



## Willful Blindness: The Rule 506 Securities Law Exemption and the New “Bad Actor” Rules

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Entrepreneurs create jobs, but they generally don't do it out of thin air. Usually, they need investors. These investors are generally very wealthy people who are 1) inherently private and 2) usually very busy doing wealthy person stuff. So imagine learning, after going through all the work of finding an investor, that the Congress and the Securities and Exchange Commission (SEC) want to make it harder to raise money, including in some cases requiring investors to respond to a checklist of private and probing questions to find out if they are or have been at any time within the last 10 years a “bad actor.”

If you haven't had the chance to read the SEC's proposed rules on “bad actors” disqualifying companies from using the Rule 506 securities law safe harbor exemption, you ought to. The proposed rules, if adopted, will fundamentally change Rule 506 offerings and the startup financing legal landscape.

How, you might ask? By imposing on startups the “did-not-know-and-in-the-exercise-of-reasonable-care-after-factual-inquiry-could-not-have known” standard when it comes to investigating “covered persons” (including prospective 10% or greater investors). Covered persons who are bad actors might disqualify a startup from using Rule 506 by virtue of their prior bad acts (including in some cases misdemeanors committed as long ago as 10 years before the sale of the securities).



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“Willful blindness” is a legal concept that is bandied about in scandal from time to time. Remember Watergate? Or last week’s scandal for that matter? It all comes down to the fundamental question of what did the President or CEO know and when did he know it? The opposing question is, of course, how is a President or CEO supposed to know everything about everyone involved in her or his company?

One of the beauties of Rule 506 right now, of course, is that it is easy for startups to use. There is no due diligence requirement currently built into Rule 506. To use rule 506, there are a few requirements, for sure, but the primary requirement—that the company had a reasonable belief that each of the investors was accredited, does not affirmatively require investigation or diligence, like the new “bad actor” rules would.

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