Hagan Law

Raising Capital For Start-Up Companies

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Except in the rare case where a new company can create its own cash flow from sales and operations, obtaining capital is the first and most essential task of every start-up. This task of raising capital has two components, (a) the actual sale of securities such as common or preferred stock and (b) compliance with the federal and state securities laws. These two components are equally important. The first component is difficult enough as a practical matter. The second component requires an experienced securities lawyer. Compliance with the securities laws from the very first sale of stock is important because, if the company succeeds, later investors will inspect all the earlier securities offerings, and one botched offering can block all later investment. In addition, if the company fails, litigation lawyers may inspect all the earlier securities offerings seeking a foothold for a lawsuit against officers and directors.

Securities laws and regulations generally prohibit two practices:

1. The sale of securities without the prior registration of those securities with state and federal authorities. [2] (The JOBS Act, which became law in April, 2012, gave some relief from these securities laws. See Section III below.)
2. The offer and sale of securities without disclosing all material facts about the issuer and the stock that it is selling.[3] These latter rules are called antifraud disclosure laws.

I. THE REGISTRATION REQUIREMENTS

The registration of securities is expensive and time-consuming. However, there are many exemptions from the registration requirements.

A. Exemptions Under Federal Securities Laws

With respect to the registration requirements, exemptions are the tail that wags the dog. They are the crucial part of the securities laws for start-ups. It is critically important for a start-up company to find an exemption to registration that will work for it, and then to adhere scrupulously to the rules that govern that exemption. Strict adherence to the rules is crucial. If an issuer does not fully comply with the rules which govern exemptions, then the exemption dissolves and becomes null and void, and the company may face harsh civil and criminal penalties, not least of which is the liability of the company (and sometimes its officers and directors) to give back the money, pay fines, or go to jail.

Private Placements. Under federal law, there are four primary exemptions from the registration requirements to permit the private placement of securities as defined in Section 4(2) of the Securities Act of 1933[4] and SEC Regulation D. These exemptions are set forth in SEC Rules 504, 505, and 506 which are a part of Regulation D[5] and in the text of Section 4(2) of the Securities Act.

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[2] Sections 4 and 5 of The Securities Act of 1933, 15 U.S.C. §§ 77d and 77e.

[3] Section 10(b) of The Securities Exchange Act of 1934, 15 U.S.C. § 78j, and SEC Rule 10b-5.

[4] 15 U.S.C. § 77d (2).

[5] 17 C.F.R. §§ 230.504 thru 230.506. The definitions and other provisions of sections 230.501 thru 230.503 should be read in conjunction with these three rules.

Rule 504. Under SEC Rule 504, an issuer may within a twelve-month period sell and issue up to $1,000,000 worth of securities to an unlimited number of unsophisticated investors who purchase the securities for their own account and not for resale. There are no required disclosures under Rule 504 except those that are necessary under the antifraud disclosure laws, and the issuer may use a general solicitation. (This is, however, usually limited or prohibited by state law.) The securities are not "restricted securities," and so are free of some restrictions on resale. A Form D must be filed with the SEC within 15 days after the first sale. The date of the first sale is the date on which the first investment agreement is signed by an investor, not necessarily the date on which the money is transferred. The issuer must comply with the securities laws of each state in which a purchaser is a resident, and must usually file a notice with that state's commissioner of corporations or similar official. The persons who acquire the securities should sign an investment agreement as proof of their investment intent and other required representations.

Rule 505. Under SEC Rule 505, an issuer may within a twelve-month period issue up to $5,000,000 worth of securities to thirty-five unsophisticated investors plus any number of "accredited investors." There are a number of required disclosures, which are described below, if the sale of securities includes investors who are not accredited investors. Advertising and general solicitation are prohibited. The securities are "restricted securities" and may not be readily resold. A Form D must be filed with the SEC within 15 days after the first sale. The Issuer must comply with the securities laws of each state in which a purchaser is a resident, and must usually file a notice with that state's commissioner of corporations or similar official. The persons who acquire the securities should sign an appropriate investment agreement.

Rule 506. Under SEC Rule 506, an issuer may issue an unlimited amount of securities to thirty-five sophisticated investors plus any number of "accredited investors." There are required disclosures, described below, if a sale of securities includes purchasers who are not accredited investors. Advertising and general solicitation are prohibited. The securities are "restricted securities" which may not be readily resold. **There is a singular and great advantage to Rule 506.** That Rule supersedes and preempts the securities laws of all the states. Accordingly, the issuer need not comply with any state securities laws. This can saves a lot of time, effort, and expense. An SEC Form D must be filed with the SEC within 15 days after the first sale of securities and also with the commissioner of corporations of each state in which a purchaser is a resident. The persons who acquire the securities should sign an appropriate investment agreement.

