SCOTT LEGAL SERVICES, P.C.

The Law Firm For Entrepreneurs, Business Owners & Investors
Ian E. Scott
110 East 59th Street, Suite 25
New York, NY 10022

TELEPHONE: (212) 223-2964
www.legalservicesincorporated.com
iscott@legalservicesincorporated.com

Top Questions From Start-Up Business Owners/Founders When Seeking Funding From Family & Friends

In the search for startup capital funding, family and friends can be a great source of financing as they will have a vested interest in your success, and they may be willing to take a chance on you that no bank or other investor would. This initial investment can mean the difference between operating or not as it can provide a financial bridge for the founder of a start-up enterprise until venture capital funds come along to provide a more substantial capital investment. As the initial investors are family and friends though, you have to structure any financing for your business very carefully to preserve relationships, and you should ensure that your investors fully understand the risk.

Scott Legal Services, P.C. regularly represents start up founders and investors and the same questions often come up. Here are some of the common questions asked with short answers. This article focuses on the top Start-up Founder/Investor questions asked by our clients. The answers are short answers to complicated questions and should only be used as a basis for a discussion with a qualified start-up business attorney. Here are the top questions.

1. **What are some of the ways that a Start-Up Founder can structure an Investment for Family & Friends?**

There are various ways that an investment can be structured. One simple way that family and friends can invest is through a loan. While this is a simple form of investment, it is not very practical as most start-up companies cannot afford to pay interest (or pay back anything) and will not be in a position to do so for years. As such, most founders keep common voting stock for themselves and issue either convertible notes or preferred shares to investors. Convertible debt is a somewhat complicated financial product that is debt (like a loan) that converts to equity (usually preferred stock) based on some trigger (usually a venture capital funding round). The debt usually accrues interest but the interest is not paid until the trigger event occurs. Once the trigger event occurs, the debt holders can convert the money they loaned and accrued interest to preferred stock and they can usually purchase the preferred stock at a discount. Preferred shares are equity stock and the stock is usually non-voting. A number of features can be added to the preferred stock (eg. right to appoint board members) to give investors comfort. Both Preferred Stock and Convertible Notes are financial securities and require extensive legal documentation to set up.

2. Should a Founder Sell Preferred Shares or Convertible Debt to Friends & Family?

Many start-up founders ask the question of whether or not they should issue convertible notes or preferred stock to investors. Convertible debt has the advantage of being a bit cheaper as the legal set up is not as complex. In addition, convertible notes push off the valuation of the company to a later date (usually when a Venture Capital fund comes along). On the down side though, some find the product complicated and difficult to explain to investors. Preferred stock is a simpler product to explain to investors but does cost more in legal fees to set up and at the start-up phase money is usually not abundant. In addition, a valuation must be done and when a company is just formed and does not have any sales, founders and Investors may not agree on the initial valuation. This could cause complications as the valuation is going to be the basis for the price that an Investor pays for their shares.

It is not possible to give an answer of which instrument (preferred stock v. convertible debt) is "best" and you should sit down with your lawyer to fully understand the different options to assess which one works best for you. In fact, many in industry have very different view on which product is the best product for start-up companies. Regardless of which one is selected, there are a number of legal documents that must be prepared in addition to ongoing SEC compliance.

3. If Family & Friends invest in a Founder's company and the Founder sells them stock, does the Founder have to follow any laws or regulations?

Yes. You are required to comply with the Securities Exchange Commission's (SEC) requirements if you sell stock or any security. The term "security" is defined by Statute but most financial products that a company can sell to an investor would qualify as a security. (For example, preferred stock, convertible debt, member units, common stock, etc.) In addition to federal SEC requirements, a company that issues securities would also have to comply with State Securities regulations.

All of the government requirements have been set up to protect investors and generally require any company who wants to attract investors to provide the investors with information such as financial statements, offering documents, prospectuses and other information so that an investor can make an informed decision. Failure to follow these requirements can result in dire consequences.

4. How much Information must be provided to friends and family investors? Is it as much information as if the offering were to be made to the general public?

If you are offering securities to your friends and family, you can usually file Federal and State exemptions so that you can limit the amount of information that you provide to investors. If you qualify for the exemptions, you can provide investors with your business plan and other information you have available. If you do not qualify for the exemptions, the full SEC disclosure requirements kick in and you are required to provide investors with a complete set of information including offering documents, audited financial statements, prospectuses and more. The exemptions are complicated and rules often limit who you can sell securities to and place restrictions on the securities that are sold. For example, some

exemptions require that your friend and family investors be "Accredited Investors" such that they have significant financial assets and superior knowledge of financial markets.

5. What happens if SEC Regulations are not followed?

A company or individual that issues securities and does not follow U.S. law can be subject to sanctions including prohibition of future securities issuances, fines or imprisonment. A founder must take special care not to mislead Investors by providing false or misleading information as Securities prosecutions can result in both hefty fines and imprisonment for egregious violations.

6. Can a company pay employees with Stock?

Yes but this is very complicated area. In the United States if you issue a security (stock is a security), you are required to comply with the Securities Exchange Commission's (SEC) requirements. This is the case even if investors are awarded shares in lieu of salary or other compensation. In addition, if you set up a stock option plan, this is another area where you must comply with complex regulation. Compensation is a complicated area and a founder would always be well served by seeking legal advice in this area.

7. Does a Founder Need A Lawyer to Raise Funds From Friends & Family?

Yes. Unless your friends and family are giving you a loan, you are probably issuing securities to them. When you issue securities the law and regulations are complicated and you need an expert to make sure you are complying with both federal and State requirements. In addition, a lawyer can get you to start thinking about the right questions to ask and can put a legal framework around your business that could save you money. Moreover, as investors are friends and family it is important to ensure that a founder is providing the investors with all of the information that they need to make an informed decision. Also, a founder has to ensure they are following the law to protect themselves in the event an investor becomes disgruntled.

If you are considering issuing securities to friends and family, contact Scott Legal Services, P.C. for a consultation. You can call us at 212-223-2964 or email us at iscott@legalservicesincorporated.com.