

**THE CHICAGO BAR ASSOCIATION**  
 Buying and Selling a Business  
 Parts I & II

**Raising Capital To  
 Finance the Purchase  
 of a Company**

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 February 4, 2010

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Buyer/Issuer Issues

Dual System of Regulation

- Federal Regulation
  - U.S. Securities and Exchange Commission ("SEC")
- State Regulation
  - All 50 states have a state securities regulator
    - Office of the Secretary of State, Illinois Securities Department

WHY IS THIS IMPORTANT?

- All securities **MUST** be registered, unless an exemption to registration is claimed.
- You **MUST** be registered to offer or sell securities.
- You **MUST** comply on both the federal and state level.

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Dual System of Regulation

Selling Violation of Securities Laws...

What Can Happen??

- SEC can investigate and initiate an action
  - Fines
  - Prohibitions
- State securities regulator can investigate and initiate an action
  - Fines
  - Prohibitions
- Criminal Liability
- Private parties may bring suit and seek rescission

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**THE REGISTRATION PROCESS**

1. Time Consuming - average about eight to ten weeks.
2. Expensive - \$400,000 - \$600,000 is not out of the ordinary.
3. Liability - Persons involved in the process, such as the issuer's directors, officers, managers, lawyers and accountants, are exposed to significant liability.

Accordingly, avoid by using an Exemption.

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**Section 5 of the Securities Act of 1933**

Requires any sale of a "security" to be registered pursuant to an effective registration statement under the 1933 Act unless an exemption is available. If no registration or exemption, sale is unlawful.

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**Security**

Includes:

- Stock
- Notes / Bonds / Debentures
- Limited Partnership Interests
- Limited Liability Company Interests
- Investment Contracts

Does Not Include:

- Bank Loans

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THE INTRASTATE EXEMPTION

The transaction is an "intrastate offering" under §3(a)(11). No filing is required to claim an exemption under §3(a)(11). The "safe harbor" provision corresponding to this section is Rule 147.

Requirements of an "intrastate offering" are as follows:

- 1. Securities must be offered and sold to persons residing in one state;
- 2. Issuer must be incorporated and doing business within that state; and
- 3. No resales are permitted outside the state for 9 months after the last sale.

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THE INTRASTATE EXEMPTION

"Doing business within a state" under Rule 147:

80% RULE

- 1. The issuer derived 80% of its recent gross revenues from operations or ownership of a business within the state unless it had less than \$5,000 in gross revenues in the most recent 12 month fiscal period.
- 2. At the end of its most recent semi-annual fiscal period, at least 80% of its assets and those of its consolidated subsidiaries are located within such state.
- 3. The Issuer intends to use 80% of the net proceeds in the offering for "operations" in that state.

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Regulation D.

Rules 504, 505 and 506 of Regulation D establish three categories of limited offerings that are exempted from §5 registration.

Regulation D has a long set of definitions. One important defined term is "accredited investor" under Rule 501.

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Rule 501 of Regulation D defines "accredited investor" as any of the following:

- i. certain financial institutions (ex. banks, investment companies);
- ii. any entity, including a Massachusetts or similar business trust, not formed for the specific purpose of acquiring the securities offered with total assets in excess of \$5,000,000;
- iii. directors, executive officers or general partners of the issuer;
- iv. any individual with individual or joint net worth in excess of \$1,000,000;
- v. any individual whose annual income for the past 2 years exceeded \$200,000 (\$300,000 with a spouse) and such individual reasonably expects to reach the same level of income in the current year;
- vi. Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a sophisticated person; and
- vii. Any entity in which all equity owners are accredited investors.

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1. Rule 504: based upon the rule-making authority of §3(b) of the Securities Act of 1933, it permits issues up to \$1,000,000 within a 12 month period to an unlimited number of purchasers. It is not available to "§12 reporting companies" (the 1934 Act) an investment company or a development company that has no specific business plan. No formal disclosure is required and there are no suitability requirements for investors.

2. Rule 505: also based upon the rule-making authority of §3(b), it is limited to issues up to \$5,000,000 within a 12 month period to an unlimited number of accredited investors, but no more than 35 non-accredited investors. Some financial disclosure and a private placement memorandum usually are required and issuers are subject to disqualification provisions.

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3. Rule 506: based upon §4(2), the private placement offering. Unlimited amount of securities may be issued to an unlimited number of accredited investors and up to 35 sophisticated persons. A non-accredited investor qualifies as sophisticated if such investor, either alone or through a purchaser representative, has sufficient knowledge and experience in financial and business matters to make him capable of evaluating the merits and risks of the prospective investment. Again, some financial disclosure and a private placement memorandum usually are required.

