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SECURITIES LAWS FOR START-UPS

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I. IN GENERAL

As a Start-up Company, there usually comes a time in the natural growth of the company when, in order to raise operating and expansion capital, you need to raise money by selling corporate stock, whether common or preferred shares (herein referred to as "securities"). There are many state and federal restrictions with which a corporation must comply in the sale of its securities. This article is intended as a primer of the state and federal securities laws which have been enacted to protect investors from fraud in the sale of securities.

In general, state and federal securities laws generally prohibit two practices:

A. Securities laws generally prohibit the sale of securities, such as stocks or bonds or warrants or options, without the prior registration of those securities with state and federal authorities. Registration with the United States Securities and Exchange Commission takes months and months and costs hundreds of thousands of dollars. However, some issues of securities are exempt from the registration requirement. Exemptions are described in Section II below.

B. Securities laws also prohibit the offer and sale of securities without disclosing all material facts about the issuer. These are called antifraud disclosure laws and are referred to in Section II-A-3-b below. As a practical matter, prior to selling stock, every start-up company needs to prepare and deliver to investors an offering document (sometimes referred to as a "prospectus") which describes the business and financial affairs of the company, the risk factors of investment, and the investment opportunity. Selling stock

without such a document almost always violates the antifraud disclosure laws.

II. EXEMPTIONS FROM THE REGISTRATION REQUIREMENT

Exemptions are the tail that wags the dog. In other words, exemptions are the crucial part of the securities laws for start-ups. Because the registration of securities requires enormous amounts of time and money, if a start-up must register its securities, then it will never start up. As a result, 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 is crucial. If an issuer plays a little fast and loose with the rules which govern exemptions, then the exemption dissolves and becomes null and void, and the issuer has violated the law with all the bad consequences that follow, 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.

A. FEDERAL LAW

1. Private Placements. Under federal law, there are three primary exemptions for the private placements of securities as defined in Section 4(2) of the Securities Act of 1933 and SEC Regulation D. These exemptions are set forth in SEC Rules 504, 505, and 506.

a. RULE 504. Under SEC Rule 504, an issuer may within a twelve-month period 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.

b. RULE 505. Under SEC Rule 505, an issuer may a within 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 a 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 person who buys the security 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.

c. 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 a 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 save a lot of time, effort, and expense if the issuer is obtaining money from people in several states. 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.

2. Accredited Investors. The concept of an "accredited investor" has become quite important in securities law. The SEC (and some states) has concluded that accredited investors can fend for themselves and do not need government protection. Accordingly, when issuing securities to accredited investors, a start-up is somewhat free of bureaucratic regulation. For practical purposes, accredited investors are:

- a. Individuals with a net worth which exceeds \$1,000,000.
- b. Directors and officers of the issuer.
- c. Corporations, partnerships, and trusts with total assets in excess of \$5,000,000.
- d. Banks, insurance companies, venture capital funds, and similar financial institutions.

3. Required Antifraud Disclosures.

- a. As noted above, if an issuer sells securities under SEC Rules

505 or 506 to any person who is not an accredited investor, before any such sale, the issuing corporation is required to deliver to all investors, including any accredited investors, a package of information that includes at least the following:

1. The name, address, and telephone number of the issuer.
2. The description and price of the securities offered.
3. A description of the issuer's business and products or services, and the market therefore.
4. A recent audited balance sheet. (It does no good to argue that the company has no money. This is what the rule requires, and, if you do not produce an audited balance sheet, even if reflects no assets, they the issuer has not complied with the rule and there is no exemption.)
5. Recent statements of income and cash flow prepared without audit.
6. A statement 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.
7. A description of risk factors which should include at least the following:
 - a. No operating history;
 - b. No profits from operations;
 - c. Uncertain financial position;
 - d. A description of the competition.

8. The use of the proceeds to be realized from the offering.

9. A description of prior offerings, stock options, and present capital structure.
10. How the offering price was determined.
11. Dilution.
12. The amount of the offering (minimum and maximum amounts, if any).
13. The plan and cost of the distribution of the securities.
14. Restrictions on the resale of the securities and the fact that no market exists for them.
15. Exhibits, such as Articles of Incorporation, founders agreements, tax opinions (if any), et cet.
16. An offer to answer questions.

b. As a practical matter, in order to comply with state and federal antifraud disclosure laws, before any sale of securities, every issuer must deliver to every purchaser a disclosure document containing at least the information specified above. If the issuer does not do this, then every investor may have a legal right to get his or her money

**back and the
company and its
officers and
directors risk
civil and
criminal
penalties.**

4. Restricted Securities. The securities purchased in a private placement (except pursuant to Rule 504) are restricted against resale. This means that the person who purchases those securities can resell them in only in two circumstances, that is, when those securities are registered at a later date or under Rule 144. Pursuant to Rule 144, a purchaser may resell the those securities when two conditions have been met: (i) after he or she has held the securities for more than one year and (ii) after the company has made a public offering.

