The Invest Georgia Exemption

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The Commissioner of Securities for the State of Georgia adopted the Invest Georgia Exemption and created one of the most attractive tools for small companies to raise capital. Legitimate and operating companies, such as hotels and restaurants, were largely foreclosed from seeking investor funds due to the complexity and expense that involved the "registration" of a securities offering and the general prohibition to publicly solicit the investment where reliance on an "exemption from registration" was being made. Prohibitive regulatory burdens for participation by registered securities broker-dealers prevented the operators of these legitimate companies from finding the pool of investors that might have had an interest in providing the necessary funding for smaller offerings, but then the unavailability to publicly advertise the securities offerings disallowed companies from presenting their offerings to the investor community.

This memorandum is prepared for issuers operating businesses "local" to Georgia and which may consider expanding their operations within the state or developing businesses or subsidiaries within Georgia. Since dual levels of regulation apply, we first begin with a background on federal legislation and the corresponding need to comply with federal law on securities offerings. We then provide information on the compliance requirements for Georgia law and, in particular, the Invest Georgia Exemption. The memorandum then concludes with a legal practitioner's standpoint on the benefits and application of the exemption.

A PRIMER – THE USE OF A SECURITIES OFFERING FOR BUSINESS CAPITAL NEEDS

For readers who do not have experience or familiarity with securities offerings, we include this section as a primer. We begin with caution and note that introducing private capital for a company's operating or growth needs presents tremendous benefits, but this is a

heavily regulated area and a failure to comply with the law can result in serious consequences. As a percentage of the amount of violations occurring, enforcement is comparatively rare, but the consequences can be so severe that we recommend involving an experienced securities attorney any time a security is offered.

Structuring a securities offering allows the operator to stay in control of its business and set the terms upon which capital is accepted. The alternative, bank financing or traditional private equity, may be available, but typically on either restrictive or onerous terms. Most banks, on the one hand, will require personal guaranties from the operators of the business and the pledging of personal assets, in addition to setting various restrictive covenants in the operation of the business. Venture capital or private equity investment, on the other hand, is generally regarded as expensive and commonly associated with either partial or complete loss of control by the former owners. Many of these investment funds are professionally managed and themselves seek high rates of returns for their investors; thereby resulting in negotiations with highly sophisticated parties which implement strict oversight requirements on their own investments. The alternative, creating a securities offering, whether such is "registered" or structured under an "exemption from registration," allows the operator of the business to set the terms of investment and such are typically done without any personal guaranties, restrictive covenants, or even loss of management control. The company's discretion in an offering may include the decision of whether to offer debt or equity, or some form of hybrid security, setting interest rates or dividends, establishing preferences on distributions or liquidations, and among others, restricting voting control. The company may also generally decide the manner in which the invested funds will be utilized, known as "use of proceeds," and thereby allow flexibility to, for example, acquire real estate, purchase supplies and equipment, pay rent and salaries, acquire franchise licenses, and a variety of other uses, generally so long as those uses are disclosed in the offering documents. Investor pools are commonly passive and while investors may follow the development of the business, they rarely take part in its management and operation.

With regard to the "registration" process, a background is helpful to appreciate the value in an "exemption from registration." We begin with a presumption that any offering must be registered at

USE OF PROCEEDS

The use of proceeds section identifies how the company intends to use the proceeds of the offering. This should identify (i) estimated offering expenses (commissions and finders' fees, legal and accounting expenses, copying and advertising costs, etc.), (ii) the gross and net proceeds from the offering, including a range if there is a minimum funding contingency or if the offering is fully-subscribed, and (iii) details regarding how the proceeds are intended to be used.

Securities laws generally allow an issuer substantial flexibility in determining the allocation of proceeds, but do require transparency. Hence, for example, it would be permissible to allocate proceeds to purchase real estate with investor funds even before the particular parcel or building is identified, so long as the criteria in identification are specified in the offering documentation. However, a general classification of "working capital" may not be sufficient as it does not identify precisely where the investor proceeds will be applied.

