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# Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.


## ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at **www.alexanderdavie.com**.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.


## Can a friends and family round include non-accredited investors? Should it?

The so-called "friends and family" round is often the first capital raise a new startup will engage in. Many entrepreneurs often go into it without any knowledge of securities laws and as a result, end up violating them, sometimes with real and significant consequences later. However, plenty of entrepreneurs do take the time and effort to comply with securities laws and make use of an exemption from the registration requirements under the Securities Act of 1933. Regulation D covers the most often used exemptions (at least by smaller companies). The most common form of a Regulation D offering is one conducted under Rule 506, which essentially requires that the issuer offer the securities only to preexisting contacts (no advertising or widespread communication of the offering) who are accredited investors. An accredited investor is someone who either: (i) has an individual net worth, or joint net worth with that person's spouse, at the time of purchase, exceeding $1,000,000, excluding the value of the primary residence of such person or (ii) had an individual income 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 has a reasonable expectation of reaching the same income level in the current year.[1] However, it is often the case that an entrepreneur's friends and family are not accredited and so if he limits his capital raise to accredited investors, the capital raise will go nowhere. Not everyone has a rich uncle. So, if you are an entrepreneur in this situation, can you raise money from investors without those investors being accredited? Yes, you can, but proceed with caution.

Regulation D offers a number of ways to accept investments from non-accredited investors. Rule 506 itself allows a company to include up to 35 non-accredited investors in the offering. However, this is impractical for two reasons. First, any non-accredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." This is a very subjective standard and unfortunately the only way to get a final determination if an investor meets this qualification is in the courtroom. By relying on this subjective standard in the offering, the issuer is taking a huge risk of litigation later. In addition, Rule 506 presents an even more significant obstacle to including non-accredited investors. If a Rule 506 offering includes non-accredited investors, then it must provide investors with much of the same information as is provided in a registered offering, which largely defeats the purpose behind conducting an exempt offering and is likely to drive up costs of the offering to the point where it is not economical to conduct a small friends and family capital raise. In contrast, when a Rule 506 offering is conducted without non-accredited investors, there is no information requirement, which means that there is no specific information that is mandated by securities regulations to be given to investors.[2]

So is there a way to include non-accredited investors in an exempt unregistered offering and still retain the "no information requirement?" Yes, through Rule

504. Rule 504 allows a company to raise up to $1 million over a 12 month period. There is no requirement that the investors be accredited and, as in the case of a Rule 506 offering made exclusively to accredited investors, there is no information requirement.[3] The one major limitation placed on a Rule 504 offering is that, like a Rule 506 offering, there must be no general solicitation. All investors must be preexisting contacts of the issuer and its principals and no advertising or widespread promotion of the offering is permitted.

Rule 504 does have one major disadvantage as compared to a Rule 506 offering. Rule 506 preempts state registration requirements whereas Rule 504 does not. So, when conducting a Rule 506 offering, as long as the correct notice filings are made, issuers need not worry about finding an exemption from state securities registration requirements. However, if an issuer relies on Rule 504 in its capital raise, the issuer's counsel will need to research the state law of every single state in which the company will be soliciting investors in order to find a separate exemption from registration in each state. In some states there are exemptions allow for residents to take part in a Rule 504 offering. For instance, in Tennessee, offering up to 15 investors in a 12 month period are exempt. Other states may or may not have similar provisions and it may be possible that you might not be able to accept investments from residents in certain states.

The next question that needs to be asked is should you include non-accredited investors in your capital raise as a matters of morals and good business sense. The law may permit it (subject to restrictions), but is it a good idea? Recall the proverb: "Before borrowing money from a friend, decide which you need more." With any entrepreneurial venture there is a substantially high chance of failure. You may think that you have the best idea in the world and it's a sure thing, but chances are there are unforeseen forces that could derail your efforts. Therefore, for both moral and legal reasons, it's a good idea to only take investments from people who can bear the risk of loss of the investment. Therefore, you should never accept investor money from a friend or family member when that money constitutes a significant portion of that person's life savings or if losing that money could substantially harm them or those that depend on them. In any event, before taking an investment from a friend or family member, ask yourself this: if he or she lost all of the money invested because the business failed after you did your very best to make it succeed, would this cause hard feelings? If there answer is yes or maybe yes, then either don't take the money from this person at all, or reduce the amount of the investment to something that this person would consider to be insignificant. If you don't, the hard feelings you create can cause you to lose the relationship and may land you in court.

Conducting a first capital raise can be an exciting time for any company. It can also be fraught with pitfalls. You should consult an attorney who is familiar with securities laws to help you navigate this exciting but high stakes stage in the growth of your company.

Footnotes

[1] It is also possible for business entities to qualify as accredited investors if they meet certain net worth or other requirements. In addition, directors and officers of the issuer also qualify.

[2] "No information requirement" does not mean that no information is given to investors; rather it means that the issuer is free to choose the overall format, degree, and composition of information given to investors, as long as that information does not violate the anti-fraud provisions of securities laws. Frequently, the compiled information in a Rule 506 offering is called a "private placement memorandum."

[3] Again, as a matter of clarification, "no information requirement" means no specific mandated information is required to be given to investors. However, if the information that is given is misleading, the offering could violate the anti-fraud provisions.

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