IS YOUR COMPANY PLANNING TO RAISE MONEY FROM OUTSIDE INVESTORS?

From time to time, many private companies have a need for additional capital that cannot be satisfied by bank debt or further investment by the existing shareholders. Before seeking private investment capital, it is a good idea to know how these transactions are typically structured and what potential investors are likely to be expecting. Capital raising activities are also subject to federal and state securities laws and it is important to know what you should and should not do in the course of seeking investment capital.

Set forth below are some frequently asked questions, which we have tried to answer in non-technical terms.

Are outside investors likely to lend money to the company or do they want an ownership interest?

Investing in even the most promising private company involves a high degree of risk. Investors typically want to structure their investments so that their return compensates them for the risk they are taking. This typically translates to either promissory notes which may be converted to preferred or common stock ("convertible debt") or preferred stock which may be converted into common stock ("convertible preferred"). A variation of this structure is to sell either notes or preferred stock, along with "warrants" (the right to purchase a stated amount of common stock in the future for a stated purchase price.) Both structures have advantages and disadvantages and the proper choice depends on the particular facts and circumstances.

How much money should the company try to raise?

It depends on what the money is needed for (e.g., working capital vs. building a prototype for a new product or device). Every situation is different, but you should usually plan to raise enough to carry the company for 6 to 9 months. Remember, the higher the company's value when you bring in investors, the less equity you will need to give up to raise the money. (See discussion below.) For that reason, companies often seek investor capital in several smaller installments ("rounds" or "tranches") rather than all at one time.

How do potential investors evaluate investments opportunities?

In general, it is much easier to finance a management team with a successful track record than it is to finance a great idea or great technology in a company with inexperienced management. If your company's management does not have a demonstrated track record (ideally, one of successfully founding, building and selling a prior company) consider strengthening your management team with experienced outside directors or an experienced advisory board.

How do I find investors?

With very limited exceptions, federal and state law usually prohibits any form of "general solicitation". Therefore, unless you qualify for an exception to the general rule, you CANNOT use advertising, mass mailings or email solicitation. The best source of investors is often people who know the company and its management – key customers, suppliers, friends, family and business associates. There are also an increasing number of "angel investor" groups that make investments in private companies.

Can the company sell shares to anyone who wants to invest in the company?

The law divides potential investors into two groups: "accredited investors" and "non-accredited investors". To be an accredited investor an individual generally must have a net worth in excess of $1 million or income in excess of $200,000 for each of the last two years and a reasonable expectation of at least that income level for the current year. For a variety of reasons, it is generally advisable to limit the company's offers and sales of securities to accredited investors only. Including even a single non-accredited investor requires much more comprehensive disclosure of information and will significantly increase the legal and accounting expenses of the offering.

What information must I give to prospective investors about the company?

If the company limits offers and sales of securities to accredited investors, there are no specific disclosure requirements, nor any mandated form for the disclosures. If a single non-accredited investor is included in the offering, the disclosure that must be given to all investors (not just the non-accredited investor) is much more extensive, must follow certain strict guidelines and is expensive and time consuming to prepare.

Can the company start using investors' money as soon as it is paid?

You can if the terms of the offering expressly permit the company to do so, but as a practical matter, it usually makes it much more difficult to raise the money because everyone wants to be the last investor in, not the first. A common approach is to require the company to raise some minimum amount of money, at which point the company can start using the money and the initial investors are admitted as shareholders. Thereafter, the offering continues until the maximum stated amount is raised. For example, if the company needs at least $350,000 but would like to raise $600,000, the offering could be structured so that the company can start using the money if, but only if, it raises at least $350,000. Thereafter, new investors can be admitted as shareholders up to the maximum offering size of $600,000. There is usually a period during which the offer remains outstanding; often 3 to 12 months.

Can the company pay a commission or "finder's fees" to people who help raise money?

This is often a difficult issue because the law and what goes on in the marketplace are often at odds. The law is very clear. With very few exceptions, persons and entities cannot accept compensation (including cash, stock or other things of value) for finding investors to purchase your company's securities unless they are licensed as broker dealers under applicable securities laws. The reality is that these laws are not widely enforced because of limited funding of the various securities regulators. However, the lack of historic enforcement is not a good reason to ignore the rules, nor does it provide a defense if your transaction comes to the attention of federal or state regulators. Historically, any action taken by the SEC or state regulators has been directed against the unlicensed "finders." However, in 2013 the SEC also brought a civil action against the party which paid the "finder's fee", alleging that the party making the payment was aiding and abetting violation of federal securities law. The matter was settled by the company agreeing to pay a substantial civil penalty.

How much ownership will I have to give up?

How much it costs to raise a given amount of capital will depend on the valuation of the company and the amount of money the company is attempting to raise. Valuing a closely held company, particularly an early stage company, is very subjective. The investors will usually establish their own valuation, which is often much lower than the company's valuation. However, if management has a sound rationale for the higher valuation, you may be able to negotiate a middle ground as the basis for the investment. The final company valuation will determines how much equity the company will have to give up and how much dilution of their ownership interest the existing shareholders will suffer.

Example: Assume the "pre-money" valuation of the company is $4 million and the company needs to raise $1 million in exchange for stock. The existing shareholders own 100% of the company, valued at $4 million, immediately before the financing closes. After the financing closes the company is worth $5 million ($4 million "pre-money" plus the $1 million of new cash.) Since the new money represents 20% of the value of the company after the closing, the new investors would generally expect to receive a 20% ownership interest in the company. (Actual transactions are often more complicated than this example because of the attributes of convertible securities, outstanding options, etc., but this illustrates the basic analysis.)

Do existing shareholders sell part of their stock to investors?

In almost all cases, the investors want new stock or other securities issued by the company, rather than purchasing any stock from existing stockholders. There are several reasons for this. First, the investors want the money they invest to go into the company and not to existing stockholders. Even if the company's stockholders agreed to put the money back into the company, investors may have concerns about potential liens and other claims against the stock of existing stockholders. Thirdly, the issuance of stock or other securities for a cash investment is usually not taxable to the company or the investor. A sale of stock held by an existing stockholder is a taxable event.

Raising private equity is always a challenge, but sometimes it is the only viable option for a company which needs to grow and cannot access more traditional sources of financing. If your company is planning to raise money from outside investors, here are two things to keep in mind. First, look for investors who bring more to the company than money. Investors who know your industry or have other valuable skills or experience can provide advice, perspective and other intangibles beyond their cash investment in your company. Secondly, do not fall into the trap of ignoring the applicable federal and state securities laws. Small offerings frequently escape the attention of regulators. However, it is not at all uncommon for a failure to comply with the securities laws in an early financing to adversely affect future financings or a possible sale of the company. Furthermore, investors sometimes decide they want their money back for reasons having nothing to do with your company's performance. Failure to comply with applicable securities laws at the time of the offering gives such investors a legal basis for rescinding their earlier investment and obtaining a return of their capital, plus interest.

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