. Accordingly, once a decision is made to deliver an offering memorandum to prospective investors, it cannot contain only selective information. One cannot, for example, merely highlight the positive aspects of the issuer's business or deal only with certain areas of the business.

Clearly a prospectus standard of disclosure is not required in the offering memorandum, and something short of that is acceptable. Nevertheless, it is not unusual to find that the offering memorandum frequently resembles the format and appearance of a prospectus for practical, although not legal, reasons.

While the securities legislation does not provide that an offering memorandum be reviewed by staff at the applicable securities commissions, there is often a requirement that it be delivered to the securities commissions after completion of the offering.

It should be recognized that the legislation does not contemplate delivery of a draft offering memorandum. Each document (or version thereof) delivered to each investor (including various versions of the offering memorandum) constitutes an individual and separate offering memorandum which must include a contractual right of action.

Use of Future-Oriented Financial Information

It is not always necessary or appropriate to include in the offering document future-oriented financial information (FOFI) consisting of forecasts or projections. Nevertheless, the securities regulators have established a FOFI policy with respect to the inclusion of FOFI in certain specified types of offering documents. The FOFI policy is not generally

considered to apply where the offering of securities follows the private company exemption.

A "forecast" is essentially FOFI prepared using assumptions which reflect the issuer's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions. A "projection," by comparison, is FOFI prepared using assumptions that reflect the entity's planned courses of action for the period covered, given management's judgment as to the most probable set of economic conditions, together with one or more hypotheses (i.e., assumptions that assume a set of economic conditions or courses of action that are consistent with the issuer's intended course of action and represent plausible circumstances).

The policy relating to FOFI specifies the manner in which FOFI may be prepared, disclosed, pre-cleared, dated and subsequently compared with actual results, and also addresses the involvement of auditors with such documents. The FOFI policy applies to disclosure documents such as prospectuses and to offering memoranda prepared for use in connection with the seed capital exemption and the private placement exemption, but does not apply to offerings where the minimum acquisition cost under the offering memorandum is at least $500,000.

The requirements of the policy in connection with the preparation of FOFI are implicitly a list of why many issuers may find that they may not effectively rely upon FOFI in connection with their offerings. Among the requirements are the following.

(a) FOFI shall be in the form of a forecast. Notwithstanding this, projections may be used for issuers engaged in a business with less than 24 months of relevant operating history or in certain other limited circumstances. A forecast or a projection may be used, but not both.

(b) The period covered by the FOFI shall not extend beyond the time for which such information can be reasonably estimated (normally the end of the next year i.e., a maximum of 24 months).

(c) FOFI prepared in accordance with the FOFI policy must be prepared in accordance with the CICA Handbook together with any additional requirements in the policy.

(d) The need to pre-clear FOFI with the securities commissions in a province prior to filing a preliminary prospectus varies from province to province. Frequently, the requirement to pre-clear before the preliminary prospectus is filed only exists in connection with an initial public offering or in circumstances where an issuer is conducting its first public offering in the particular province. Otherwise, the FOFI is reviewed after the preliminary prospectus is filed and during the normal review process for the remainder of the preliminary prospectus.

(e) FOFI must be accompanied by an auditor's report, which shall not contain any reservations of opinion.

(f) The FOFI policy provides that FOFI (other than FOFI in an offering memorandum) shall be reviewed each time the issuer is required to file historical financial statements with the securities commission under its continuous disclosure requirements (i.e., both quarterly and annually) to identify material changes resulting from events that have occurred since it was issued. The FOFI policy also deals with updating the FOFI when a change occurs in the events or in the assumptions used to prepare FOFI that has a material effect on such FOFI. The securities regulatory authorities must approve of the withdrawal of FOFI when it is not being replaced by updated FOFI.

Most companies do not necessarily have expectations that their financial results will be particularly impressive within the 24-month period which is generally the outside date for the FOFI. As a result, the use of FOFI is not generally practical for use by such issuers.

Statutory Liabilities

Criminal Liability
The Criminal Code of Canada provides that every one who, "by deceit, falsehood or other fraudulent means," defrauds the public or any person, whether ascertained or not, of any property, money or valuable security is guilty of an indictable offence and on conviction is liable to imprisonment for 10 years where the value of the subject matter of the fraud exceeds $1,000 and lesser penalties where the value is under $1,000. The Criminal Code of Canada specifically provides that every one who, "by deceit, falsehood or other fraudulent means," affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public, is guilty of an indictable offence and, on conviction, is liable to imprisonment for a term not exceeding 10 years.

Quasi-Criminal Liability
The securities legislation of certain of the Canadian provinces provides that a director or officer who "authorized, permitted or acquiesced in" certain activities, including a breach by an issuer under the legislation (such as the issuance of securities without the preparation of a prospectus in circumstances where a prospectus exemption was not available), commits an offence and, on conviction, is liable to a fine and imprisonment. In Ontario, for example, the fine is up to $1,000,000 and the imprisonment is up to two years, or both.

Conclusion
At some stage in a company's development, it will likely be necessary for the founders to seek additional funding for the company's operations by attempting to get access to the capital markets. Securities regulation generally presumes that an offering of securities by an issuer must be made pursuant to a prospectus unless an exemption from the prospectus requirement is available. This paper has outlined some of the considerations for an issuer pursuant to an offering by way of private placement. The method by which the issuer

gains access to the capital markets and the types of prospectus exemptions which are relied upon will have a dramatic impact upon the requirements which are imposed upon (and the issues which should be addressed by) the issuer and its senior officers and directors before and during the offering, as well as on an ongoing basis.