



A Practical Guide To Raising Capital

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Without sufficient capital even a well-run business with great potential may fail. The financing of a start-up company tends to follow a predictable pattern, with money being raised from the same types of investors over and over and over. A typical equity investment cycle for a start-up company might be: issuance of founders' shares, sales to "friends and family," sales to a mixed bag of accredited and nonaccredited investors, venture capital financing ("VC") and initial public offering or acquisition.

The federal regulatory scheme, which applies to all sales of equity interests, takes into account the typical pattern of investment. Following the market crash of 1929, Congress determined that to offer and sell securities to the public (a "distribution") requires the filing with and review by the SEC of a registration statement containing financial and other information about the issuer and its securities as well as delivery to investors of a prospectus. This registration process can be very costly - with companies typically spending hundreds of

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thousands of dollars on accounting, underwriting and legal fees.

Congress realized that it would dramatically harm the companies seeking money if they failed to balance the need for business to raise money quickly and cheaply against the need for investor protection. To create this balance, Congress determined that a "public" versus a "private" offering was the appropriate place to draw the line and require SEC registration of the offering.

Most start up companies utilize "private offerings" in seeking early financing. Exemptions from the requirements of registration with the SEC are provided for these privately negotiated sales that by definition must not involve any public solicitation or public advertising. In very general terms, exemptions are premised either on the small size of the offering, the private nature of the offering or the extent to which purchasers need the protections of the securities laws. Offerings that are not registered, and do not qualify for an available exemption, are illegal. Legal counsel can provide guidance as to how to comply with the requirements of the different exemptions.

Most start-ups begin by creating a business plan that they can use when approaching investors. The business plan tells the story of the company. A business plan must convey credibility and accuracy, while at the same time generating excitement and enthusiasm. It should also be professional, realistic and concise.

Early-stage investors typically invest in a "concept" and do not require detail, but a business plan typically includes a description of your:

- market;

- business, products or services, properties, etc.;
- capitalization and securities being sold;
- management and principal shareholders;
- material risks;
- selected financial data and financial statements; and
- some type of discussion and analysis of the financial situation and operations of the company.

Statements of fact should be supported as fact and statements of opinion must have a reasonable basis. When it comes to discussing risks and uncertainties do not hide the ball from investors for to do so will impair your credibility. Remember that even exempt transactions are subject to the antifraud provisions of the federal securities laws.

Depending on the size of the offering and the nature of the purchasers, more or less documentation than a basic business plan may be required. Typical documents in a private financings may include:

- *Term sheet* - contains the essential terms of the investment and business terms of the transaction, such as type of security, valuation/price, liquidation preference, conversion rights, registration rights, pre-emptive rights/rights of first refusal, voting rights, seats on the board of directors and dividends. Although term sheets are not always used, using one will likely save you time and money in the long run because a term sheet helps the parties focus on key issues that need to be documented.

- *Business plan or PPM*² - describes the business, products/services, and risks and may provide financial information.
- *Board of director resolutions* - authorizes transaction, reserves shares, etc.
- *Stock purchase agreement* - sets out the terms, representations and warranties of the parties and conditions of closing. Establishes the factual basis for exemption under federal securities laws.
- *Certificate of designations/amended and restated articles of incorporation* - sets out the rights, preferences and privileges of preferred stock sold to investors.
- *Investors' rights agreement* - sets out rights of investors such as registration rights and rights of first refusal.
- *Co-sale agreement* - sets out rights of investors to share in any premium and participate in sales of the company's stock by founders and other major stockholders.
- *Warrant* - contractual right given to purchaser to buy a specified number of shares at a specified price. Sometimes offered as a kicker to lower the effective price of the securities purchased.

As discussed above, every offering of equity in your company must either be registered with the SEC or fall under an exemption to the registration requirements. You need to contact counsel to determine which exemptions from the registration

² A private placement memorandum ("PPM") is not required for every offering. For example, if more than \$1 million is raised in a 12-month period, such that the limitations of Rule 504 are surpassed, a PPM would be required to offer securities to nonaccredited investors in reliance on certain exemptions. An offering to "all accredited" investors by comparison does not require a PPM. Even if not required, delivering a PPM or at least a detailed business plan is probably advisable for liability and marketing reasons.

requirements of the federal securities laws are available for the potential financing. If all conditions of the exemption are not met, the sale will not be exempt and purchasers may be entitled to a refund of their purchase price. The following is a general description of the most common federal exemptions:

Section 4(2) - the private-offering exemption. Section 4(2) of the Securities Act exempts from registration “transactions by an issuer not involving any public offering.” To qualify for this exemption, the purchasers of the securities must:

- have sufficient knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (“sophisticated investor”), or be able to bear the economic risk of investment;
- have access to the type of information normally provided in a prospectus; and
- agree not to resell or distribute the securities to the public.

In addition, no form of public solicitation or general advertising, such as an offering made via the Internet, may be used in connection with the offering.

