Securities Law and Corporate Law Issues

for Companies Raising Capital From Investors

Nancy Fallon-Houle © 2002-2011

**Raising Equity Capital**

***Built the foundation, have business plan, now ready to prepare to raise capital***

**The capital raising process for small businesses is comprised of a series of cash infusion events in several stages.**

* **No such thing as 12 months to IPO, and it’s a myth that a company can “go public” on its first capital raise, or even within 5 years of start-up. Generally 5 to 10 years to IPO, generally companies with 300+ employees and $1 million in net income.**
* **Normal route is that a company is funded in the many stages:**
* **Seed capital from founders’ personal savings & credit cards**
* **Family & close friends**
* **Angels / friends/ business associates**
* **VC round**
* **More VC rounds**
* **Then “liquidity” event:**
  + **Continued self-funding by the businesses revenue**
  + **Acquisition**
  + **Merger**
  + **IPO, or**
  + **Management buy out of investors.**

***Equity advantages over Debt:***

* If equity deal crashes, you are **not personally liable** (However, you ***are personally*** liable in equity raise, if you have in any way, mislead investors or misstated any fact, or even a shade of meaning in the disclosure, and they sue you in a securities fraud lawsuit)
* Equity Broadens the company’s horizons because decisions will now be made by “committee” of investors and larger board, rather than narrower decision factors determined by bank loan officer and you and your small, closely held board.
* Access to capital not based on loan-to-value, or personal collateral available for security, especially attractive for early stage companies who don’t qualify for equity.
* Investors share fully in your losses (and profits!)
* **Realistic Expectations as to Cost, Timing, Involvement –** 
  + **Months** not weeks
  + Cash from your pocket – Money where your mouth is
  + Not free or cheap, no payments out of proceeds
  + **Operational Documents Needed**: **[NFH]** Founders Agreement; Offering Memo; Shareholder Agreement; Subscription Agreement. No detail required here.
  + **Full time job while its in process**
* **Due Diligence - Clean Background is Key** 
  + **Due Diligence that Investors will conduct on Principals**
  + **Background checks**, criminal, regulatory, tax liens, bankruptcy
  + Principals (D’s & O’s, Control Shareholders), the entity itself, and prior business and legal history) – All of above, plus business reputation
  + *All material info about the principals must be in the offering memo*

[Hand out – Due Diligence Questionnaire for Private Placements]

***Securities Sales and Laws***

* **Issuing *any* equity interest in your company, in exchange for cash, property, or services, or a vendor/supplier contract, is a securities issuance. Even selling stock to your mother is a securities sale.** 
  + **Any share of stock, LLC interest, or LP interest,**
  + An “investor” is any person who gives you money, property, or free services, in exchange for equity, with intention of making return or profit on their investment in your company. Such a transaction is the issuance of a security.
* Even issuing, *or giving*, **equity interests to employees**, board members, advisors, or consultants, in exchange for services, is a securities issuance.
  + A “Securities” issuance includes shares, options, warrants, any employee plan interest, (employees and advisers), even for services and no cash
* **If we have the issuance of a security, then registration or exemption required.**
* **Key to find exemptions from registration.**
* **However, there are *no exemptions from disclosure – the “Offering Memo”***
  + ***Exemptions are from registration, and not from disclosure*** or notice filings.
  + ***Disclosure is the SOLE requirement of the 4(2) and Reg D exemptions in most cases, if all investors are accredited.***
  + ***Disclosure is the CYA, the insulation (not 100% protection, but insulation) against a lawsuit if deal crashes. Investors can sue, but they likely will not win if you have provided full and complete disclosure doc.***
* Even **disclosure can be curtailed,** but not omitted, in a few instances of
  + ***Seed capital, first small money in after founder’s money***, and
    - Only in cases where all investors would ***never*** sue you even if you lost all of their money (I call it the “folks who would never sue you exemption”
    - Very limited in number, like 1 to 3 investors
    - Immediate family (parents siblings), small number, providing start-up seed money (perhaps up to 5 immediate family members)
    - “Single, Sophisticated” investor providing single shot of start up seed money, someone well-known to the company and principals.
    - Other very limited situations by judgment of the attorney after discussion with attorney about the facts of the investors
    - Even without a traditional disclosure document, you still need to provide disclosure some how, and comply with the requirements. Don’t do this at home without professional advice and help
    - Land mine of errors that, in the worst case:
      * Have to give back the money (rescission), and/or
      * Can forever bar you from raising additional money
  + Other methods of accomplishing disclosure under 10b-5: Providing everything investors need, or ask for, all material information, in the form of a “document stack and financials”. Include full disclosure of all due diligence info.
  + 4(2) – exemption, very small group
* **Exempt from complex disclosure, but investors often require complex terms and investment documents before they will invest**
* **Or Use the safe harbor of a Reg D 506 with Offering Memo**

***Disclosure Document / Offering Memo***

* **The “CYA” Document**

[Hand Out – Why Offering Memo Required]

* + - * Securities law rules require Disclosure of all info material to investment decision
      * Not promising to make money, not promising a fair deal, just telling facts of people, industry, strategy
      * If you are uncomfortable disclosing it, its probably material
      * Protect, not insulate, from liability
      * Cost: Is a $25,000 insurance policy
      * Initial Cost is high, but the first private placement memo can be recycled and enhanced with each successive deal, more complex deal, and even act at the foundation for the IPO prospectus or the M & A Disclosure Document.
      * **Saves you time as a business tool, so that you are covering much of your presentation first in writing, presentation is consistent.**
      * No need to repeat same info to multiple parties over and over.
      * CYA so that you are saying the same thing to each investor – no deviation

*[Hand Out – Why Offering Memo Required]*

* + **Disclosure Doc Highlights Bios, Use of Proceeds, Cap table, Industry Analysis, Risks**, Corporate and Personal Due Diligence, Summary of all material agreements.