4. For purposes of determining the 35 purchasers who are unaccredited the following are considered one purchaser.

- a. The spouse, relatives of the purchaser and relatives of the spouse who share the principal residence of the purchaser.
- b. Trusts, estates, corporations and other entities are not included as separate purchasers if 50% or more of the entity is owned by the purchaser or the purchaser's relatives.
- c. Entities, unless the entities were formed for the sole purpose of acquiring the securities.

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**OTHER HIGHLIGHTS**

Rule 502(a) - Integration

All sales that are part of the same Regulation D Offering, must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than 6 months before the start of a Regulation D Offering or are made more than 6 months after the completion of a Regulation D Offering will not be considered part of that Regulation D Offering, so long as during those six month periods, there are no offers or sales of securities by or for the issuer that are of the same of a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act.

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**OTHER HIGHLIGHTS**

Rule 502(a) - Integration (Cont.)

Factors to be used to determine whether offers and sales should be integrated (a) whether the sales are part of a single plan of financing; (b) whether the sales involve issuance of the same class of securities; (c) whether the sales have been made at or about the same time; (d) whether the same type of consideration is received; (e) whether the sales are made for the same general purpose.

Generally, transaction otherwise meeting the requirements of an exemption will be now integrated with a simultaneous offerings being made outside the United States in compliance with Regulation S.

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**OTHER HIGHLIGHTS**

Rule 502(b) - Information Requirements

Specific information needs to provided to unaccredited investors in any offering under Rule 505 or Rule 506. Generally the information that must be required depends upon the size of the offering and whether the Issuer is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act.

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OTHER HIGHLIGHTS

Rule 502(b)(2)(iv) – Information Given to Accredited Investors

In addition, at a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under Rule 505 or 506, the issuer shall furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser. The issuer shall furnish any portion or all of this information to the purchaser upon his written request a reasonable time prior to its purchase.

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OTHER HIGHLIGHTS

Rule 502(b)(2)(v) – Questions and Answers – Additional Information

The issuer must also make available to each purchaser at a reasonable time prior to his purchase of securities in a transaction under Rule 505 or Rule 506 the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under Rule 502.

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OTHER HIGHLIGHTS

Rule 502(c) – Limitation on Manner of Offering: Issuers cannot offer or sell securities by means of general solicitation or general advertising, including, but not limited to:

1. An advertisement, article, notice or other communication published in any newspaper, magazine or similar media (internet and web) or broadcast over television or radio;
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

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**OTHER HIGHLIGHTS**

Rule 502(d) – Limitations on Resale:  
 Securities sold under Regulation D are “restricted securities.” Restricted securities may be sold under Rule 144. Rule 144 has several requirements including a holding period, which is one year for non-reporting companies. You should inform the purchaser of the restricted nature of the securities prior to the purchase and put a legend to that effect on issuer’s private placement memorandum.

Rule 503 – Filing of Notice of Sales:  
 Issuers must file a Form D within 15 days of their first sale to claim any of the safe harbors discussed above. As of March 13, 2009, all Form D’s must be filed electronically.

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**OTHER HIGHLIGHTS**

Rule 507 - Disqualifying Provisions Relating to Exemptions Under Rule 504, 505, and 506.

These rules are not available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with Rule 503.

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**OTHER HIGHLIGHTS**

Rule 508 - Insignificant Deviations from a Term, Condition or Requirement of Regulation D:  
 Failure to comply with terms or conditions of Regulation D will not effect the exemption if the person relying of the exemption shows:

- (1) The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; and
- (2) The failure to comply was insignificant with respect to the offering as a whole provided that certain deviations are always considered significant such as dollar limitations (\$1,000,000 in Rule 504 and \$5,000,000 in Rule 505); numerical purchaser limits. (35 unaccredited investors in Rule 505 and 506); and general solicitation conditions.
- (3) A good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Rules 504, 505, 506.

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ACCREDITED INVESTORS ONLY

If you are selling only to accredited investors, there is no formal disclosure required. At present this is an easy test since the net income and net worth tests for individual accredited investors has not changed since 1982 when Regulation D was enacted.

Fraud

CAVEATS: Even if you are exempt from registration, you are not exempt from the fraud provisions of the securities acts (e.g. 10b-5 under the Exchange Act).

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10b-5 Unlawful by the use of any instrumentality of interstate commerce or the mails or any facility of any national securities exchange.

