SECURITIES LAW ISSUES FOR PRIVATE COMPANIES: A ROAD MAP FOR ENTREPRENEURS

Gerardo M. "Gerry" Balboni II, Esq.
Krevolin & Horst, LLC
1201 West Peachtree St.
Suite 3250
Atlanta, Georgia 30309
(404) 835-9400

email: gbalboni@khlawfirm.com

Copyright © 1995-2012. Gerardo M. Balboni II

All Rights Reserved

KH200499.DOCX

TABLE OF CONTENTS

1. Sorting Out the Landscape 1
1.1 What is a Security? 1
1.2 What is an Offer? 2
1.3 What is a Sale? 3
1.4 What is the Regulatory Scheme? 3

2. Federal Securities Compliance 3
2.1 Section 3(a)(11) - The Intra-state Exemption 3
2.2 Section 4(a)(2). 4
2.3 Section 4(a)(5) 5
2.4 Section 4(a)(6) 6
2.5 Regulation D 7

3. CIVIL LIABILITY EXPOSURE 14
3.1 Section 12(1) of the Securities Act 14
3.2 Section 12(2) of the Securities Act 15
3.3 Section 17 of the Securities Act 15
3.4 Rule 10b(5) of the Exchange Act 16

RAISING PRIVATE CAPITAL:
A ROAD MAP FOR ENTREPRENEURS

Start up, development stage, and "expansion stage" companies often need external financing. With a few exceptions, which are not generally applicable, obtaining external financing will almost certainly involve the issuance of a security. The company and those acting on its behalf must be cognizant that the offer and sale of a security is subject to concurrent state and federal regulation. of the state and federal securities laws and the restrictions they place on capital raising activities. This memorandum focuses on offers and sales of securities by an issuer and reviews the exemptions generally available to start up, development stage, and "expansion stage" companies.

1. Sorting Out the Landscape

1.1 What is a Security?

Section 2(a)(1) of the Securities Act provides that "Unless the context otherwise requires, the term "security" includes any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

The United States Supreme Court noted the definition is "quite broad" and meant to include "the many types of instruments that in our commercial world fall within the ordinary concept of a security," including "stocks and bonds, along with the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[1]

An "investment contract" is "any contract, transaction or scheme whereby a person invests money, in a common enterprise and is led to expect profits from the efforts of others."[2] The elements of the so-called "Howey Test" are (a) an investment of money (b) in a common enterprise (c) with an expectation of profits (d) from the "efforts" of others.

Under the first element of the Howey Test, an investment of money would be likely to include a contribution of property.

Under the second element of the Howey Test, a common enterprise exists (a) under the so-called "horizontal" commonality test, if there are at least two investors who have a similar relationship in the business enterprise, that is, they pool their investments and share in the profits or (b) under the "vertical" commonality test, if the promoter and at least one investor share in the success (or failure) of the business venture.

---

[1] Marine Bank v. Weaver, 455 U.S. 551 (1982).

[2] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

The fourth element of the Howey Test turns on a determination of "*whose* efforts" are expected to result in profit. Generally, this aspect of the Howey Test is determinative of the existence or non-existence of an investment contract, and therefore is the most important design feature to consider in structuring a transaction. Franchise transactions, are generally not investment contracts, because the investor/owner/operator must operate and manage the franchise on a day to day basis. So even though there is significant levels of support and direction from the franchisor, it is the efforts of the investor/owner/operator that are the "undeniably significant efforts" that determine success or failure. If on the other hand, the investor is not actively involved in the operation of the business, it is probable that the proposed business arrangement would be an investment contract, and subject to regulation under the Securities Act.

As an example consider route sales. If the "investor" buys vending machines from a route company, picks the locations for the vending machines from a list provided by the route company, and services the vending machines, it is unlikely that there is a security, because the investor isn't relying on the efforts of others. However, if the investor deals with a management company that buys the vending machines, puts them in locations selected by the management company, and services the vending machines, the arrangement would be likely to be a security because the investor is relying on the efforts of others.

Investment contracts involve complex analysis that will turn on the specific facts of the transaction. Because of the factual aspect of this analysis, if an investment fails, it can be difficult to predict in advance how a court would view a particular business arrangement. To that end clear contracts that emphasize the responsibilities of the investor are critical. In addition to the contracts, you will want to be able to demonstrate that the investor is responsible for providing the essential efforts that determine success or failure and not the promoter/management company.

