

The Dangers of Raising Capital Through Social Media



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The use of social media for business, networking and personal purposes is increasing exponentially. Savvy entrepreneurs and businesses are using social media to market their products to a wider audience, drive traffic to their websites and increase sales. It's hardly surprising that many of those same individuals and companies are turning to social media to fulfill their funding needs. However, in doing so, they may be inadvertently violating federal and state securities laws and putting themselves in a difficult situation.

You may have seen posts on LinkedIn, Facebook, or other social media websites requesting funding or suggesting a great investment opportunity. You might even have thought it would be a great way to raise money for your own business. What you are probably not aware of is that the primary method of raising money is by selling your company's securities, which is a highly regulated practice. Federal securities laws generally prohibit any person from selling securities unless a registration statement covering the securities has been declared effective by the SEC or an exemption from the registration requirement is available. As you might imagine, registering securities in a public offering can be prohibitively expensive. Consequently, the only option most private companies have to raise money relies on certain limited exemptions from registration referred to as "private placements".

Private placements are exactly that - private. A company seeking to raise money through a private placement may not offer or sell its securities by any form of "general solicitation" or "general advertising" and, in some cases, may only sell the securities to a limited number of eligible investors. Due to the restricted nature of these offerings they are not considered "public offerings" and, therefore, are not subject to the registration requirements.

What does this mean to the young company looking to raise money? It means what may seem like a harmless online post may in fact be deemed a "public" communication prohibited by federal and state securities laws. Although the law has not kept pace with social media, and there is no clear rule on what constitutes "general solicitation" or "general advertising", securities laws generally prohibit communications regarding a stock offering published in any newspaper, magazine or similar media. Consequently, a widely disseminated online post that your company needs money is likely a prohibited communication.

What about posts in group forums on LinkedIn or to "friends" on Facebook you may ask? That is not quite as clear. A company may prove a stock offering was not based on general solicitation or advertising if the company or its principals had a pre-existing substantive relationship with the prospective investors. It may be possible for such a relationship to develop online. However, companies should be wary of making such an assumption. The SEC has stated that such a relationship is one that existed before the offering was contemplated and that enables the company to be aware of the financial circumstances or sophistication of the potential investors. While parties may develop such a relationship in an online setting, it is unlikely that merely joining a group on LinkedIn or adding a new

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“friend” on Facebook would, by itself, be sufficient for a company to understand all of the group’s members’ or friends’ respective financial circumstances or sophistication. The relationship must be substantive enough to ensure a reasonable belief can be formed that the potential investor meets the requirements to invest.

That are the consequences of these violations? First, the private placement exemption may no longer be available, resulting in the delay or even termination of your effort to raise capital. Second, the investors could have the right to rescind the offering, essentially giving them the right to demand the return of their investment at any time if they are not pleased with the company’s performance. Finally, the SEC could impose civil, and possibly criminal, enforcement actions against the company and its principals. Given these potential ramifications, it is in each company’s best interest to carefully consider what it, and its employees and agents, are posting online.