

The Prudent Startup

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SECURITIES HAPPENS

You may have noticed the recession. What you might not have noticed is that, notwithstanding the difficult market conditions — or perhaps because of them as the result of losing employment — many people are starting new businesses.

Forming a business is a relatively easy process of choosing an entity form and drafting the appropriate paperwork. Even though formation is a pretty simple process, a number of factors should be considered when choosing a type of entity. This column is about issues around funding the operation.

Financing a new business venture comes from either debt or equity. Obviously, debt is a loan from someone and, not surprising in current market conditions, obtaining a loan is not easy, particularly for a start-up venture. Therefore, many new businesses seek equity investors.

The problem is that any equity investment in any business implicates the securities laws. Because of the penalties and liabilities associated with non-compliance with those laws, any new business is advised to look before leaping into equity financing. Given the limited space we have here, this column clearly cannot contain a full discussion of applicable securities laws. It is meant to give you the flavor of the numerous issues involved in equity financing.

The first consideration is the federal securities laws. Under the federal securities laws, the offering of securities must be done pursuant to a registered offering with the Securities and Exchange Commission (SEC) or be made pursuant to an exemption to the registration requirement.

A registered offering is an extremely onerous process that most businesses are unlikely to engage in — for exactly that reason. Accordingly, most businesses — start-ups or otherwise — look for an exemption to the registration requirement. Fortunately, the securities laws contain a number of exemptions, most notably the so-called “private offering exemption.”

Under the umbrella of the private offering exemption, the SEC has cre-

ated a body of rules, principally under Regulation D, allowing for the offering of securities without registration. The rules under Regulation D have six general considerations relating to: (1) the number of investors involved; (2) the sophistication of investors; (3) whether multiple offerings will be integrated; (4) ensuring that information is available to investors; (5) restrictions on solicitation of investors; and (6) resale restrictions on the securities sold. Each of them involves a number of considerations and requirements.

Next, an issuer must consider the states in which its potential investors are located and review the applicable state securities laws, because there is a whole series of them that apply. The good news is that if an issuer complies with Regulation D, it will also comply with many states' securities laws; but not all states are covered. Sometimes, filings must be made that can be either simple or very complicated, depending on the company's approach to the factors described above.

Finally, consideration must be given to the civil fraud provisions of the securities laws. In addition to the governmental penalties for failure to comply with exemption requirements, any issuer is subject to lawsuits from its own investors if the material available to them when they made an investment misstates or fails to include information that is material to an investor's decision to invest in the company.

Accordingly, the simple rule of thumb is that you should disclose to potential investors everything that you know about your new business — the good, the bad, and, if applicable, the ugly.

As you can see, properly issuing securities is not an easy matter. However, businesses get formed and securities get sold every day, even in a recession. Given the numerous issues involved and the potential problems of non-compliance, one should consider all those issues before undertaking any effort to sell securities. ●

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