

YVCS Article:

The Disclosure Syndrome:

The Problem With Early Stage Companies Cut Corners Early On.

To most that operate within the early stage company space, the initial foray into the venture capital world is known as the “*Friends and Family*” round (obviously getting its name from the people who are most likely to invest in the nascent company). However, to experienced venture capitalists and service providers, this early stage investment round presents a host of problems typified by the problems associated with inadequate investment disclosure documents. Simply put, it is in the earliest stages of the capital raising cycle that a company (due to lack of financial resources, know-how, *etc.*) neglects to provide investors with the necessary information to make an educated decision regarding the investment opportunity presented by the company and it is at this time that the company unwittingly takes on risks associated with neglecting to do the same.

In reality, the “friends and family” round (for the purposes of this article the “Friends and Family” round shall not include professional angel investors) is not very different from any other capital raise. The company, in need of capital, seeks investors who are willing to make an investment in exchange for an equity position in the company. What differentiates the friends and family round from the later rounds of investing is the sophistication of the investor (and quite often the company). Most unsophisticated investors do not turn over of the proverbial due diligence “rocks” of the potential investment and in the same vein most startup companies do not provide investors with the necessary documents to do so. The reason for the lack of disclosure documents and short cuts taken is because the friends and family round is generally a quick, get-it-done on a shoe-string budget where the company drafts one-page disclosure statement that is (usually) not in compliance with disclosure rules set forth by state and federal securities law.

While a discussion on how securities laws protect investors is far too complex for this article, the spirit behind the laws are to protect the investor by giving her as much information as possible in order to make an educated decision regarding the prospective investment. To achieve this objective, the security laws (both state and federal) force companies to disclose as much information about themselves as possible so to enable a reasonable investor to make an educated assessment about the investment risk associated with the company.

Ideally, the company would want to draft a private placement memorandum (the “PPM”) or a document as close to a PPM as possible. It should contain, among other things, the business description, risk factors (*i.e.*, you could and may lose all of your investment), terms of the offering, current financials, an affirmation by the investor that it is an accredited investor (as defined by Regulation D) and a snapshot of the management team. These documents should give the proposed investor enough knowledge about the company to make an educated and discernable decision as to whether it wishes to invest.

A well prepared private placement will serve both the function of disclosing the risks and the potential investment upside. Unfortunately, however, what the investor usually receives is a business card and a one-page business plan that contains phrases such as “can’t miss”, “holy grail” and “ground breaking”.

Undoubtedly, the decision to forego the proper disclosure documents by most early stage companies, especially companies with novice entrepreneurs at the helm, is more of an error of omission than an overt decision to defraud a proposed investor. Even where the investor does have considerable knowledge of what the proper disclosure documents should resemble, many an entrepreneurs will make self-serving justifications such as the shareholders of the company are better served by not spending money on consultants, accountants and lawyers since the company and investors are theoretically aligned in interest. While, this frugal approach might be well received by some like-minded shareholders most regulators would not be in agreement. In fact, if a regulator is alerted to the non-conforming offering (usually by a by a disgruntled investor, employee or both) the company and perhaps even the management, may wish that it had elected to spend the money to provide the proper documentation.

Even if all investors of the company are content with the company and its progress, the lack of proper documentation in the offering round may haunt the company in future offerings. For example, if the company is successful and elects to pursue professional investment, the professional investor is sure to discover that the company never complied with governmental regulations and could either walk from the deal or force the company to go back and recreate the transaction (which could prove problematic if the company has sputtered and the initial valuation was much higher than the current valuation). Nonetheless, it would be foolhardy for a professional investor to proceed with its investment if, as a result of an incomplete offering, the possibility existed that the company might have to defend itself against an investigation or lawsuit (a question for debate is whether this potential liability should be disclosed on the balance sheet).

So, what should a company do to avoid such a potentially disastrous situation? First, the management team should contact an attorney who is versed in this area and will help the management team and company navigate the potentially dangerous waters of seeking capital. For many startup companies, the fees involved in retaining experienced counsel are often too high and as a result the inexperienced management team will forego retaining experienced counsel. When in fact the fees associated with obtaining experienced counsel will undoubtedly be far less than the fees associated with defending a lawsuit brought by a disenchanted investor or the loss of a professional investor as a result of its unearthing of incomplete or non-existent disclosure documents from previous capital raises.

Second, after the company has interfaced with experienced counsel, it should, with the aid of counsel, begin to sculpt its offering documents including its business plan (an executive summary will do), offering memorandum, which should have a fairly straight forward risk factor section, description of the management team, an affirmation

from the investor that it is an accredited investor and the stockholder or voting rights agreement.

Third, the company should attempt to target investors who add intangible value as well as cash. The importance of having the right investors is paramount in any company but especially critical in a startup company where the investors may be the first introduction to professional management and assist the company in areas such as intellectual capital (big ideas), social capital (who you know), and management capital (the willingness to share management ideas, know-how).

Lastly, it is equally important that the company understand the expectations of the investor and if and when possible manage those expectations so as to avoid any over promising and under-delivering on potential returns (a classic startup company dilemma). Accordingly, it is as important to receive smart money as it is to receive money itself and as so the management team should use jurisprudence in deciding which investor will become a part of the company.

In conclusion, while obtaining capital may be the paramount activity of a startup company, the fact is that the management team should also be aware that every decision it makes regarding how it seeks investors and the information it presents to the same may impact both current and future events.