One important note regarding the use of proceeds pertains to different standards with respect to tax and securities law. Items such golf club memberships, luxury vehicles, and meals and entertainment, among other fringe benefits, may be permissible and deductible under the Internal Revenue Code, but should be avoided in the context of a securities offering. This is because the source is third party funds and upon subsequent review by a court or regulatory agency, excessive or lavish benefits to management will likely be viewed as indicia of fraud. We accordingly advise to follow conservatism where officers, directors, or any related parties benefit from the proceeds of a securities offering.

The directions for the use of proceeds in registration statements are specified in Item 504 of Regulation S-K, 17 C.F.R. §229.504, and may be consulted in the preparation of private placement memoranda for required disclosures.

either the state or federal level. Once a "security" is being offered or sold, affirmative obligations arise under law and claiming a lack of knowledge of the law is not a defense. The registration process involves comprehensive disclosure about the industry, company, and the specific offering of securities and is designed to empower the reader with sufficient information to make an investment decision. However, several "exemptions from registration" exist and those can be applicable to the type of security being offered (exempt securities) or the transaction by which securities are sold (a transactional exemption). Hence, if an exemption is identified, this would alleviate the requirement to register the securities, but would not waive the anti-fraud prohibitions under state or federal law. The result is such that even if an exemption is claimed, the law may require the same types of disclosures as would be mandated if the securities were registered. This concept makes sense as even if the business would not need to apply and file with the state or federal government for approval, the investor should still be informed regarding the industry, business, and details of the securities being offered in order to make their investment decision.

AN EXEMPTION FROM REGISTRATION UNDER FEDERAL LAW FOR INTRASTATE OFFERINGS

A starting point for planning a securities offering begins with federal law. Once a concern or possibility arises that a "security" is being offered, expansive bodies of regulation become applicable, namely the Securities Act of 1933 ("**Securities Act**") and the Securities Exchange Act of 1934 ("**Exchange Act**"), and a failure to comply can result in civil liability, regulatory enforcement, or possibly even criminal prosecution.

As it applies to this memorandum, we turn our attention to §3(a)(11) of the Securities Act, 15 U.S.C. 77c(a)(1). This section identifies the classes of securities exempt from federal registration and the definition includes:

> "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."

Based on such statutory definition, (i) limiting the offers and sales of securities to residents of a single state where (ii) the issuer is resident or incorporated and (iii) doing business within offers an exemption from the registration requirements under federal law. This statute provides authority for the individual states and U.S. territories to regulate securities offerings which are inherently "local" in nature, thereby representing "local financing by local industries, carried out by local investment." [1]

As is common with federal law, the statute provides a general overview of legislative intent, but then delegates the interpretation of the details to a governmental agency which, in this case, is the Securities and Exchange Commission ("**SEC**" or "**Commission**"). In application of §3(a)(11), the SEC promulgated a rule to provide objective standards, or a "safe harbor," for intrastate securities offerings under Rule 147 of the Securities Act, 17 C.F.R. §230.147. The terms for reliance on the rule are as follows:

(a) <u>Issuer Resident in the State</u>. Paragraph (c)(1) provides that an issuer will be deemed a "resident" of the state or territory in which (i) it is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law, (ii) its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law, or (iii) his principal residence is located if an individual.

1 See preliminary note 3 to Rule 147, 17 C.F.R. §230.147. The note then emphasizes that the nine (9) month resale restriction to non-residents is applicable for reliance on the federal exemption.

(b) Issuer Doing Business within the State. Paragraph (c)(2) defines "doing business" within a state or territory and an issuer is deemed to be doing business in the state if the issuer (i) derived at least eighty percent (80%) of its gross revenues, and those of its subsidiaries on a consolidated basis, in the state or territory, (ii) had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least eighty percent (80%) of its assets, and those of its subsidiaries on a consolidated basis, located within such state or territory, (iii) intends to use and uses at least eighty percent (80%) of the net proceeds in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory, and (iv) maintains its principal office within the state.