Section 4(2). If securities are sold to only a few local purchasers, the company may sometimes rely on the bare text of Section 4(2) of the Securities Act of 1933 that the sale of the shares did not involve any public offering.

Other Federal Exemptions from the Registration Requirements

Under Section 3(a)(11) of the Securities Act of 1933[6] and SEC Rule 147,[7] a corporation in a given state may issue securities without federal registration as an "intrastate offering" to residents of only that state. The issuer must, however, comply with that state's securities laws. The persons who acquire the securities should sign an appropriate investment agreement containing proof of their residence and other important representations.

[6] 15 U.S.C. § 77c(a)(11).

[7] 17 C.F.R. § 240.147.

Under Section 4(b) of the Securities Act,[8] an issuer may sell securities of up to $5,000,000 only to accredited investors. This exemption is not very useful. If an issuer intends to sell securities only to accredited investors, doing so under Rule 506 is a better choice because Rule 506 supersedes and preempts state securities laws.

SEC Rule 701[9] applies to stock options. Under that rule, an issuer may sell securities to officers, directors, employees, and advisors under a written compensation plan or stock option plan. Securities sold under Rule 701 enjoy very favorable terms with respect to resale. The persons who acquire such securities must sign appropriate agreements which meet and reflect the specific provisions of Rule 701 as well as the provisions of any applicable state laws or regulations. In granting stock options, the company must also comply with applicable state laws and regulations.

B. Exemptions Under State Securities Laws ("Blue Sky Laws")

In order to protect investors, every state has some form of securities laws. Most state laws require registration or qualification or some of form of state approval, prohibit general solicitation, and place restrictions on the resale of the securities. All state securities laws have exemptions from the registration requirement. Unless an issuer sells securities under Rule 506, it must satisfy the securities laws of each state in which a purchaser of the securities resides. This can be quite an expensive and time-consuming undertaking. However, most states have adopted some form of the Uniform Securities Act that includes an exemption for any sale of securities to not more than ten persons in the state. In most cases, the filing of a notice and the payment of a filing fee are required for any state in which a purchaser resides. In California, there is an ample exemption from qualification with the Commissioner of Corporations contained in Section 25102(f) of the California Corporations Code. There is also a provision for a limited public offering to accredited investors in Section 25102(n).

C. Accredited Investors

As the reader can see from the foregoing material, the concept of the "accredited investor" is very important in establishing an exemption from registration requirements. Selling securities only to accredited investors may significantly reduce the time, expense and effort in raising capital. This also greatly reduces the risk of future lawsuits.

SEC Rule 501(a) defines an "accredited investor" as follows:[10]

1. Banks and investment companies.
2. Private development companies.
3. Corporations and partnerships with assets over $5,000,000.
4. Directors and officers of the issuing company.
5. Natural persons with a net worth in excess of $1 million.
6. Natural persons with an annual income of over $200,000, or if married, over $300,000, in each of the most recent two years prior to purchase.
7. Trusts with assets over $5 million.

[8] 15 U.S.C. § 77d (2).

[9] 17 C.F.R. § 230.701.

[10] 17 C.F.R. § 230.701.

II. COMPLIANCE WITH ANTIFRAUD DISCLOSURE LAWS

A. Friends and Family

As a practical matter, there are two ways to comply with the antifraud disclosure laws. One way is to offer and sell securities to only a few friends and family members after long and thorough discussions with them about the company, its products or services, its prospects, and the securities. If the company intends to sell securities to a larger number of investors, some of whom will be strangers, then, in order to be safe and as insurance against future litigation, the company must follow the second method. The company must prepare and deliver to each investor a disclosure document known as a Private Placement Memorandum.

B. The Private Placement Memorandum ("PPM")

The antifraud securities laws state that it is a violation of law for an issuer to sell securities by means of any oral or written communication that falsely states any material fact or fails to state all material facts about the issuer and the investment. The company must be able to prove that it complied with those laws. In practical effect, in order to be able to prove that it made full and complete disclosures to investors, an issuer must prepare and deliver to each investor a Private Placement Memorandum. The PPM is a complex document that is crucially important to the issuer's future and to the future of the issuer's officers and directors. It should be prepared with the help of the officers and directors of the issuer by attorneys who are skilled in complying with the securities laws.

