

Is it Legal to Sell Stock in My Company to Investors? By Darian B. Andersen

Do you need additional money in your business? Have you ever thought about raising that additional money by sell a part of your company? Is it legal or not legal to do it? Here are some of the guidelines.

A brief orientation to the securities laws appears at <http://www.sec.gov/info/smallbus> on the Internet. The Securities and Exchange Commission (“SEC”) provides a brief explanation about how we got the securities laws and what they are to accomplish with the following explanation:

“In the chaotic securities markets of the 1920s, companies often sold stocks and bonds on the basis of glittering promises of fantastic profits - without disclosing any meaningful information to investors. These conditions contributed to the disastrous Stock Market Crash of 1929. In response, the U.S. Congress enacted the federal securities laws and created the Securities and Exchange Commission (SEC) to administer them.

“There are two primary sets of federal laws that come into play when a company wants to offer and sell its securities to the public. They are:

“the Securities Act of 1933 (Securities Act), and

“the Securities Exchange Act of 1934 (Exchange Act).”

These laws don’t prohibit selling stock but provide a detailed set of rules that require that a seller to disclose detailed information about the company so that the investor has the necessary information to be able to make an informed decision about the company so as to decide whether to invest in the stock. The only other way to sell is by way of an exemption, normally based on the number of persons being offered stock, their financial condition and/or the limitation in dollar amount of the value of the shares being offered.

Each of the states also has a “small SEC”, and the laws governing state securities regulations are called “blue sky laws”. A seller must comply with both laws before selling stock. Some of the details are set forth below.

First a note about who we are as businesses in the State of Oklahoma. A financial consultant friend of mine provided me with the following information about Oklahoma’s businesses. There are about 85,100 businesses that call Oklahoma home, 21,200 are in Oklahoma County and 18,300 are in Tulsa County. Fifty five percent of the Oklahoma businesses have 0 to 4 employees. Twenty percent have 5 to 9 employees, twelve percent have 10 to 19 employees and only five percent of Oklahoma’s businesses have 50 or more employees.

That means, that for most federal securities purposes, about 98% of Oklahoma’s businesses are classified as small businesses.

Here is a brief summary of the rules:

1. You may not legally sell stock in your company unless you have registered the sale of the stock by filing a registration statement with the SEC or under an exemption from registration. A registration includes a prospectus and additional information required to be filed with the SEC,

but which does not need to be provided to prospective investors. The registration statement must be on the proper form for the application, and most Oklahoma businesses would be using either a form SB-1 (for offers up to \$10 million) or an SB-2. The SEC reviews the registration statement and either approves it or gives comments which must be complied with in order to get approval to sell the stock. Sellers must also comply with the Oklahoma Securities Laws.

2. The common exemptions include the intrastate offering exemption, Regulation A, and a “private offering”, under Regulation D with the use of Form 504, 505, or 506, and a few other exemptions not discussed here in detail. An intrastate offering must be solely to investors in the state. Compliance with the Oklahoma Securities Laws is still required. Regulation A requires the filing of an offering statement with the SEC which includes a notice, the offering circular and exhibits. It may only raise \$5 million, but does not require audited financial statements. Form 504 is used to raise up to \$1 million in a 12 month period and may be offered to an unlimited audience but you may not use advertising or public solicitation (and this rule also applies to Forms 505 and 506). The stock is not yet publicly tradeable and is considered restricted until it becomes registered for regular trading. Form 505 is used to raise up to \$5 million in a 12 month period and is limited to 35 persons who are not accredited investors and an unlimited number of accredited investors. Accredited investors are persons whose income and assets are sufficient so that the SEC doesn't worry about their being taken advantage of by the offering company, typically having assets of \$1 million or income for 2 of the last 3 years of \$200,000 or more. The Form 506 may raise unlimited funds by offering to a similar audience as a Form 505 offering (unlimited accredited investors and up to 35 non accredited but sophisticated investors). In all cases, compliance with the Oklahoma Securities Laws is required.

So with all that complexity, is it worth it? Can you really use the tools of offering stock to others? Here are some general guidelines: In order to raise money effectively through a public or private offering, it is easier and highly recommended to have a 3 year track record before you sell publicly. It is not required, just recommended by me and many others. What can you do? I had a client a few years ago who invited a single investor into his business. When the business went south the investor sued. The company was not doing well enough to afford the legal fees to fully defend the case, (\$25,000 called for by one of the local large law firms) so I worked toward a compromise between them for a lot less in legal fees but it was not a totally satisfactory result because the case was defensible but the investor had deeper pockets than the company. So even with a single investor, it is recommended to provide full and clear disclosure of the benefits and disadvantages of the business. It is also possible for a founders group to get together and form a company in which they will invest time and/or money. The smaller the group the safer, but legally include 15 or more persons in the group, but special caution is suggested for over 5. The real rule of thumb I use is that if the company makes money for its investors then no one sues. If the company loses money or otherwise disappoints expectations, people are more likely to sue.

The securities laws are complex and treacherous. In order to raise funds in this way, you should really need the money and not have another means of getting it, such as borrowing it. But if you need it and there is no other way, then by all means, utilize the securities laws to raise the funds. Be prepared for significant cost and a big time investment on the part of many company people. Companies have been using these methods for a lot of years and will continue to do so in the future.