(c) Offers and Sales Made to Residents of the State. Rule 147(d)(1) limits offers and sales to state residents and defines a "resident" as (i) a corporation, partnership, trust or other form of business organization that, at the time of the offer and sale to it, has its principal office within such state or territory and (ii) an individual if he or she has, at the time of the offer and sale, his or her principal residence in the state or territory.[2]

In interpreting Rule 147, it is important to note that compliance with the federal statute may be possible even where all of the provisions of the rule are not met, but such should be done with extreme caution since the "safe harbor" would no longer be available.[3] Also, the Commission has made clear that the presumption of compliance with Rule 147 is limited to federal law and will not affect the need for compliance with state law.[4] The rule further contains limitations on resale to non-residents and (i) prohibits resales of the securities to non-residents for a period of nine (9) months from the date of last sale and (ii) requires that the issuer place a legend on the certificate, or other stop transfer instruction, stating that the securities have not been registered under the Securities Act and setting forth the limitations on resale.

2 Any business entity which is organized for the specific purpose of acquiring the securities is disregarded and the residence of the beneficial owners is controlling.

3 See preliminary note 1 to Rule 147, 17 C.F.R. §230.147.

4 See preliminary note 2 to Rule 147, 17 C.F.R. §230.147.

THE INVEST GEORGIA EXEMPTION

The Invest Georgia Exemption, Ga. Comp. R. & Regs. r. 590-4-2-.08, is a form of exemption from registration promulgated under the state law of Georgia. Assuming an issuer complies with federal law on the exemption under §3(a)(11) of the Securities Act and Rule 147 thereunder, it may then also rely on a state exemption to avoid the burden of registration under either state or federal law. The Invest Georgia Exemption is an exemption from the securities registration requirement under O.C.G.A. §10-5-53 and then also affords individuals representing an issuer an exemption from the broker-dealer registration requirement under §10-5-30.[5] To demonstrate reliance on the exemption, the following requirements apply:

(a) For-Profit Business. The issuer is a for-profit business entity formed under the laws of the state of Georgia and registered with the Secretary of State.

(b) Compliance with the Federal Exemption on Intrastate Offerings. The transaction meets the requirements of the federal exemption for intrastate offerings in §3(a)(11) of the Securities Act of 1933, 15 U.S.C. §77c(a)(11), and SEC Rule 147, 17 C.F.R. §230.147.

(c) Securities Offering up to $5,000,000. The

5 Ga. Comp. R. & Regs. r. 590-4-2-.08(5) prohibits any "individual" representing an issuer from (a) offering investment advice or recommendations, (b) soliciting purchases, sales, or offers to purchase the securities, (c) compensating employees, agents, or other persons for the solicitation of purchases, sales, or offers to purchase the securities, or (d) taking custody of investor funds or securities. Review of Exchange Act Rule 3a4-1, 17 C.F.R. §240.3a4-1, should also be made for determination whether federal broker-dealer registration may be required.

sum of all cash and other consideration to be received does not exceed $5,000,000.

(d) $10,000 Cap on Investment from Non-Accredited Investors. The issuer shall not accept more than $10,000 from any single purchaser unless the purchaser is an accredited investor as defined by Rule 501 of SEC regulation D, 17 C.F.R. §230.501.

(e) Use of Bank Escrow Agent. All funds received from investors are to be deposited into a bank or depository institution authorized to do business in Georgia, and all the funds shall be used in accordance with representations made to investors.

(f) Filing of Form GA-1. Before the use of any general solicitation or the twenty-fifth (25th) sale of the security, whichever occurs first, the issuer shall file a notice on Form GA-1 with the Commissioner of Securities.

(g) Not an Investment Company or Publicly-Traded Company. The issuer shall not be, either before or as a result of the offering, an investment company as defined in §3 of the Investment Company Act of 1940, 15 U.S.C. §80a-3, or subject to the reporting requirements of §13 or §15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §78m and §78o(d).