1.2 What is an Offer?

Section 2(a)(3) of the Securities Act defines the terms "offer to sell," "offer for sale," or "offer" in the context of a sale of securities. Generally, the terms "offer to sell," "offer for sale," or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

Section 2(a)(3) of the Securities Act, excludes form the definition of "offer", preliminary negotiations between an issuer and an underwriter, certain "testing the waters" discussions[3], and the publication or distribution by a broker or dealer of a research report about an emerging growth company that is the subject of a proposed public offering of the common equity securities of such emerging growth company pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective[4]. The term "research report" means a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.

---

[3] Added by Title I of the Jumpstart Our Business Startups Act. Pub. L. No. 112-106 (April 5, 2012).

[4] Added by Title I of the Jumpstart Our Business Startups Act, Pub. L. No. 112-106 (April 5, 2012).

1.3 What is a Sale?

Section 2(a)(3) of the Securities Act defines the terms "sale" or "sell" in the context of a sale of securities. Generally, the terms "sale" or "sell" includes every contract of sale or disposition of a security or interest in a security, for value.

1.4 What is the Regulatory Scheme?

The offer and sale of securities is subject to concurrent state and federal regulation. Section 5 of the Securities Act of 1933 (the "Securities Act") prohibits the use of the U.S. mail or other means of interstate commerce to effect the offer or sale of any security ***unless*** a registration statement is in effect or an exemption is available. States have a similar regulatory scheme and in addition may regulate officers and directors as "sales" personnel.

2. Federal Securities Compliance

The most important exemptions from the registration provisions of the Securities Act of 1933 are discussed below.

2.1 Section 3(a)(11) - The Intra-state Exemption.

Section 3(a)(11) of the Securities Act provides an exemption from the registration provisions Section 5 of the Securities Act for:

> "[A]ny security which is part of an issue offered and sold only to persons resident within a single state or territory where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state or territory."

Rule 147 defines "resident" and "doing business" for purposes of the intrastate exemption. Under Rule 147, the issuer is a resident of the state in which it is incorporated, and an offeree or purchaser is a resident of the state in which he has his principal residence ("individuals") or the state in which its principal office is located ("corporations"). Under Rule 147 an issuer is deemed to be "doing business" in a state if:

- it derives at least 80% of its gross revenues from its business operations in that state;
- 80% of its assets are located in that state;
- 80% of the proceeds of the offering will be used in that state; and
- the principal office of the issuer is located in that state.

An offering under the intrastate exemption may be for an unlimited amount and to an unlimited number of offerees and purchasers do not need to meet any sophistication requirements. No specific information is required to be furnished other than disclosure to address the anti-fraud provisions of the Securities Act and the Exchange Act.

The only limitation on the manner of offering is that the intrastate character of the offering must be maintained. A single sale to a non-resident of the issuer's state destroys the exemption for the entire

offering. Accordingly, precautions should be taken against interstate offers and resales, including placing a legend on the certificate and obtaining a written representation from each purchaser as to such purchaser's residence.

Rule 147 sets forth limitations on the resale of securities issued in reliance on the Section 3(a)(11) intrastate exemption. Specifically, Rule 147(e) establishes a nine month holding period under which resales during the first nine months after the date of the last sale by the issuer can only be made to persons resident within the state. This resale limitation provides additional incentive to take precautionary measures such as legending the certificates.

2.2 Section 4(a)(2).

Section 4(a)(2) of the Securities Act[5] exempts from registration "transactions by an issuer not involving any public offering." The term "public offering" is not defined in the Securities Act, so issuers have relied on guidelines synthesized from various Securities and Exchange Commission ("SEC" or "Commission") releases and rules, no action letters, and court cases to fashion offerings exempt under Section 4(a)(2). These guidelines have focused on the number of offerees, the relationship of the offerees to the issuer or someone acting on its behalf, the relationship of the offerees to each other, the manner of communication of information regarding the offering, and the sophistication of the offerees. Generally, this exemption thought to be available for an offering to a limited number of sophisticated offerees (probably 35 or less) who have substantial financial means and are capable of evaluating the risks and merits of the investment. Offerees either must have "access" to all material financial and other pertinent information about the issuer through their economic bargaining power or be provided with such information.

Uncertainty regarding availability of the then Section 4(2) of the Securities Act increased when the Supreme Court rejected the SEC's use of a specified number of offerees or purchasers by holding that a public offering occurs whenever purchasers "need the protection of the Securities Act," ostensibly because they are not able "to fend for themselves."[6] The Court noted that a person can "fend for himself" if the person is sophisticated in financial and business matters and has access to the type of information disclosed in a registration statement. The underlying concepts of sophistication are knowing what to ask for and having the bargaining power to obtain it.

