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Securities Laws FAQ for Craft Breweries and Taprooms

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A private placement of securities, coupled with a commercial bank loan, is becoming an increasingly common method to finance the operations and expansion plans of both startup and existing craft breweries and taprooms. While there is a strong appetite among private investors to become "owners" and not miss out on the "craft boom", careful planning is critical for breweries and taprooms to ensure their securities offerings are legal, fair to investors and do not put the business and its owners at risk.

What is a security?

Federal and state securities laws broadly define "securities" to include stock (common and preferred), LLC units, partnership interests, options, warrants, puts, calls, promissory notes, convertible debt, bonds, debentures, profit-sharing agreements and investment contracts. Securities can be acquired for cash, in exchange for services or property, and can be sold to passive third-party investors, employees, "founders", friends and family. No matter what they are called, how they are structured or who they are sold to, securities generally have the same characteristics: they are (i) an investment of money or other value; (ii) in a common enterprise; (iii) with the expectation of profits or appreciation in value; (iv) solely from the efforts of a third party or promoter. Breweries and taprooms raising capital from investors in exchange for an ownership percentage in the business or a promissory note with a rate of return are most likely selling securities that are subject to federal and state securities laws.

Which securities laws apply?

The federal government and every state have their own securities laws, so the laws of each must be met. If offers and sales of securities are made and closed with investors in multiple states, then the securities laws of each state (a/k/a state "blue sky" laws) must be observed. One important caveat though is that if the offering meets the requirements of Rules 506(b) or 506(c), which are discussed below, then federal law preempts and the offering is generally not subject to state blue sky laws, though states may still require notices of sales, impose filing fees and regulate fraud.

Do I need to register my offering?

Every sale of a security must either be registered with the SEC and the applicable state securities regulators or be exempt from registration. Registration is a lengthy and expensive process with extensive mandated disclosures and review by regulators, so the vast majority of sales of securities are private and rely on the private placement exemptions described below.

What is a private placement?

A private placement is a sale of securities that does not have to comply with the registration requirements of federal and state securities laws. The tradeoff for increased speed and reduced expense is that a private offering must be more limited in scope. For instance, depending on the exemption the issuer is relying on, sales can only be made to "accredited investors" and/or a limited number of non-accredited investors. Some exemptions also limit the issuer's ability to solicit and advertise the offering in public. Finally, some exemptions limit the amount of funds that can be raised in the offering.

Which private placement exemptions should I consider?

SEC Rule 506(b) offers is the most widely used exemption. Unlike other exemptions, Rule 506(b) has no limit on the dollar amount that can be raised and allows for unlimited sales of securities to "accredited investors" as well as sales to a maximum of 35 non-accredited investors (Note: states may further limit the number of non-accredited investors). Accredited investors are defined as individuals with annual incomes greater than $200,000 (or $300,000 combined with a spouse) in each of the past two years; or individuals with a joint net worth with their spouse that exceeds $1 million (excluding the value of their primary residence).

While sales to non-accredited investors are permissible under Rule 506(b), they are often avoided by issuers because they create a significant disclosure burden that corresponds to the information required to be disclosed in a registered offering. In contrast, if sales are made <u>only</u> to accredited investors, Rule 506(b) does not require any specific information be provided to investors; however, as described below, it is still advisable under the anti-fraud rules of federal and state securities laws for issuers to provide some minimum amount of information even to accredited investors. One limitation in Rule 506(b) offerings that issuers have found frustrating is the prohibition against general solicitation and advertising. This means that issuers must limit offerings only to investors with whom they have a close or preexisting business relationship and that they cannot market the offering to prospective investors they do not know or more broadly through the media, Internet, etc.

SEC Rule 506(c) is a relatively new exemption that drops the prohibition on general solicitation and advertising. Rule 506(c) piggybacks off Rule 506(b) with an unlimited offering amount, but in exchange for the liberalization of the general solicitation and advertising rules, the SEC requires all (100%) of investors to be accredited, and issuers must verify accredited investor status through the examination of bank statements, tax forms or confirmation letters from an attorney, accountant or investment advisor. Given the increased verification requirements, Rule 506(c) is primarily being used in offerings where the issuer has a limited network or access to accredited investors and needs to market the offering more broadly (e.g., through the Internet, cold calls, mailings, investor presentations).

Other exemptions include Rule 504, Rule 505 and Regulation A, but offerings under those exemptions have limitations on offering size and/or require state registration, which makes them much less appealing to issuers than Rule 506(b) and Rule 506(c) offerings.

What are the information requirements? Do I need a PPM?

While there is no information requirement under Rules 506(b) and 506(c) if sales are made strictly to accredited investors, the anti-fraud rules under both federal and state securities laws require the disclosure of "material" information to investors. Courts have held that "material" means information that a reasonable investor would find important for making an investment decision. Material information therefore cannot be withheld, and all information, regardless of materiality, must be accurate and balanced (i.e., both positives and negatives presented). Therefore, a private placement memorandum

(PPM) that includes a business plan, historic and pro forma financials, risk factors, management team overviews and proposed use of proceeds is often advisable. This is especially the case if the offering is made to large numbers of unknown investors who have no previous relationship with the issuer. If properly and accurately drafted, the PPM serves as a *de facto* “insurance policy” against possible fraud claims by such investors. Alternatively, if the offering is limited to just a handful of better known investors, then simply a risk factors section attached to the investor’s subscription agreement may suffice.

How can I learn more?

The foregoing is only a limited overview of federal and state securities laws. Every issuer and industry has unique circumstances – breweries and taprooms should speak with a securities law attorney to ensure compliance with securities laws and to develop a strategy for their capital-raising goals. Please contact John Remakel at jremakel@mmblawfirm.com or 952-885-5967 for a free initial consultation.