(h) Notice of Reliance on Exemption and Resale Restrictions. The issuer shall inform all purchasers that the securities have not been registered and that the securities are subject to the limitation on resales contained in subsection (e) of SEC Rule 147, 17 C.F.R. §230.147(e).

PRACTITIONER DISCUSSION

The Invest Georgia Exemption is a valuable tool for the small business owner in Georgia. It has historically been difficult for smaller companies to raise capital because of the time and expense associated with the filing of a state or federal registration statement and the disproportionate cost in comparison to the amount of funds to be raised. However, without the filing of a registration statement, the company would then generally be prohibited from publicly soliciting the availability of its securities. In practice, the issuer, which would rarely be able to attract the interest of a registered securities broker-dealer to help place the securities, would then be required to draft private placement documentation and then pre-qualify each person as accredited before making either an offer or sale. The result of this structure was that a broker-dealer could not be engaged to help provide an investor base and the issuer would have substantial challenges in developing their own in compliance with the law.

For smaller companies that can limit their operations to the State of Georgia, the Invest Georgia Exemption is an attractive option. The five million dollar ($5,000,000) limit provides sufficient capital to form and develop many of the local types of businesses for which the exemption was specifically adopted. The availability of public solicitation allows the company to also make their offering known and this would permit the use of websites, radio, television, and many other mediums in promoting the securities. Unlike the federal exemption available under Rule 506(c) of Regulation D, 17 C.F.R. §230.506(c), the issuer is not subjected to heightened verification requirements and therefore, the investor is not forced to divulge personal financial information as a condition of investing. The permission to accepted nominal investment (ie. $10,000) from non-accredited investors is also helpful as it allows the general community to participate in the company's growth and thereby build a larger shareholder base. In contrast to other states and the federal crowdfunding rules, Georgia does not appear to require the use of an intermediary portal and thereby allows the issuer to maintain substantial control in the manner in which the offering is made. In summary, the Invest Georgia Exemption is a valuable tool for the legitimate business operator to develop their business in Georgia and without seeking more traditional forms of financing.

ABOUT THE GROUP AND THE AUTHOR

This memorandum is presented by the Securities Practice Division of the Convergent Capital Group. Convergent Private Equity Partners was created with a focus on growth-stage companies and for the provision of technical guidance in the business development for limited industry sectors, including retail, hospitality, and multi-family or commercial / industrial real estate. The affiliated law firms focus on structuring securities and other complex commercial transactions and then also civil litigation, including civil securities suits and regulatory enforcement matters.

Michael Stegawski serves as our team's leader and oversees the creation and retention of client relationships and the success of any projects we undertake. Michael is an internationally admitted attorney who currently heads both the transactional and litigation groups of our affiliated law firms. He has served in a variety of roles in venture capital and private equity, private wealth management, and investment banking; in addition to his involvement in both legal transactional and litigation matters. Prior litigation experience has included civil and regulatory securities fraud defense, shareholder common fund and derivative litigation, cross-border securities fraud, and a variety of complex commercial litigation. Mr. Stegawski has also guided both private and public companies, including registered and exempted financial institutions, through matters such as corporate governance, financial reporting and disclosure, regulatory disciplinary proceedings and investigations, and the preparation of both private and public securities offering documentation. Michael founded the Convergent Capital Group and, in addition to the practice of law, formerly served as the chief executive officer of a SEC registered broker-dealer, where he oversaw operations in the private placement of securities and merger and acquisition advisory activities. Michael is admitted to practice law in the States of Florida and Georgia and is admitted to appear before the United States District Courts for the Southern, Middle, and Northern Districts of Florida, Middle and Northern Districts of Georgia, District of Colorado, as well as the United States Court of Appeals for the Eighth and Eleventh Judicial Circuits. Stegawski has also made special appearances in the United States District Courts for the District of Utah and the Central District of California. Internationally, Mr. Stegawski is admitted to practice law as a solicitor in England and Wales (currently non-practising). Michael received his bachelor's degree in finance from Wake Forest University and juris doctorate from the Georgia State University College of Law.

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