



Growing Your Business.

TEXT BY Courtney C. Crouch

Turning an idea into a small business or a small business into a thriving industry leader takes hard work, ingenuity, help from others, and sometimes even some luck along the way. We don't have to look far to see impressive examples of this here in Arkansas.



Courtney Crouch is an attorney with Mitchell, Williams, Selig, Gates & Woodyard, P.L.L.C. in Little Rock where he specializes in corporate law, securities law, and mergers and acquisitions.

Getting a business started or growing an existing business also often requires a significant amount of money, otherwise known as capital. Many entrepreneurs and business owners obtain this capital by finding others who are willing to invest money in their business in exchange for an equity interest (a share of ownership and profits) in the business. Some of them, however, may be unaware that offering others an ownership or profit-sharing interest in a business in return for investing in that business may be subject to both federal and state securities law requirements.

“Securities laws are designed to protect investors by ensuring that investors are fully informed about the risks of investing in a particular security before making their decision to invest in that security.”

Securities laws regulate the offer and sale of securities, the most common of which are stocks, bonds, notes and similar financial instruments. The term “security” under federal and state securities laws, however, broadly encompasses many different types of investment vehicles. Securities laws are designed to protect investors by ensuring that investors are fully informed about the risks of investing in a particular security before making their decision to invest in that security. Based on the principal of full and fair disclosure, federal and state securities laws contain both registration and anti-fraud requirements.

You may think securities laws apply only to those big corporations whose stock is traded on a public market like the New York Stock Exchange or NASDAQ. But, in reality, securities laws apply to any offer or sale of a security. That means the sale of stock or other form of ownership interest in a small company may also be subject to federal and state securities laws.

Failure to comply with securities laws can result in being required to give investors their money back or reimburse them for their loss, as well as potential criminal liability. These are not pleasant issues to be faced with, especially if your business has hit hard times and you have lost or stand to lose your entire investment as well. If you are contemplating seeking capital from potential investors to help start or grow a business, taking some precautionary steps can reduce your risk of running afoul of securities laws and finding yourself in such a situation.

1. THE FIRST STEP

The first step is to determine whether the interest you plan to offer investors is a security. As stated above, stock in a corporation is almost universally considered a security and any issuance of stock to an investor will likely be subject to securities laws. Many businesses today, however, are partnerships or limited liability companies (LLCs).

Partnership interests and ownership interests in an LLC are not expressly listed as securities under federal and state law, but may be considered securities depending on the characteristics of the specific partnership or LLC interests. If the investor will invest money in return for a share of the profits of the business but will have little or no involvement in managing the business, there is a good chance the partnership or LLC ownership interest will be considered a security. Other traditional characteristics of equity securities include the right to receive dividends from profits of the business, the right to vote on matters pertaining to the business, the ability to resell the interest or pledge it as collateral, and the potential for its appreciation in value. If the ownership interest has some or all of these characteristics, it may be a security.

2. THE SECOND STEP

The second step, assuming the interest is a security, is to determine what requirements may affect how and to whom you offer this investment opportunity. Application of the securities laws will depend on the specific circumstances involved and the specific laws of each state where your potential investors live. Generally, securities laws require that a security be registered before it is offered or sold, unless the security or its sale qualifies under an exemption. Registering securities is time consuming and expensive. Fortunately, issuances of securities that are limited in nature or small in aggregate value can qualify for exemption under federal and state securities laws if certain conditions are met. While the appropriate federal and state securities registration exemptions can vary and may require some filing be made, knowing some of the common exemption requirements can help you plan your capital-raising efforts.

→ Advertising and Solicitation:

Many federal and state exemptions prohibit or significantly restrict advertisements and general public solicitations to purchase a security. These limitations should be determined before placing any advertisement or conducting any public solicitation of investors for any interest that may be a security.

→ Disclosure:

Some exemptions require sellers to provide to prospective investors a written document disclosing certain information that an investor may consider significant in making their decision whether or not to invest, including factors that could cause the value of the investment to decline. For certain investors, known as “accredited investors,” who meet net worth, income or asset thresholds specified by law, the disclosure requirements are often less extensive. In any case, the seller is responsible for ensuring that anyone to whom a security is offered has access to full information—through a written disclosure document or otherwise—when making their investment decision.

→ Number of Investors and Amount of Offering:

Some exemptions limit the total number of investors or the number who are not accredited investors (typically anywhere from 10 to 35) to whom offers or sales may be made in any specific offering of securities. In addition, some states exempt sales of securities to a small number of investors if the sales are in connection with the formation of a business, although other conditions may apply. Other exemptions allow offers to an unlimited number of people if the aggregate price of all of the securities being offered does not exceed a certain threshold, such as \$1,000,000.

→ Investment Intent:

Securities registration exemptions are often conditioned on the investor purchasing the security with the intent to hold onto the security as a long-term investment and not to resell within a short period of time. The buyer is therefore restricted from reselling that security except under certain conditions. The seller in this case must take steps to ensure investors understand and will abide by such resale restrictions.

→ Commissions:

Many exemptions prohibit anyone issuing a security from paying any commission or other compensation to any individual on the basis of his or her involvement in the issuance of the security, unless the individual is registered with the federal or state regulator to sell securities. This may apply even where the person offering or selling the security is an owner or officer of the business that is issuing the security.

Finally, with any sale of a security, anti-fraud provisions under federal and state securities laws also apply. These typically forbid a seller of securities from making any untrue statement of fact, or failing to disclose information necessary to keep a statement made from being misleading,



that would be significant to an investor in their investment decision, and from taking any other action to deceive or defraud investors. Again, the key is to fully and truthfully disclose all information that an investor might want to know before deciding whether or not to invest in the security being offered.

These are a few general issues to consider if you plan to raise capital for your business through equity investors. Starting your own business or working to grow an existing business can be an exciting venture. By taking some important steps on front end, you can minimize your risk of a securities law violation and in turn foster a trusting relationship with your investors that can help propel your business along the path to success.