Regulation A. Section 3(b) of the Securities Act authorizes the SEC to exempt from registration securities offerings based purely on their small size. Regulation A was created under Section 3(b) to exempt public offerings not exceeding \$5 million in any 12-month period. If you rely on this exemption, you must file an offering statement (called a “Form 1-A”) with the SEC for review. The offering statement consists of a notification, offering circular and exhibits.

Regulation A offerings share many characteristics with registered offerings. For example, you must provide purchasers with an offering circular that is similar in content to a

prospectus. Like registered offerings, the securities can be offered publicly and are not “restricted,” meaning they are freely tradeable in the secondary market after the offering. The principal advantages of Regulation A offerings, as opposed to full registration, are:

- the financial statements are simpler and do not need to be audited;
- there are no Exchange Act reporting obligations after the offering (unless the company has more than \$10 million in total assets and more than 500 shareholders);
- companies may choose among three formats to prepare the offering circular, one of which is a simplified question-and-answer document; and
- you may “test the waters” (make limited general solicitations) to determine if there is adequate interest in your securities before going through the expense of filing and review with the SEC.

Regulation A offerings historically have not been popular with investors, probably because there are other exemptions that are easier to use.

Regulation D. The three exemptions from Securities Act registration under Regulation D are Rule 504, Rule 505 and Rule 506.

- *Rule 504* provides an exemption for the offer and sale of up to \$1 million of securities in a 12-month period. Like the other Regulation D exemptions, you may not use public solicitation or advertising to market the securities. It is important, as with any private offering, that purchasers receive “restricted” securities, meaning that they may not sell the securities without registration or an applicable exemption.

Rule 504 is the typical means to accomplish a “friends and family” or “seed capital” offering.

- *Rule 505* provides an exemption for offers and sales of securities totaling up to \$5 million in any 12-month period. Under this exemption, you may sell to an unlimited number of “accredited investors”³ and up to 35 other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions. Purchasers must buy for investment only, and not for resale. The issued securities are “restricted.” You may not use general solicitation or advertising to sell the securities.

³ An “accredited investor” is:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Securities Act, if a bank, insurance company, or registered investment advisor makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- a charitable organization, corporation or partnership with assets exceeding \$5 million;
- a director, executive officer or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person with a net worth of at least \$1 million (not including the equity in the personal residence);
- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or a trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.

- *Rule 506* is a “safe harbor” for the private offering exemption. Purchasers receive “restricted” securities. The following standards must be followed the amount of capital that can be raised under the exemption is unlimited:
 - you cannot use general solicitation or advertising to market the securities;
 - you can sell securities to an unlimited number of accredited investors and up to 35 “sophisticated” nonaccredited investors--that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;
 - you must give nonaccredited investors disclosure documents that generally are the same as those used in registered offerings; and
 - financial-statement requirements are the same as for Rule 505.

Section 4(6) of the Securities Act exempts from registration offers and sales of securities to accredited investors when the total offering price is less than \$5 million. This exemption also does not permit any form of advertising or public solicitation. There are no document-delivery requirements.

Rule 701 is a particularly useful exemption. It exempts sales of securities if made to compensate employees according to a *written* plan of compensation. The exemption is available only to private companies that are not subject to Exchange Act reporting requirements. It is useful because it frequently will exempt sales to employees that are not otherwise qualified purchasers under Section 4(2). As with any exempt offering, employees receive “restricted securities” in these

transactions and may not freely offer or sell them to the public.

It should also be noted that an offering that is exempt under the federal securities laws is not necessarily exempt from state securities laws. State exemptions do, however, generally parallel federal exemptions. Often there is a requirement to pay a filing fee, supply state securities regulators with a copy of the offering document and make a filing with states in which securities are offered and sold.

The parties to an equity investment have divergent interests to consider. You, as the founder may want to minimize the dilution you will suffer as a result of funding your business. You may also want to maintain sufficient control over and avoid unnecessary restraints on the direction of your business, transfer of your shares, and your own economic interests. You may also not want to restrict your ability to seek additional financings or to be acquired in the future. Investors have their own agenda. Aside from wanting the “upside” appreciation of owning equity, investors are most interested in anti-dilution protections and having an exit strategy. They also would like to avoid “downside” risks and avoid windfalls at their expense to noncash contributors.

In the negotiation process, investors may seek a variety of concessions, such as, restrictions on payment of dividends. Concessions that may be inappropriate in early rounds with angel investors may become more relevant in later rounds with venture capital financings. Similarly, concessions that might interfere with subsequent larger VC financings should be avoided. Ultimately, the deal points will depend on your leverage (what you have to offer investors) and, often, on how badly and quickly you need the money.

Raising capital is one of the most important activities that emerging companies engage in. To be successful, it requires planning, good counseling and common sense. As you can see, many of the legal requirements are complex and interrelated. However, there are things you can do to benefit your cause and to move the process along. You can begin by writing a good business plan, or retaining someone who is experienced in preparing business plans to assist you, and keeping corporate records and documents in good order for review.

Please let Jackson Walker L.L.P. know if we can be of assistance in your efforts to raise capital by contacting [Stephanie Chandler](mailto:Schandler@jw.com) at schandler@jw.com or at (210) 978-7704.

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