5. Other Federal Exemptions.

a. Under Section 3(a) (11) of the Securities Act of 1933 and SEC Rule 147, 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.

b. Under Section 4(b) of the Securities Act, 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.

c. Under Rule 701, 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.

B. STATE LAWS ("BLUE SKY" LAWS)

In order to protect investors, every state has some form of securities laws. Most such laws require registration or qualification or some 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 every 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 which 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.

III. Special Note on California Law

California is probably the most active place in the world with respect to the formation and financing of new technology businesses. This results from a combination of several factors, such as California's large population, its unusual concentration of wealth, its educational institutions, California's history as the birthplace of movies and the electronics and internet revolutions, the large amount of venture capital in California, the general attitude of being willing to take a risk for the possibility of a large reward, and the ambition of people to do or make something new and different and better, to create a new form of business or product. And also to get rich.

California law has greatly encouraged new business formation in several important respects.

First, Section 16600 of the Business & Professions Code makes void almost all covenants not to compete which employers would otherwise impose upon employees. This has been very significant. Such covenants have stifled new enterprise in other states.

Second, the California legislature has made it relatively simple and cheap to form corporations and has provided for the indemnification by a corporation of its officers and directors.

Third, the legislature and the office of the Commissioner of Corporations have established laws and policies which make it relatively easy for new businesses to raise capital and attract new employees with stock options.

California has been very forward-looking in these matters and has reaped great rewards from these policies. Some of the California laws concerning the sale of securities deserve special comment.

Under Section 25102(f) of the Corporate Securities Law, a California corporation may without registration raise start-up capital from up to 35 investors plus accredited investors. All that is required is the filing of a notice with the Commissioner of Corporations.

Under Section 25102(n), a California corporation may raise up to \$5,000,000 from accredited investors by means of a limited public offering including a restricted form of a general solicitation. This is very progressive legislation. It is the first break in the barrier first created almost 70 years ago against general solicitation by advertisement. And the Commissioner of Corporations has permitted such general solicitations to be made on the internet as well as in newspapers, magazines, or on radio. The SEC has actually adopted a special regulation (Regulation CE, Rule 1001) just to approve this specific California initiative. This provision of the Corporate Securities Law is unique and is as yet not fully appreciated.

Under Section 25102(o), a California corporation may readily issue stock options to employees, officers, directors, consultants, and advisors. Once again, a notice is required.

A new section, Section 25102(p), has been recently enacted to encourage the formation of venture capital companies in California for investment in California start-ups.

As noted above, by rule and comment, the California Commissioner of Corporations has been a pioneer in permitting the use of the internet for raising start-up capital.

IV. Conclusion

Except in the rare case where a new company can create its own cash flow from operations, obtaining capital is the first and most essential task of every start-up. This is a task at which the founders of the company must succeed. Otherwise there is no new company or, worse yet, a bankruptcy.

This task of raising capital has two components: (1) compliance with securities laws, and (2) the actual sale of stock and receipt of funds.

The first component can be accomplished with some time and effort and legal services. The second component may be the most difficult task ever to face the start-up.

In order to be successful, the project of raising the company's initial capital must be carefully planned in advance and then carried out with a clear focus and relentless persistence. And it must be done right the first time, or there can be disastrous

consequences.

As for the securities laws, they are complex and confusing. However, as a practical matter, the legal requirements boil down to this:

A start-up must prepare not only a business plan, but also the required antifraud disclosure documents. Then, if it can, it should obtain investment capital from either (i) only accredited investors under SEC Rule 506 or (ii) any investors under SEC Rule 504.

This effort to obtain start-up capital requires close cooperation between the founders of the company and its lawyers. The lawyers need to be familiar with both the company and securities laws, and the work needs to be done before, not after, the sale of securities. Selling securities and then running to the lawyers is penny wise and pound foolish. There will be so many mistakes to correct that the company will spend far more for legal services than if it had gone to the lawyers in the first place, and some mistakes cannot be fixed.

After you raise the money, then comes the fun part. You must run the company well, dominate your industry, and go public. And thus you realize the American Dream.

To all who seek the great adventure of starting your own company and riding the big wave, we wish you good luck.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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