"Steer Clear of the Tempest: A Startup Tragedy in Three Acts"

by Joe Hadzima

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ACT I

Scene 1.

Bill bootstraps his company for several years and manages to develop a beta version of an exciting education electronic consumer product.

Scene 2.

Bill raises some money in an MCI offering (friends and family) and continues to sell stock to a variety of people in a series of sales over an 18-month period. He uses the money to produce a commercial version.

ACT II

Scene 1.

Bill's company receives a $1 million advance order for the Christmas season from a major specialty store chain. Bill needs to raise $1 million in additional equity money to finish the product and to provide working capital while he ramps up production to meet this major order.

Scene 2.

Bill tells everyone he meets about his big order and the opportunity. As a result he raises $500,000 from a variety of people at different prices. Bill's lawyer becomes aware that in the past six months, Bill has taken in money from more than three dozen people. He decides Bill should make a filing with the Massachusetts Securities Commissioner, whose office sees what has happened and starts to ask all sorts of questions.

ACT III

Scene 1.

A potential investor group likes the opportunity presented by Bill's company and is prepared to invest $750,000. Seeing that Bill has filed with Massachusetts, and having

been "burned" by securities law problems before, this investor group calls me and asks me to look the situation over, saying, "If you can figure out how to fix the securities problems quickly and without undue expense, then we will probably invest."

Scene 2.

I look over the paperwork, including a series of increasingly heated letters between Bill's lawyer and Massachusetts. I make some "no name" calls to the Massachusetts Securities Commissioner's office to point out that an investor group is willing to invest in a company if Massachusetts will approve a pending offering which has some problems. I point out that, without the new investment, this "unnamed company" may go out of business, and prior investors could lose everything. Not unexpectedly, I don't get a clear answer. I tell the investors that it will take some time, but I believe that eventually we will be able to resolve the situation. The investors say "life is too short" and pass on the investment.

What happened? Even though everything is coming together in Bill's business, he might find himself out of business because he did not comply in a timely fashion with the Massachusetts securities law. The tragedy is that this ending was avoidable with a little planning.

What Are Securities Laws?

In the United States, the offer and sale of securities is regulated by the federal Securities and Exchange Commission and by each state's securities authority under so-called "blue sky" laws. The term "blue sky" comes from the snake oil securities hustler's claims that "the sky's the limit on how much money you will make if you buy the stock of..." Although the securities laws have become somewhat technical, the main ideas can be summarized in two sentences: (1) "Every offer or sale of a security must be registered with the federal and appropriate state agency unless an exemption from registration is available." (2) "Whether or not registration is required, the 'anti-fraud' rules always apply."

Registration/Exemption.

You want to avoid registration like the plague unless you really intend to do a public offering with investment bankers and a fancy prospectus. Registration is time consuming and very expensive. So the name of the game is to find an exemption from registration; hopefully one that does not involve making any filing with federal or state agencies.

As a result of the adoption of Regulation D by the SEC, it is usually possible to avoid any cumbersome filings at the federal level. Although there are a number of technical issues involved, Regulation D basically allows you to sell securities to not more than 35 "non-accredited" investors and an unlimited number of accredited investors, provided you don't do any general advertising. Accredited investors are certain types of financial institutions and venture capital funds, persons with a million dollar net worth, individuals who make

more than $200,000 per year, or a couple who makes more than $300,000 per year. In counting purchasers, the general rule is that you count sales made within six months before or after a sale, so-called "integration."

A more serious problem arises at the state level. You must comply with the law of each state in which a purchaser resides. Many states are coordinated with Regulation D and only require a simple post-sale filing and a filing fee, which typically ranges from $100 to $500. Some exemptions require a filing before you can offer and require a waiting period of five to ten days. This is where problems can arise.

Many states are "disclosure" states, which means that the securities administrators only look to see if your offering material makes clear and adequate disclosure of the risks involved in the business. Other states are "merit review" states, which means that the regulators will not let an offering go forward if the sale "tends to work a fraud on the public," i.e., if they don't like the merits of the deal. Perhaps the most egregious example of this approach in action was the refusal of the Massachusetts Securities Commissioner to allow Apple Computer to offer its initial public offering in Massachusetts because the price was too high. If the state securities authorities decide to question your offering, they are in the driver seat. They can delay the offering and delay can kill the offering and hence your business. Their concept of "quick response" is not the same as that of a fast-moving entrepreneur. You have to avoid the temptation to argue with them.

Are these regulators "pointed head bureaucrats"? Well, some may be, but in general they are an overworked and underpaid group of people who have to deal with real fraud and scams all the time. They aren't out to kill your business, but they are required to protect the public. Their nightmare is those "60 Minutes" or "20/20" TV segments about some elderly couple, widow, or orphan getting bilked by a hustler. Because there is a big gap between your needs and the regulators' concerns, the name of the game is to avoid having to deal with these regulators if at all possible.

In Massachusetts, the most commonly used "non-filing" exemption is the 402(b)(9) exemption, which does not require a filing if you have no more than 25 offerees and no commissions are being paid. Note that this applied to offerees not purchasers. A catch here is that the regulations state that cheap promoter stock constitutes "commissions" unless the stock is subordinated to that of the investors.

Finder's Fees.

In Massachusetts, can you pay a "finder's fee" to someone who arranges financing for you? If you do, you will not qualify for the 402(b)(9) "no filing" exemption. In addition, if the person is not registered as a broker-dealer or exempt from such registration, then the payment of such fees could make your offering illegal. This is a complex area and the result is not usually a satisfactory one for the entrepreneur who is usually perfectly willing to pay someone who can "deliver the goods." In my opinion, this policy does little to foster protection of investors and imposes needless impediments to funding promising new ventures.

Disclosure.

Anti-fraud rules require that the persons offering securities disclose and not omit or mistate any material information about the business. A "material fact" is one which a reasonable investor would consider important in making an investment decision. As a test, if you were investing in your company, ask yourself if you would you be upset if someone didn't tell you a particular fact.

Regulation D and other exemptions require you to make certain disclosures to investors who are not "accredited." No particular disclosure is required if the offering is only to accredited investors because it is presumed they are big boys who can take care of themselves. However, it is advisable to make similar disclosures to accredited investors for the reasons described below.

What happens if you don't comply with securities law? You could be subject to criminal penalties, but that doesn't happen all that often. Of more practical importance is the fact that if you fail to comply, a purchaser of securities gets a "free put," meaning that the investor is entitled to get his or her money back from the company and from controlling persons individually. This is a personal liability; the purchaser can reach all of your assets: your home, car, etc. In Bill's case, the potential investor did not want to put money into the company only to have prior purchasers be able to get their money back.

Closing Curtain.

Raising money is hard enough, but to lose a funding opportunity because of a securities law foul-up is a real tragedy. If you are selling securities, check out the details before you become the victim of your own tragedy.

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