- (a) To employ any devise, scheme, or artifice to defraud;
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

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Note: The SEC proposed changes to Regulation D in August 2007, Release 33-8828. These proposed changes including the following:

1. New Rule 507 – Exemption of Large Accredited Investors – Issuers will be permitted to sell an unlimited amount of securities to an unlimited number of “large accredited investors.” “Large accredited investors” include entities with at least \$10M in investments and individuals with \$2.5M in investments or an annual income of \$400,000 (or \$600,000 with spouse). Also, banks, registered investment companies, other regulated entities and directors and officers of the issuer.
2. Changes to Accredited Investor Definition – New definition will provide an alternative standard for qualifying as an accredited investor - \$5M in investments for entities and \$750,000 in investments for individuals. For joint investment, you can only use 50% of investments held by investor and his spouse unless spouse also co-signs the commitment.

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3. Adjustments for Inflation – starting in 2012, Dollar amount thresholds contained in the definition of “accredited investor” will be adjusted for inflation every five years.

4. Shorter Time Period for Integration – Offerings made more than 90 days before or after a Regulation D offering will not be integrated and considered part of the same offering.

5. Disqualification Provisions – Disqualification provisions will be applied to all Regulation D offerings.

6. “Accredited Investor” would be expanded to include certain entities and organizations with total assets in excess of \$5,000,000.

NOTE: I spoke to a lawyer in the small business division of the SEC on January 21, 2010. These proposed changes probably will not happen any time soon and will probably not be in this form. No work has been done on this in a while.

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SECTION 4(2) EXEMPTION  
Fall Back Exemption

§ 4(2) provides that transactions by an issuer “not involving any public offering” are exempt from registration. Openly relied upon in a sale of securities to one’s family and (perhaps) friends.

Rule 506. The SEC has adopted Rule 506 (part of Regulation D) as a “safe harbor” rule for § 4(2) . Even if an issuer fails to qualify under Rule 506, it may still rely on § 4(2) to conduct a private placement offering.

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Important factors for availability of the § 4(2) exemption are as follows:

- > Offeree qualification:
  - > Sophisticated in business & finance.
  - > Can evaluate available information.
  - > Understands risks of the offering.
  - > Can demand the information.
  - > Can bear the risks of the investment.
- > Availability of information – offering memorandum or access to information necessary to evaluate the prospective investment.

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Important factors for availability of the § 4(2) exemption are as follows:

- > Manner of offering – no general advertising or solicitation.
- > Absence of redistribution – securities must come to rest in the hand of investors who do not intend to redistribute.
- > See SEC v. Ralston Purina Co., 346 U.S. 119, 97 L.Ed. 1494, 73 S.Ct. 981 (1953) and its progeny.
- > See also SEC v. Murphy, 626 F.2d 633, (9<sup>th</sup> Cir 1980) for the principle that there is no rigid limit to the number of offerees to whom an issuer could make a private offering.

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### OTHER EXEMPTIONS

Regulation A: Conditional Small Issues Exemption – non-reporting companies may issue up to \$5M during any 12 month period upon filing of a Form 1-A, otherwise known as a mini registration statement. Companies may be disqualified from using Regulation A under Rule 262.

§4(6): Exempts transactions involving offers or sales by an issuer solely to one or more accredited investors, not to exceed \$5M. To take advantage of this exemption, the issuer must file a notice of sale form – Form D serves as such form. Securities issued under §4(6) are restricted securities.

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### STATE EXEMPTIONS

#### On the State Level

Illinois Securities Act of 1953, Section 4G: Corresponds to Rule 504. Issuer must file an IL Form 4G "Report of Sale" or a copy of the SEC Form D no later than 12 months after the date of first sale to an Illinois resident. Section 4G may be relied upon in conjunction with Rule 504 since you cannot sell more than \$1,000,000 to "purchasers" (a/k/a unaccredited investors) in the offering and within the 12 month period preceding the offering.

#### Requirements:

1. No more than 35 unaccredited investors and not more than \$1,000,000 raised.
2. No general advertising or general solicitation in Illinois.
3. No commission or remuneration in excess of 20% of the sale price of the security is paid on account of a sale to a resident of Illinois.

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## STATE EXEMPTIONS

### On the State Level

Accredited Investors. Illinois does not use the term “accredited investors” but it has very similar provisions for parties who fill the “accredited investor” type definitions. Some are actually broader. An unaccredited investor for purposes of Section 4G is a “purchaser.”