***Notice Filings Required for EVERY deal and Every Sale to Investor***

* **Notice filing required with the SEC -** SEC Form D if Reg D
* **Blue Sky Law - Notice filings are required in each state in which investors reside;** 
  + Whether it’s a Reg D or not
  + For sales or issuances to family, friends, employees, angels, VCs and sometimes institutions.
    - **Filings required in almost every state**
    - Tell company counsel & securities lawyer immediately when investor checks come in, because filings are required with in 15 days after sale.

[Hand out summarizing 50-state notice filing requirements.

* **Securities Law Issues for Private Offerings** 
  + - **Private vs. Public**
    - **Why It’s Illegal to Offer Your on the Internet**
    - **Limitations on Solicitations**
  + **Manner of Offering – No general Solicitation**
    - Private vs. Public Fund – Don’t want to be a public fund
    - Illegal to Offer Your Fund on the Internet,
      * IPO.Net and Lamp Technologies apply to brokered funds only
    - Cold Calls, Advertising prohibited
    - Pre-exiting relationship or private introduction
    - Cold calls to Professional VCs are probably OK, but gray area
    - **What Is an SEC Reg D 506 Offering?** 
      * **Compare to 4(2)**
      * **Why Reg D 506 most preferable** Why Reg D 506 most preferable – Blue Sky – But disclosure required
      * **Limits on # of investors 35**

[Handout – Private Offering Exemption Q & A Chart]

* + - **Investor Qualifications** - **What is an Accredited Investor?** 
      * **Why prohibit, or limit, sales to them**  sophistication
      * **Audited Financials requirement for nonaccrediteds**
      * **What about family who are not accredited ?**
    - **Risk of non-compliance is rescission (give back the money)**
* **Selling the deal –** 
  + **Full disclosure,** whole truth and nothing but the truth.
    - **No superlatives.**
    - **No BS**
  + **Separate selling your product** and the virtues of you company from selling the stock in the company, Turn off the marketing press.
  + You’re **not selling a used car or real estate** – Taking the approach of “if you don’t buy into the opportunity to day, it will be gone” is not appropriate.
  + Will be **partners with your investors** for a long time, and want to develop and maintain a good relationship with them, don’t BS them.
  + **Investors can file Lawsuits for misstatements or even misleading statements**
* **Using Money finders to sell your stock – Don’t Unless they Are Registered BDs:**
  + **Illegal if they are not registered** securities brokers under 1934 Act. Ask for their CRD number and run it through [www.nasdr.com](http://www.nasdr.com).
  + **Be careful**, as the finder pool contains a high percentage of **disbarred** stock brokers and lawyers, de-licensed insurance brokers and real estate brokers, and convicted felons.
  + **Check references** and experience level
  + Make sure they have **good book of investor** business
  + Red Flag if they are advertising in the paper or on Internet “money available”.

**Handout “Deal Structure and Term considerations”**

***Common Mistakes:***

* Salaries to Founders, or paying back founder loans, early in the game. Don’t expect to get paid back the money you invested until after the investors have cashed out. Don’t expect to receive salary as a founder out of early stage seed money, perhaps an option after a year or two after funding by investors.
* Pie-in-the-sky projections, or
  + Only one set of projections (use 3, min, mid, max) or
  + No substance as back-up for the projections
  + Excel sheet that does not add up
* Using AOL or hot mail or as your business email account,
  + looks unprofessional and
  + emails of any size will bounce,
  + can’t store emails to keep as business records
  + Spend some money on technology so you look like a professional playing in the tech field (or any other field.)
* Unrealistic expectations about % of equity give-up for the funding you so desperately need. Professional investors will expect to take 40% or 50% or 70% or even higher, if the company is not yet well developed.
* Ignoring Due Diligence Issues in backgrounds of principals, officers and directors. Run a background check on yourself, and also Google yourself, before you contact any investors. Do a credit check on yourself as well. Investors will do all of the above.
* Dispensing stock loosely, to everyone including the cleaning lady. Don’t make promises of “I’ll take care of you” to people you can’t keep, or will not keep. You will need to account for all of the “pieces” of equity you have doled out along the way. It dilutes your ownership and/or investors, and they don’t like that.
* Waiting too long to start preparation for a capital raise, creating an emergency out of it.
  + Desperate will be written all over your face and your financials
  + Intention is to overlap between the next capital raise and the end of the current money.
  + Allow 12 to 18 months to do the preparation, find the money and close the deal.
* Wrong Motivation for doing capital raise – to Cash you out
  + Examine your motivation
  + Not a get rich quick scheme based on exit quick strategy – expect to be in it for the long haul
* Believing that your lawyer or accountant will find your investors for you
  + Definition of private placement means that the issuer knows the investors. The main group of investors you bring in, should be people you know first hand.
* Believing that your lawyer, accountant and other professionals can be paid out of proceeds of offering.
* Thinking that a Business plan works as an Offering Memo.
* Not realizing that Sophisticated Investors will negotiate terms: You can raise larger $$ from professional investors, but they will hold you hostage to their own terms. Friends and family will not negotiate terms, but you can’t raise much $$ from them.