If an issuer does not prepare and distribute a PPM, or if it is inadequately prepared, unfortunate things may happen if the company does not succeed. Foremost, every investor may have a legal right to sue and recover his or her money from the company and possibly from its officers and directors, and the company and its officers and directors may be at risk for criminal penalties. A well-prepared PPM acts as insurance against such risks. For that reason, an issuer should not be lazy in the preparation of a PPM, and should pay close attention to the details of the distribution, execution, and permanent safe-keeping of the PPM and all related investment documents.

A well-prepared Private Placement Memorandum should include at least the following:

1. The name, address, and telephone number of the issuer.
2. A description and the price of the securities offered.
3. The amount of the offering (minimum and maximum amounts, if any).
4. The plan and cost of the distribution of the securities.
5. An identification of the officers and directors of and advisors to the issuer.
6. A description of the investment opportunity for the company.
7. A description of the issuer's business and products or services and how they solve the problem referred to above. This should include a thorough review (excluding the disclosure of trade secrets) of any technology which is a key to the issuer's proposed business.
8. A thorough discussion of the market for the issuer's products and services.
9. A description of the specific risk factors of the investment.
10. A specific warning that an investor might lose his entire investment in the issuer.

11. A recent balance sheet that can be prepared without audit. It is better if the balance sheet is prepared by an outside accountant.
12. Recent statements of income and cash flow prepared without audit.
13. Projections for future revenues, expenses, and profits or losses.
14. A description of the use of the proceeds to be realized from the offering.
15. A statement detailing that neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities or passed on the adequacy or accuracy of the disclosures in the prospectus.
16. A statement describing how the offering price was determined.
17. A description of the issuer's present capitalization and a calculation of dilution.
18. A description of prior offerings, stock plans, and stock options.
19. A description of the restrictions on the resale of the issuer's securities and the fact that no market now exists or may ever exist for them, together with a description of legends to be placed on the issuer's securities.
20. A disclosure of any contracts or agreements with management, and a disclosure of the shareholdings and compensation of management.
21. A disclosure of all material contracts with, or commitments to others.
22. Exhibits, such as Articles of Incorporation, founder's agreements, tax opinions (if any).
23. An offer for the investors to meet with management, tour the issuer's facilities, and ask questions and receive answers to questions.

Depending upon the particular nature of the issuer and its business and products, other disclosures may be needed. The law requires complete and accurate disclosure about each unique issuer so that an investor can make a fully informed decision about investing in the issuer's securities.

If an issuer prepares and distributes a PPM that provides all the required disclosures, even if the company fails later, then the issuer and its officers and directors should not be liable to investors for the money that they lost, and the issuer and its officers and directors will not be subject to criminal prosecution. This is the value of the PPM.

III. THE JOBS ACT

The Jumpstart Our Business Startups Act (the JOBS Act) was signed into law on April 5, 2012. It was intended to encourage the raising of capital by small businesses by easing many of the securities laws and regulations that would otherwise apply thus making it easier for companies to both go public and to raise capital privately. Title III of the Act, the crowdfunding provisions, has been called one of the most momentous securities exemptions enacted since the original Securities Act of 1933. Among other things, changes made by the JOBS Act include the exemption for crowdfunding, a more useful version of Regulation A (which provides for smaller and simpler public offerings) general solicitation for offerings made under Rule 506 of SEC Regulation D, and an easier path to registration of an initial public offering (IPO) for emerging growth companies. Specific changes made by the new law include:

1. An addition of a new exemption from the registration requirements to enable crowdfunding for small public offerings

which would allow use of internet "funding portals" to raise up to a yearly aggregate from unaccredited investors tiered by that person's net worth or yearly income. The limits are $2,000 or 5% (whichever is greater) for people earning (or worth) up to $100,000, and $10,000 or 10% (whichever is less) for people earning (or worth) $100,000 or more. Maximum offerings are $1 million, and the law requires only reviewed financial statements for offerings between $100,000 and $500,000, but requires audited financial statements for offerings greater than $500,000.

2. An exemption from the ban on "general solicitation" and advertising in private placements of securities to accredited investors under SEC Regulation D.

3. An increase of the limit for securities offerings exempted under Regulation A from $5 million to $50 million.

4. A change in the requirements that a company may have before being required to register its common stock with the SEC and become a publicly reporting company to assets of $10 million and 500 unaccredited shareholders or a total of 2000 shareholders.

IV. CONCLUSION

The effort to obtain start-up capital requires close cooperation between the founders of the company and its lawyers. Prevention is less expensive and more important than cure. Careful preparation for raising capital will help the start-up company obtain investment funds and do so in full compliance with the many securities and antifraud laws and regulations that apply to offerings.