Caution: Under Section 4H of the Illinois Act an “accredited investor” includes any natural person who has or is reasonably believed to have a net worth or joint net worth with such person’s spouse in excess of \$1,000,000 excluding the value of a principal residence.

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## RECOMMENDATIONS

Use Rule 504 or 506 and Sell only to Accredited Investors:

- The definition of “Accredited Investor” has not changed significantly since 1982.
- If you sell only to accredited investors or you sell only under Rule 504 (\$1,000,000 limitation), you do not have to comply with the specific information requirements of Rule 502(b). This can save a lot of money.
- You still must comply with integration rules under Rule 502(a) which is a concern under 504 which has a \$1,000,000 limitation.
- Otherwise, your main concern is complying with the limitation on the manner of offering (Rule 502(c)) and Limitation on resale (Rule 502(d)).
- Under the National Securities Market Act of 1996 (NSMIA) securities sold under Rule 506 are “covered securities.” With respect to a covered security, states can: a) require notice filings similar to Form D; b) require issuers to file a consent to service of process; and c) require a filing fee. That’s it.
- No Bad-Boy provisions under Rule 506 like under 505.

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## Briefly on Broker Issues

### ISSUE:

Can a Buyer’s broker/intermediary assist Buyer in raising capital?

Short Answer:

Federal and State securities laws regulate broker/intermediaries who are “effecting the transaction. For purposes of the securities laws.

A “broker” is “any person engaged in the business of effecting transactions for the account of others.

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Typical Elements

- Introducing parties plus involvement in the transaction (e.g. representing a party, negotiating terms, assisting in closing).
- Transaction based compensation (e.g. success fee).

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Seller Issues

You should care:

- If investors in Buyer's companies believe that Buyer breached the securities laws for:
  - Failing to secure an exemption; or
  - Committing fraud.
- Among other things, investors can sue to rescind their investment.
- At best, this creates instability of Buyer:
  - "Bank in good faith reasonably feels insecure" is a default under many bank documents.
  - Disrupts focus of Buyer
  - Effects cash flow of Buyer
- Possible Result:
  - Imperils note payments to Seller

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Seller Issues

- Practical Tips:

- Do due diligence on Buyer. Find out how he is financing the deal.
- Put a Buyer's representation in the Purchase Agreement that:
  - Buyer is financing the deal with conventional financing and is not raising money in a private placement.
  - Buyer has complied with the securities law.

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# MP&S

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Terence P. Kennedy has been a member of the law firm of Meltzer, Purtill & Stelle LLC since 1996. Prior thereto, he was a partner at the law firm of Keck, Mahin & Cate for five years.

### **Areas Of Practice:**

His practice is focused on mergers and acquisitions and raising capital in the private markets. In addition, he acts as general counsel to a number of closely-held businesses and handles management buyouts, capital formations, loans and other commercial transactions. He also assists closely-held businesses, including early stage companies, in identifying capital needs and obtaining working capital and in general corporate matters.

### **Professional Associations and Memberships:**

Mr. Kennedy is a member of the Leading Lawyers Network, and a director and secretary for the Midwest Business Brokers & Intermediaries Association. He is also a member of the Schaumburg Business Association, the American Bar Association and the Illinois Bar Association. In addition, he is a director of the Northwest Suburban United Way. Mr. Kennedy has given numerous seminars throughout the state of Illinois on mergers and acquisitions and raising private capital and is licensed to practice in Illinois.

### **Education:**

Mr. Kennedy graduated from Fordham University School of Law in 1984. He was an associate editor of the *Urban Law Journal* in 1983. He also received a Master of Fine Arts degree from Virginia Commonwealth University in 1978 and a Bachelor of Arts degree from the University of Notre Dame in 1975.

### **The Firm:**

Meltzer, Purtill & Stelle LLC is dedicated to providing high quality, responsive legal services to financial institutions, real estate developers, the corporate middle market, entrepreneurs and high net worth individuals. Our orientation is management-focused. The location of our suburban office in Schaumburg places us in close proximity to one of the largest commercial and industrial complexes in the country – providing a rich and diversified client base. In addition, we have an office in downtown Chicago to assist our clients who are Chicago based. We often introduce clients (such as lenders and borrowers) in an effort to help them advance their mutual business interests. Our areas of practice include organizing and advising businesses, employment law, closely-held corporations, mergers and acquisitions, financial institutions, real estate, commercial litigation, lifetime and estate planning, and employee benefits and executive compensation. We welcome your interest in Meltzer, Purtill & Stelle LLC and look forward to serving you in the future.