The offering must be accomplished through limited means, usually involving direct communication to the offerees. General solicitation and advertising by the issuer or a person acting on its behalf are not permitted in a private offering. The SEC has stated that "negotiations or conversations with, or general solicitation of, an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers.[7]

---

[5] Section 4(2) of the Securities Act of 1933 prior to amendment by the Jumpstart our Business Startups Act, Pub. L. No. 112-106 (April 5, 2012).

[6] SEC v. Ralston Purina, 246 U.S. 119, 124-25 (1953).

[7] Securities Act Release No. 33-4552 (Nov. 6, 1962)

The securities issued pursuant to a Section 4(a)(2) exemption are restricted securities which must be acquired for investment purposes and may not be resold for an indefinite period of time, which for persons not closely associated with the issuer is generally not less than two years. An offering pursuant to the Section 4(a)(2) exemption can be for an unlimited amount of funds and no filing with the SEC is required.

As with all the exemptions from registration, the Section 4(a)(2) exemption does not remove the applicability of the state and federal anti-fraud provisions, which require the issuer to provide all material information about the issuer and the investment necessary to allow the investors to make an informed investment decision.

General solicitation and advertising by the issuer or a person acting on its behalf are not permitted in a private offering. The SEC has stated that "negotiations or conversations with, or general solicitation of, an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers.[8]

2.3 Section 4(a)(5)

Under Section 4(a)(5) of the Securities Act, offers and sales of securities by an issuer to an unlimited number of accredited investors are exempt from the registration requirements of Section 5, provided:

- the aggregate offering price does not exceed the amount allowed under Section 3(b)(1) of the Securities Act (currently $5,000,000);
- no advertising or public solicitation is utilized; and
- a notice of sale on Form D is filed with the SEC.

The definition of "accredited investor" is substantially identical to the definition of such term contained in Regulation D. Because the rationale underlying Section 4(a)(5) is that sophisticated investors can fend for themselves when purchasing securities in a small private offering, Section 4(a)(5) does not set forth specific information requirements to be furnished by the issuer to accredited investors. Nevertheless, the anti-fraud provisions of state and federal securities laws apply to Section 4(a)(5) offerings.

Despite the many similarities between Section 4(a)(5) and Rule 505 of Regulation D, there are important differences. Section 4(a)(5) is available to investment companies, contains no "bad boy" disqualification provisions, and sales pursuant to other Section 3(b) exemptions during the prior 12 months are not included in the $5,000,000 offering amount limitation **unless** such sales are required to be integrated under general integration principles. Also, in contrast to Resolution D, which requires that the issuer "reasonably believes" that the purchaser is an accredited investor, section 4(b) specifies that the purchaser must be an accredited investor.

---

[8] Securities Act Release No. 33-4552 (Nov. 6, 1962)

Securities sold in reliance upon Section 4(a)(5) are restricted securities. Thus, the securities must be acquired for investment and cannot be resold unless registered or exempted.

2.4 Section 4(a)(6)

Section 4(a)(6) is the so-called "crowd funding" exemption added by Title III of the JOBS Act. Under Section 4(a)(6) private companies are permitted to raise up to $1 million over a 12 month period from an unlimited number of investors, including unsophisticated investors if:

- the amount sold to any investor (not limited to sales in reliance on Section 4(a)(6) does not exceed the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;

- The transaction is conducted through an intermediary registered with the SEC or a self regulatory organization as a broker or a funding portal that complies with the information and risk disclosure requirements, the investor education, awareness, and other requirements of Section 4A(a) of the Securities Act, and rules to be promulgated by the SEC; and

- The issuer files with the SEC and provides to investors and intermediaries basic information about the issuer, including its financial statements, its officers, directors, 20% shareholders, the risks related to the offering, and complies with the other requirements of Section 4A(b) of the Securities Act.

Crowdfunding offers an interesting new method of funding outside of traditional angel or institutional investors. However, companies should carefully consider the implications of having a large number of unaccredited and unsophisticated investors, including:

- the additional time and resources for administration and communication with shareholders. For example, items such as shareholder actions may be more challenging to manage and may require more detailed communication or extended time to complete.

- including potential limitations that crowdfunding may have on the ability to attract funding from venture capital firms or other institutional sources or to sell or restructure the company.

- Equity financings, M&A events, and corporate restructurings may be significantly more difficult and expensive from a legal point of view.

In addition, a company that chooses to raise money under crowdfunding will be required to use an intermediary to conduct the transaction. It is not clear what rates intermediaries will charge for their services and there will not be a track record for issuers to judge the effectiveness of these intermediaries.

