

RAISING EQUITY CAPITAL FOR A PRIVATE COMPANY

This paper looks at what and how a private (proprietary) company can raise equity capital. There are legal rules you should know.

The power

The directors usually hold the power to decide to raise equity capital on such terms, in such amounts and from whom as they may decide.

There are some qualifications:

- in a rare case, the Constitution (memorandum and articles of association) of a company may require the existing shareholders to consent
- in a “joint venture” company, a Shareholders Agreement may, and often does, restrict the power
- in some cases, the terms of issue of some existing shares (particularly preference shares) may restrict the issue of further shares having equal or better rights
- in some cases, the Constitution (or replaceable rule applicable to the company) requires new shares to first be offered to existing shareholders
- the power must always be exercised in good faith and in the best interests of the company as whole – there must be good commercial reasons for the decision and the implementation must not unfairly prejudice existing shareholders, or any class of shareholders.

The securities

Various forms of securities are available to choose from, though in reality the choice turns on what the investors want. Within the possible range are different rights, rewards and risk profiles for the investor. The taxation treatment of dividends (franking credits) and capital gains is often very important to the choice.

- an **ordinary share** carries a right to vote at general meetings, a right to receive annual financial statements (if any) that the company publishes, a right to participate in dividends (if any) the company pays and, on a winding up, a right to the return of the capital paid up on

the share and participation in any surplus assets then left over

- a **preference share** usually carries a limited right to vote at general meetings, a right to receive annual financial statements (if any) that the company publishes, a right to participate in dividends (if any) the company pays up to a fixed maximum rate and, on a winding up, a right to the return of the capital paid up on the share but with no participation in any surplus assets then left over. It is “preferred” because the rights to payment of dividend and return of capital have priority over an ordinary share. In practice a preference share can have a blend of rights to suit the investor and so it might be redeemable by either the shareholder or the company, convertible into ordinary shares and/or given a fixed or floating rate of dividend. A preference share a listed public company issues is more restricted in the rights it can carry
- a **convertible note** is really a loan to the company that carries a right for the noteholder to convert all or some of the loan into ordinary (or preference) shares; the loan may be secured by a mortgage over company assets or unsecured and usually bears a low interest rate that recognizes the benefit the noteholder has in being entitled to later convert the loan into equity
- an **option** is a right to be issued with ordinary (or preference) shares in the future, if the optionholder so chooses.

Shareholders own the company and have a range of statutory and contractual rights against the company and its officers; convertible noteholders are creditors of the company and have contractual rights against the company.

Prospectus

The basic rule is that the company must prepare, lodge with ASIC and distribute to investors a prospectus, or an offer information statement (that has less disclosure requirements) (both are a **disclosure document**). Another basic rule is that a proprietary company must not engage in any activity that would require a disclosure document. Obviously we need then to look for exemptions to be able to do anything.

Exemptions from the disclosure document requirement:

- personal offers that do not, in any 12 months, result in more than 20 investors being issued securities nor collectively raise more than \$2 million – you count the personal offers that succeed and ignore personal offers that fail to be accepted, but you cannot advertise as that would not be a “personal offer”
- an offer to an investor whose investment is or will be at least \$500,000
- an offer to an investor with at least \$2.5 million in net assets or \$250,000 in income
- an offer made through a stockbroker (or other financial services licensee) to an experienced investor
- an offer to a professional investor (a defined term with a special meaning) such as a fund manager
- an offer to an executive of the company or of a related company (including his or her family members and family companies)
- an offer under a dividend reinvestment plan or a bonus share plan.

Exemptions from the proprietary company prohibition (only required if an exemption from a disclosure document is not available):

- an offer of shares to existing shareholders
- an offer of shares to employees of the company or of a subsidiary.

Liability

Though no formal disclosure document will be needed, the law still gives remedies to an investor who was subjected to misleading or deceptive conduct in the fundraising. That could arise from inadequacies in any informal “Information Memorandum” put out or even in a response to a verbal query from the investor about the position or prospects of the company. An express disclaimer in an Information Memorandum or similar document is most likely **not** effective.

It is also possible that an investor will require the company (and perhaps the directors) to expressly warrant in a contract the position or prospects of the company.

Culture

Bringing outsiders into a private company often leads to a change in culture and work practices because they bring with them expectations of receiving reasonable dividends and having a voice in management. They may also want to see more financial discipline and compliance with strict legal requirements and processes.

A joint publication of Adam Gamble (partner) (mobile 0439 384 298; agamble@crawfordlegal.com.au) and Mark Sallis (barrister) (mobile 0438 834 430; msallis@senet.com.au).