

## **Raising Capital 101: Legal Considerations for Entrepreneurs, Start-ups and Small Businesses**

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**If you are raising capital, you are probably selling securities.** Many businesses at some point need to raise capital from outside sources. Generally if you raise money from one or more outside investors (other than bank loans), you are selling those investors a security. This makes you subject to both federal and state securities laws. Securities can include common stock, preferred stock, interests in a limited liability company, notes, bonds, debentures, options, warrants and more exotic instruments.

When selling securities, you have two general obligations under both federal and state securities laws. The first is to register your securities offering unless you meet an exemption from registration. The second is to disclose all material information about your company and its business to prospective investors.

Small companies will almost always want to fit within an exemption from federal and state registration because the registration process can be very expensive in time and money. The applicable federal laws – the Securities Act of 1933 and the Securities Exchange Act of 1934 – require you to disclose a long, long, long “laundry list” of items of information, including audited financial statements. For a company registering its securities for the first time, this results in the classic IPO prospectus, which can easily be over 100 pages long and cost hundreds of thousands of dollars to prepare. The state law “laundry list” is substantially shorter for most states, but can still be burdensome.

**Avoid Costly Federal and State Registration by Selling Only to Well-Heeled, Sophisticated Investors without Publicizing the Offering.** Both state and federal laws provide multiple exemptions from registration, the most common of which has two primary requirements. First, you can only offer and sell your securities to “accredited investors.” Accredited investors are basically financially well-off individuals and institutions, who are presumed by virtue of having generated their wealth to be financially sophisticated enough to not need the protection of the long laundry-list of disclosure items required for registration and to be able to survive the loss of their entire investment. Basically, so long as you do not affirmatively mislead them, they should have enough sense to know when to ask for more details, and they should be able to recognize unacceptably risky investments.

Second, you cannot engage in a “general solicitation,” which means you cannot broadly offer your securities through newspapers, on TV or radio, on the web, by mass mailings or e-mailings or by other similar means. This can be tricky for business people anxious to get good press coverage for their products or services. It is possible to advertise your products and services without advertising your securities offering, but because it can be tricky, you should consult with an experienced securities lawyer before you broadcast to the world. The best ways to avoid a general solicitation are (1) to make offers only to a very limited number of people – at most a few dozen – and/or (2) only offer your securities to people who you know well enough through a previously-existing business relationship – i.e. people in your rolodex or Outlook™ address book -- to reasonably believe they can evaluate and bear the risk of the investment.

**Offering securities is like playing chess, not poker – your investor has to be able to see everything, both the good and the bad.** Even if you succeed in fitting within exemptions from federal and state registration, you still have to comply with the federal and state requirement to disclose all material information about your company and its business to prospective investors. Information is material if a reasonable investor would consider it important in the overall mix of information in making his or her investment decision. Information does not have to rise to the level of “make-or-break” importance to the investment decision to be material, it just has to be important to a reasonable investor.

Admittedly, this is a “mushy” standard, but that is because businesses are complex, particularly in the large public company arena where the securities laws were developed, and you simply cannot think of general rules for all the things every different specific company in the market should and should not say.

Selling securities is more like playing chess than it is like playing poker. In poker, you can bluff and you can hide some of your cards while the betting is going on. In chess, both sides can see everything – nothing is hidden. In selling securities, you have to let potential investors see everything, both the good and the bad.

This is somewhat unnatural because it is normal human behavior to want to hide our shortcomings, weaknesses and mistakes. If you have a wart on your backside, no one wants to talk about that in public. But if you are the entrepreneur-CEO, your company cannot survive without you, and the wart might be cancerous, you have to disclose it to potential investors (though you don’t necessarily have to specify that it is a wart or where it is).

**Directors, officers and controlling shareholders are personally jointly and severally liable with the company for securities law violations.** An additional thing to understand about selling securities, particularly for small, closely held companies, is that you effectively do not

have a liability shield. Both federal and state securities laws make control persons – directors, officers and controlling shareholders of the company issuing the securities – jointly and severally liable with the issuer for securities law violations.

Securities law violations expose the issuer and its controlling persons to claims for damages from injured investors up to a refund of their entire investment and to civil penalties to regulators. If you knowingly violate the securities laws, you can end up in jail.

Federal and state securities regulators generally are not out there with a “radar gun” looking for securities law “speeders.” Violations usually do not come to light unless and until the issuer has become insolvent, in which case the only people disappointed investors can look to for payment are the defunct company’s directors, officers and controlling shareholders.

**The classic steps to raising start-up capital – friends and family, angel investors, institutional venture capital funds.** If you are the founders of a small business that aspires to become big, you generally get your initial capital from your own pocket and from friends and family. In South Carolina, advanced technology start-up companies can also seek start-up capital from a non-profit organization called SC Launch!, which was formed by the South Carolina Research Authority or SCRA precisely to help advanced technology start-ups get off the ground. You seek your next several hundred thousand to a million dollars from angel investors who are mostly high net-worth individuals. If you need multiple millions, you seek the next several million dollars from institutional venture capital funds. The goal of raising venture capital is to get the company to a point where it is an attractive acquisition target for a large, mature company in the industry (a strategic buyer), it can go public through a registered initial stock offering or IPO, or it can profitably operate as a mature company.

**A business partnership is like a marriage where both parties are in it for the money – so make sure you have a good pre-nuptial agreement.** When bringing in investors, it is important to pay close attention to the specific terms of the investment. In many ways, entering into a partnership with investors is like a marriage. You may actually spend more time with your business than you do with your spouse, and your business partners can often hurt you financially more than your spouse if the relationship sours. When you marry your spouse, hopefully you do it for love. In the business marriage, however, investors are in it for money. Hopefully they will be ethical and perhaps even very charitable people, but the purpose of investing is to make money. Therefore invest the time, effort and money necessary to develop a good pre-nuptial agreement when bringing in investors.

The pre-nup between investors and entrepreneurs usually takes the form of a shareholders agreement for a corporation or an operating or LLC agreement for a limited liability company and also possibly a detailed securities purchase agreement. For preferred stock issued by a

corporation, there will also be a certificate of designation filed with the secretary of state in the state in which your company was formed. These documents can be very lengthy and detailed.

However, pay close attention to them – look carefully at both the forest and the trees – otherwise instead of bringing in a silent partner, you may find you have sold yourself into indentured servitude. The stakes of the game often revolve around how much control you will have to give up in order to raise the capital that you need for your business to survive and grow.

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