2.5 Regulation D

The following paragraphs briefly summarize the circumstances and conditions under which the Regulation D exemption from the registration provisions of the Securities Act is available. Compliance with Regulation D exempts an offering from the registration provisions of the Securities Act, but does not exempt an offering from the civil liability and anti-fraud provisions of the Securities Act and the Securities and Exchange Act of 1934, as amended (the "Exchange Act"). As more fully explained below, Regulation D provides three different exemptions for limited offers and sales of securities.

Rule 504

Rule 504 exempts from the registration provisions of the Securities Act limited offers and sales of securities not exceeding an aggregate offering price of $1,000,000. The aggregate offering price of $1,000,000 includes the aggregate offering price of all securities sold within the twelve-month period prior to the offering made in reliance on Rule 504, in reliance on any exemption under Section 3(b) of the Securities Act, and in violation of Section 5 of the Securities Act. Rule 504 permits sales to an unlimited number of purchasers. Rule 504 is not available if the issuer is a reporting company under the Exchange Act, an investment company, or a development stage company with no business plan or a business plan to acquire another business.

Rule 505

Rule 505 exempts from the registration provisions of the Securities Act the limited offers and sales of securities not exceeding an aggregate offering price of $5,000,000. All sales in the twelve months preceding any sale made in reliance on Rule 505, sales made in reliance on any exemption under Section 3(b) of the Securities Act and sales made in violation of Section 5 of the Securities Act must be aggregated to determine whether or not the $5,000,000 aggregate offering price has been exceeded. Rule 505 permits sales to an unlimited number of accredited investors and no more than thirty-five (35) non-accredited investors. Rule 505 is not available to an issuer that is an investment company.

Rule 505 expressly adopts the disqualification provisions of Regulation A. Under these so-called "bad boy" provisions, issuers, predecessors, and affiliated issuers that have been subject to a governmental enforcement action resulting in an injunction or criminal conviction or have received an SEC administrative sanction within the previous 5 years may not rely upon the Rule 505 exemption. Furthermore, Rule 505 is unavailable to an issuer if an officer, director, general partner, 10% equity owner, or promoter of the issuer has been subject to a governmental enforcement action resulting in an injunction or criminal conviction or have received an SEC administrative sanction within the five years prior to the Rule 505 offering, or is suspended or expelled as a member of any exchange or national securities association because of a securities related matter, or has been convicted of a criminal offense within 10 years of such offering. The "bad boy" disqualifiers also apply to underwriters or partners, officers, and directors of an underwriter and render Rule 505 unavailable to such underwriters who fall within the disqualification rules for officers and directors of issuers.

The SEC retains discretion to allow the use of Rule 505 by an issuer who would otherwise be disqualified by the "bad boy" provisions if, upon a showing of good cause, the SEC determines that it is not necessary under the circumstances that the exemption be denied.

Rule 506

Rule 506 exempts from the registration provisions of the Securities Act limited offers and sales without regard to the dollar amount of the offering to an unlimited number of accredited investors and to up to thirty-five (35) non-accredited investors. The exemption was conditioned upon on the issuer's reasonable belief that each non-accredited purchaser is either alone or with a purchaser-representative sufficiently knowledgeable and experienced in business matters that such purchaser is capable of evaluating the merits and the risks of the proposed investment. This sophistication requirement requires a combination of prior investment experience, general business acumen, and financial or business education. An important indication of investment sophistication is the investor's ability to understand financial statements and other disclosure information provided. Rule 506 does not necessarily permit an issuer to reply solely on a purchaser's self-serving statement as to his investment sophistication, although such statements together with other factors relating to the reasonableness of the issuer's belief that a purchaser is sophisticated, may prejudice such purchaser's ability to recover for securities fraud.

Changes made to Rule 506 by the JOBS Act

Title II of the JOBS Act requires the SEC to promulgate regulations by July 5, 2012, that:

- eliminate the prohibition of public solicitation in Rule 506 offerings, provided that the issuer takes reasonable steps to verify that all purchasers are accredited investors;
- specify the methods an issuer must use to "verify" that a purchaser is an accredited investor;

Title II of the JOBS Act amends:

- Section 4(a)(2) of the Securities Act, to provide that offers and sales of securities under Rule 506 shall not be deemed public offerings as a result of general advertising or general solicitation.
- Amends Section 15(a)(1) of the Securities and Exchange Act of 1934, to exclude from broker dealer registration, a person that maintains a platform or mechanism for Rule 506 offerings that permits the offer, sale, purchase, or negotiation of, or with respect to, securities, or permits general solicitations or general advertisements by issuers of securities whether, in person, or on-line, or by any other means.

