Capital raising considerations (Part 4)

By Daniel A. Cotter | September 7, 2016

We began by reviewing the governing documents and now you should understand how your startup is organized, what form of entity it is, and how the startup was originally capitalized. You can now review capital structure in more detail and have an understanding of the capital position and needs of your startup. You will then be able to advise your employer as it considers how to raise capital.

In light of the complexities of securities law and Securities and Exchange Commission reporting obligations, as well as the need to comply with the applicable securities regulations and rules, this article touches on only some of the options available to your startup but does not outline all of the factors that go into the decision-making process, nor can it describe all of the rules applicable to each alternative that you may consider for your startup.

CURRENT OWNERSHIP OF YOUR STARTUP

Your review of your startup's governing documents gave you an understanding of its corporate form and ownership structure. If the startup is an LLC, each member's capital position will be reflected in either the startup's operating agreement or capital account.

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If the startup is a corporation, the stock certificates will show the number of shares owned by each shareholder. Review your company's financials and governing documents to ensure that amounts listed as being paid for the ownership interests was in fact paid to your company.

Failure to do so, at least with regard to the purchase of stock, could result in unlimited liability by that shareholder to the startup's creditors. At least one state supreme court has held that a shareholder will be held liable to corporate creditors if the shareholder did not actually pay the company for the stock. See Hanewald v. Bryan's Inc., 429 N.W.2d 414 (N.D. 1988).

INITIAL PUBLIC OFFERING

Your company may be planning to go public through an initial public offering ("IPO"). If so, you will have a lot of work to do to make sure your startup is ready to have its stock publicly traded.

This includes reviewing your company's accounting and financial statements with your accounting team to ensure there are no surprises or material issues, reviewing your current infrastructure to confirm your startup is ready to comply with quarterly reporting requirements and to file ownership statements, and making sure the company otherwise has a strong compliance program.

On April 5, 2012, President Obama signed The Jumpstart Our Business Startups Act ("The JOBS Act"), which encourages the funding of smaller businesses (revenues less than $1 billion annually) through eased filing and reporting requirements. Title III of The JOBS Act governs crowdfunding and provides for certain exemptions from the registration requirements under the securities laws (see below for the activity at the state level regarding crowdfunding).

The federal government has been slow to implement regulations for Title III, but states have been actively addressing the issue by implementation statues and regulations for their residents. Your company, if it chooses to go public, will likely fall within the revenues threshold of The JOBS Act.

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PRIVATE PLACEMENTS

Rather than becoming a publicly traded company, your startup may decide to raise capital but remain a privately held company. If it chooses this option, you need to be aware of the requirements of, and understand the items that will go into, a private placement memorandum or subscription agreement.

You should need to be aware of the requirements of the Securities Act of 1933 and Regulation D, which provides three rules under which a company may be exempted from filing the securities with the SEC. You will have to determine whether your company's offer falls within any of these exemptions and what other restrictions may apply.

You may also need to submit a filing with both the SEC and with your state's securities department. Restrictions on who may invest, on advertising, and on solicitation may also apply. If your startup chooses this option, you need to completely understand the plans and documentation and make sure that it fits within the appropriate exemption.

ALTERNATIVES TO TRADITIONAL CAPITAL RAISING

In recent years, several alternatives to traditional capital raising have emerged. One is crowdsourcing and the other is crowdfunding. Both are discussed below.

Crowdsourcing:

Crowdsourcing is a means for startups to publicly fundraise. People can review your project and donate or pledge money toward your startup.

Depending on the amount pledged or donated, the participants typically receive something of value, other than an ownership interest, in return from your company.

The two best known crowdsourcing sites are Kickstarter and Indiegogo. Kickstarter focuses on crowdsourcing for creative projects whereas Indiegogo has a far broader scope.

If your startup is seeking financing in order to produce a tangible product, crowdsourcing may be an effective means for your company to raise that money.

Intrastate crowdfunding:

Another option for raising capital is intrastate crowdfunding. While the SEC took its time to implement Title III of the JOBS Act, states were busy introducing exemptions that apply when the offering is limited to that state's residents.

As of April 2016, at least 30 jurisdictions have enacted intrastate crowdfunding exemption legislation. These laws permit a startup to raise capital from its state's residents with relaxed reporting requirements and fewer restrictions.

Some states, such as Illinois, do not require that the investors in the offering be limited to "accredited investors," permitting a broader range of individuals to participate in the crowdfunding effort.

An individual accredited investor is defined under federal law to include:

> (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 [excluding primary residence and certain indebtedness].
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> (6) Any natural person who 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.
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> *17 CFR 230.501(a)(5) and (6).

Some of the Regulation D exemptions require that all, or a large percentage of, the stock or units sold to the public be sold to accredited investors. Unlike the crowdsourcing campaigns referenced above, where individuals donate funds to the startup in exchange for a thank-you gift, intrastate crowdfunding is a true investment by the individuals who participate.

Each contributor under the crowdfunding campaign receives debt of, or equity in, the startup.

When it comes to capital raising, you have many decisions to make and will have an opportunity to inform and guide your startup's management. The main driver will be your startup's need for capital - does it need the capital to hire more employees, to develop or produce its product or service, or to expand?

You should ask detailed questions and understand the plans of your senior management team to be able to give informed advice about the options available and what might work best for your startup.

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