The changes to Rule 506 will enable issuers to communicate with large numbers of potential investors, with tools such as blogs, e-mail newsletters, and listings on investing communities, to announce their intentions to raise funding without concerns regarding public solicitation or general advertising. Entrepreneurs can advertise the existence of an offering to the general public, which may help them reach potential investors who would not otherwise have known about the offering. However, if public solicitation or general advertising is used, all purchasers must be accredited investors. Under regulations to be promulgated by the SEC, issuers will be required take "reasonable steps" to verify that purchasers of securities are accredited investors.

General Conditions of Regulation D

In addition to the specific provisions mentioned above, the following general conditions must be satisfied for the Regulation D exemption to be available:

Information Disclosure – private companies

Regulation D provides that specific information about the issuer need not be furnished to the purchaser if the offering is made pursuant to Rule 504 or if the offering is made ***only*** to accredited investors. ***As a practical matter, however, if the offering will be made to individuals who are not active participants in the issuer's management, preparation of an offering memorandum is appropriate to reduce the risk of anti-fraud liability and to permit residual reliance on the Section 4(a)(2) exemption (sales of securities by an issuer which does not involve a public offering) if Regulation D is determined to be unavailable.***

If an issuer sells securities under Rule 505 or Rule 506 to any non-accredited investor, Regulation D requires specific written information be furnished to all such purchasers. The information disclosure requirements depend on whether the issuer is a reporting company under the Exchange Act. For issuers who *do not* have securities registered pursuant to the Exchange Act, the required financial statement information disclosure is determined by the aggregate offering price of the securities. All such issuers must furnish non-financial statement information of the same kind as would be required in Part 2 of Form 1-A, if the issuer is eligible to use Regulation A. Otherwise, the non-financial statement information must be the same kind of information as required in Part 1 of a registration statement that the issuer would be entitled to use, generally Form S-1.

Financial Statement Information - Offerings up to $2,000,000.

The issuer is required to provide the financial statements required by Article 8 of Regulation SX (audited balance sheet as of the end of each of the most recent two fiscal years, or as of a date within 135 days if the issuer has existed for a period of less than one fiscal year, and audited statements of income, cash flows and changes in stockholders' equity for each of the two fiscal years preceding the date of the most recent audited balance sheet or such shorter period as the registrant has been in business), except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

Financial Statement Information - Offerings up to $7,500,000.

The issuer is required to provide the financial statement information required in Form S–1 for smaller reporting companies (audited balance sheet as of the end of each of the most recent two fiscal years, or as of a date within 135 days if the issuer has existed for a period of less than one fiscal year, and audited statements of income, cash flows and changes in stockholders' equity for each of the two fiscal years preceding the date of the most recent audited balance sheet or such shorter period as the registrant has been in business). If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of Federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

Financial Statement Information - Offerings over $7,500,000

The issuer is required to provide the financial statements that would be required in a registration statement that the issuer is entitled to use. For a private issuer, this would be Form S-1 (audited balance sheet as of the end of each of the most recent two fiscal years, or as of a date within 135 days if the issuer has existed for a period of less than one fiscal year, and audited statements of income, cash flows and changes in stockholders' equity for each of the two fiscal years preceding the date of the most recent audited balance sheet or such shorter period as the registrant has been in business), and for a public issuer, it would be either Form S-1 or Form S-3.

Information Disclosure – Reporting Companies

If the issuer is subject to the reporting requirements of the Exchange Act, the issuer must furnish either its most recent annual report to shareholders and proxy statement ***or*** the information contained in an annual report on Form 10-K under the Exchange Act or Form S-1 under the Securities Act, whichever filing is the more recent. Furthermore, the issuer must furnish a copy of its most recent Form 10-K upon written request by a purchaser. Additionally, the issuer must furnish the information contained in any reports or documents required to be filed by the issuer under Sections 13(A), 14(A), 14(C), and 15(D) of the Exchange Act since the distribution or filing of the annual report or Form containing the annual report information for the most recent fiscal year.

Information Disclosure – Non-accredited investors

Regulation D also requires an issuer to furnish to non-accredited purchasers a brief written description of any additional written information concerning the offering that has been provided to accredited investors. The issuer must furnish any portion or all of this information to any purchaser upon his written request prior to his purchase. The issuer must also make available to each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of the information furnished in the offering memorandum.

Projections

The use of projections in the memorandum poses a special due diligence problem for an issuer. Generally, projections are regarded by the courts as a “fact” for the purposes of Rule 10b(5) even though projections are essentially a prediction or opinion of future events. Therefore, like any other representation, an earnings projection will be deemed to be untrue if it has no valid reasonable basis or is disclosed other than in good faith. For this reason, cautionary statements are used liberally. Reasonable and justifiable projections having a sound factual basis will probably not constitute an untrue statement under the anti-fraud provisions of the securities laws if they do not come true. In the case of a startup business, an issuer may experience difficulty in establishing a reasonable factual basis for projections. On the other hand, if an issuer has been in business for a period of time, it is possible to establish a reasonable basis for projections.

In the event that projections are included in an offering memorandum, an issuer should make certain that the assumptions and explanations of the base figures are clearly and adequately explained so that the array of numbers set out in the projections table is not misleading. There are very few reliable guidelines in this area, and management's chief responsibility is to insure that the overall impression given by the projections corresponds to the transaction and the real world. The disclosure accompanying

the projections should be adequate to enable a reasonable, prudent investor to evaluate the probability that the projections will be realized, and if any assumptions underlying the projections are in doubt, disclosure should be adequate so that a reasonably prudent investor, if such investor knew of the doubt concerning the underlying assumptions, might be deterred from crediting the forecast.

Limitations of Manner of Offering

In furtherance of the limited nature of a non-public offering, neither the issuer nor any person acting on its behalf may offer or sell the securities in a Regulation D offering by any form of general solicitation or general advertising ***unless*** the offering is made (a) under Rule 506 (after the SEC promulgates regulations pursuant to Title II of the JOBS Act) and the issuer takes reasonable steps to verify that all purchasers are accredited investors or (b) Rule 504 and is conducted exclusively in states in which the offering is registered pursuant to state blue sky laws which require a delivery of a disclosure document prior to or at the time of sale, or in one or more states which have no provision for the registration of securities and delivery of a disclosure document before sale, provided the securities have been registered in at least one state which provides for such registration and delivery, sales are made in the state of registration in accordance with such state provisions, and such document is in fact delivered to all purchasers in all states before the sale.

General solicitation includes mass mailing of business plans, prospectuses, or memoranda concerning the offering which are targeted from magazine subscription lists, trade associations, lists of investors purchased from brokerage houses, or other similar sources. Generally, if the pool of potential offerees has some pre-existing relationship with the issuer, management, or a person who sells the offering on behalf of the issuer there will be no general solicitation. The issuer should maintain records of the number, identity, and nature of preexisting relationship, if any, of all offerees. Based on SEC no action letters and releases, there is some basis to assume that there is some permissible number, albeit small, of potential offerees who may have very minimal or even no prior relationship with the issuer provided that there is some rational basis for including them in the pool of potential offerees.

Limitations on Resale

Securities acquired in a transaction under Regulation D have the status of securities acquired in a transaction under Section 4(2) of the Securities Act and therefore cannot be resold without registration under the Act or an exemption therefrom ***unless*** the offering is made under Rule 504 ***and*** is conducted only in states in which the offering is registered pursuant to state blue sky laws which require the delivery of a disclosure document prior to or at the time of sale, or in one or more states which have no provision for the registration of securities and delivery of a disclosure document before sale, provided the securities have been registered in at least one state which provides for such registration and delivery, sales are made in the state of registration in accordance with such state provisions, and such document is in fact delivered to all purchasers in all states before the sale. The issuer must also exercise reasonable care to assure that the purchasers of the securities are not underwriters. An underwriter is deemed to be any person who purchases with a view towards resale or distribution. Regulation D defines reasonable care to include reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons, written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and therefore cannot be resold unless they are registered under the Act or unless an exemption from registration is available, and the placement of a legend on the certificate evidencing the securities which states that the securities have not been registered under the Securities Act and setting forth or referring to the restrictions on transferability and resale.

Filing of Form D

Five copies of Form D must be filed within fifteen (15) days after the first sale of securities in an offering under Regulation D. Failure to timely file Form D may disqualify the Company from future reliance on the exemption provided by Regulation D, and in the absence of a 4(2) exemption, may result in the Company's violation of Section 5 of the Act.

Savings Provisions, Substantial Compliance.

Rule 508 provides a defense against private actions of rescission by purchasers for an issuer that sold securities in reliance upon Rule 504, Rule 505, or Rule 506 and failed to comply with certain terms, conditions, or requirements of Regulation D. This “substantial compliance” safe harbor is not available in enforcement actions by the Commission.

To establish a “substantial compliance” safe harbor, the person relying upon a regulation D exemption must demonstrate that (1) the term, condition, or requirement violated was not directly intended to protect the complaining party, (2) the failure to comply was insignificant to the offering as a whole, and (3) a good faith and reasonable attempt was made to comply with all of Regulation D's terms, conditions, and requirements. Rule 508 specifically excludes from the “substantial compliance” exception failure to comply with the conditions relating to (1) general solicitation, (2) dollar ceilings, and (3) numerical purchaser limits. These conditions are deemed to be significant to the offering as a whole, and failure to comply with any of these leaves the issuer without protection under Rule 508.

Calculation of Number of Purchasers

Offerings relying on Rule 505 or 506 have a limitation of thirty-five (35) purchasers. The following are excluded from the calculation of the number of purchasers:

(a) any relative, spouse, or relative of the spouse having the same principal residence as the purchaser;

(b) any trust or estate in which a purchaser and any of the persons related to him as specified in (a) or (c) collectively have more than fifty percent (50%) of the beneficial interest (excluding contingent interests);

(c) any corporation or other organization of which a purchaser and any of the persons related to him as specified in (a) or (b) collectively are beneficial owners of more than fifty percent (50%) of the equity securities (excluding directors, qualifying shares, or equity interests); and

(d) any accredited investor.

A corporation, partnership, or other entity shall be counted as one purchaser, unless that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor.

Accredited Investors

An accredited investor is a person that falls within one of the following categories or that the company reasonably believes falls within any of the following categories at the time of the sale:

- A bank as defined in Section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity.

- A savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity.

- A broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934.

- An insurance company as defined in Section 2(13) of the Act.

- An investment company registered under the Investment Company Act of 1940.

- A business development company as defined in Section 2(a)(48) of the Investment Company Act of 1940 [a closed-end company, operated for the purpose of investing in securities described in Section 55(a)(1)-(3) of such Act and makes available "significant managerial assistance" with respect to the issuers of such securities and has elected to be regulated pursuant to Sections 55-65 of such Act as a business development company].

- A Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958.

- A plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000.

- An employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA"), (a) if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of ERISA, which is either a bank, savings and loan association, insurance company, or registered investment adviser, ***or*** (b) if the employee benefit plan has total assets in excess of $5,000,000, or (c) if a self-directed plan, with investment decisions made solely by persons that are accredited investors.

- A private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940 [a company which is a business development company but which need not be closed-end and need not elect to be subject to regulation under Sections 55-65 of the Investment Company Act of 1940].

- An organization described in Section 501(c)(3) of the Internal Revenue Code, with total assets in excess of $5,000,000 not formed for the specific purpose of acquiring the securities offered.

- A corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000.

- A director or executive officer of the Company. (An "executive officer" means the president, any vice president in charge of a principal business unit, division or function

- A natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000.
    - For purposes of calculating net worth, all assets and liabilities are included, ***except***, the primary residence is not counted as an asset, and any debt secured by the primary residence is not counted as a liability, ***unless*** (a) the estimated fair market value of the primary residence is less than the amount of debt secured by the primary residence, in which case the difference is included as a liability in the calculation of net worth, and (b) the amount of debt secured by the residence has increased during the 60 days preceding the purchase of securities by the investor (except in connection with the acquisition of the primary residence), in which case the amount of the increase is included as a liability in the calculation of net worth.
- A natural person who had an ***individual*** income (not including income of spouse) in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and who reasonably expects to reach the same income level in the current year.
    - “Income” may include amounts normally excluded from “adjusted gross income” such as any amounts attributable to tax exempt income received, losses claimed as a limited partner in any limited partnership, deductions claimed for depletion, contributions to an IRA or Keogh retirement plan, alimony payments, and any amount by which income from long-term capital gains has been reduced in arriving at adjusted gross income. However, “income” is not necessarily synonymous with “revenue”; for example, a self-employed person should deduct operating expenses to give an accurate indication of income.
- A trust, with total assets in excess of $5,000,000 not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person is described in Rule 506(b)(2)(ii) under the Act.
- An entity in which ***all*** of the equity owners meet the requirements above.

3. CIVIL LIABILITY EXPOSURE

The following paragraphs briefly summarize liabilities which may be imposed upon the issuer, the officers, directors, and control persons of the issuer, and underwriters by the Securities Act and the Exchange Act.

3.1 Section 12(1) of the Securities Act

Assuming the company will conduct the private offering pursuant to Regulation D which provides an exemption from Securities Act registration. Section 12(1) liability will only arise if for any reason Regulation D or another back-up exemption is not available, in which case the company will have

sold unregistered securities in contravention of Section 5 of the Securities Act. Such violations include the sale of unregistered securities, failure to comply with the prospectus delivery requirements or the making of an illegal offer in the pre-filing period (e.g., gun jumping). For the purposes of Section 12, the term "seller" includes all persons who are a substantial factor in causing a purchaser to buy a security. Control persons are jointly and severally liable with the seller for the seller's violation of Section 12(1). Defenses to a Section 12(1) action include (i) establishing that there are no sale of a "security;" (ii) that there was no violation of Section 5; or (iii) that there was no privity of contract between the plaintiff-purchaser and the seller-defendant.

3.2 Section 12(2) of the Securities Act

Section 12(2) of the Securities Act is a general prohibition of fraud in the interstate offer or sale of securities. Section 12(2) provides that any person who (i) offers or sells a security by means of a prospectus or oral communication by use of the means of interstate commerce (including the mail and telephone); (ii) makes an untrue statement of material fact or omits to state a material fact (the purchaser not knowing of such untruth or omission); and (iii) cannot sustain the burden of proof that such person did not know, and in the exercise of reasonable diligence could not have known, of such untruth is liable to the purchaser of such security.

The primary defense under Section 12(2) is that the defendant did not know, and in the exercise of reasonable care could not have known, of the untrue statement. As a practical matter there is no substantive difference between the requirement of an investigation pursuant to reasonable care under Section 12(2) and the investigation required to prove due diligence for the non-expert under Section 11. The so-called due diligence defense is established with respect to those portions of the prospectus/offering which are not certified by a professional, by a person proving that, after reasonable investigation, the person had reasonable grounds to believe and did believe that the statements in the prospectus memorandum were true and that there was no omission to state a material fact. With regard to expertised portions of the prospectus memorandum, a person other than the issuer and other than the expert on whose authority the statement is made, must show that he had no reasonable ground to believe and did not believe at the time such part of the prospectus memorandum became effective that the statements made therein were untrue or that there was an omission to state a material fact. The standard for determining "reasonable investigation" and "reasonable grounds for belief" is that standard of reasonableness that would be required of a prudent man in the management of his own property. In general, the due diligence defense is established with respect to non-expertised portions of the prospectus memorandum that one took reasonable steps to verify that which was reasonably verifiable. Another available defense is that the plaintiff knew of the untrue statement at the time of the contested securities transaction. Section 12(2), as in Section 12(1), requires privity of contract between the plaintiff-purchaser and the defendant-seller, and utilizes the substantial factor test to ascertain who is a seller.

3.3 Section 17 of the Securities Act

Section 17 of the Securities Act imposes criminal liability upon, and in certain jurisdictions may provide the basis for private right of action against, any person who, in the offer or sale of securities by use of interstate commerce, employs any device, scheme, or artifice to defraud; obtains money or property by means of any untrue statement of a material fact or any omission to state a material fact; or engages in any transaction, practice or course of business which operates or would operate as a fraud or deceit.

3.4 Rule 10b(5) of the Exchange Act

Rule 10b(5) is a general anti-fraud prohibition which provides a private civil damages action to purchasers or sellers of securities. Rule 10b(5) prohibits any person from using interstate commerce to (i) employ any device, scheme or artifice to defraud; (ii) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (iii) engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of a security.

A cause of action under Rule 10b(5) is established if a plaintiff shows fraud, deception, misrepresentation or omission of a material fact in connection with the purchase or sale of a security. The misrepresented or undisclosed fact must be material to the investor's decision, the plaintiff must have actually believed the misrepresentation, and that belief must have been a substantial factor in the plaintiff's having entered into the challenged transaction. The plaintiff must also show the defendant had scienter, i.e., intent to deceive, manipulate, or defraud. The defenses available to a defendant in a Rule 10b(5) action are that full disclosure of all the facts was made, that the statements made were true, that the untruthful statements were not material or did not cause the plaintiff's loss, or that the defendant lacked actual knowledge of the fraud.

About the author;

Gerry Balboni is a corporate transactions attorney with over twenty years of experience representing companies and individuals that buy, sell, and invest in growth businesses. Gerry works with companies seeking capital, venture capital and private equity funds, buyers and sellers of businesses, and licensors and licensees of technology and software. Gerry also provides assistance in SaaS and cloud licensing, data privacy and security, intellectual property protection, non-competition agreements, executive compensation, stock options, restricted stock awards, software and encryption export regulation, and strategic alliances.

About Krevolin & Horst, LLC

Krevolin & Horst, LLC is a boutique law firm based in Midtown Atlanta with a focus on commercial real estate, corporate, environmental, technology, and trial and appellate litigation in all courts. Krevolin & Horst offers highly credentialed and experienced lawyers in a small firm environment. Clients include individuals, entrepreneurs, and companies nationwide ranging from start-ups to large, publicly traded and privately held businesses. Although based in Atlanta, Krevolin & Horst provides services to clients with business activities and litigation throughout the United States.