Intrastate Crowdfunded Offerings

How to ensure integrity with the SEC

Small businesses, the best engine for job creation, need to raise capital to launch and grow. However, current securities laws make it difficult to raise funds for small businesses. Federal and state laws dating from the 1930s generally prohibit companies from selling stock by soliciting investment from the public via any kind of broadcast method, known as a general solicitation.

These problems, well articulated in the article "The SEC's Inglorious Role in Limiting Small Business's Access to Capital,"[1] have led to a new form of fund-raising called crowdfunding, which reaches out to potential funding sources via the Internet, and in particular social networks.

Crowdfunding advocates have had to find ways around those laws, primarily by avoiding the actual selling of stock and instead raising money through donations, pre-sale of product and the like. Nonetheless, crowdfunding could produce much larger benefits if the laws were modified to allow for selling stock through general solicitations.

After many years of complaints by the small business community about the general solicitation ban, Congress finally took notice and passed the 2012 Jumpstart Our Business Startups Act or "JOBS Act" that authorizes a federal version of crowdfunding. But to date, nobody has been allowed to use it because Congress mandated that the SEC define implementation rules and the Commission has so far not done so. And many are pessimistic that the eventual result will fall far short of what small businesses need.

Yet interest in using crowdfunding to sell stock is growing quickly and proponents are looking for ways to get started without having to wait for the SEC. As a consequence, they are turning their attention to an alternative already on the books in many states — those 1930s federal securities laws made special provision for the states to define their own rules for securities sold exclusively within each state.

INTRASTATE OFFERINGS

Such offerings are called intrastate offerings wherein stocks and bonds (securities) are sold by companies located in a particular state exclusively to residents in that state. As long as certain guidelines are followed by the companies making these offerings, states have sole discretion to establish their own regulations on such things as to whom those securities can be sold (e.g., accredited versus non-accredited investors), how large the offerings can be, and whether the offering company can solicit investments via a general solicitation.

It turns out that a number of states already have rules that map closely to the kind of crowdfunding elements that the small business community wants. For example, Michigan adopted the Uniform Securities Act (along with Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin and the U.S. Virgin Islands) and the Act's provisions set the tone for our desired crowdfunding objectives.

Michigan's current intrastate offerings fall under a category called Registration by Qualification. A careful reading of those statutes reveals that Michigan does not limit to whom those securities can be sold (e.g., no requirement to be an accredited

investor), does not prohibit general solicitations, or limit the size of the offering. This makes for a near ideal set of conditions for a crowdfunded offering, provided that the offering company strictly adheres to the SEC guidelines for an intrastate offering. The article "Intrastate Offering Exemption" by a Michigan securities attorney explains in plain language the SEC requirements for such an offering.[2]

The article states, "The criteria for the intrastate exemption are threefold — (1) all offers and sales to investors must be made only to bona fide residents of a single state, (2) the state where offers and sales are made must be the state in which the company was organized, and (3) the company making the offering must be "doing business" within that state."

THE RESIDENCY PROBLEM

Of these three conditions, the investor residency requirement can be the most problematic. As the author points out, "It is important to note that a single offer or sale to a non-resident will defeat the availability of the exemption." And equally important, "The availability of the exemption may be lost under certain circumstances if securities offered on an intrastate basis are resold to non-residents ... the federal securities laws require that the intrastate-offered securities "come to rest" in the hands of residents ... the SEC promulgated a safe harbor rule which allows the company to assume that its securities have "come to rest" if no resales occur within nine months of the last sale made in reliance on this exemption."

If either of those two conditions occur, i.e., an initial sale to a non-resident or a subsequent resale to a non-resident before the shares come to rest, the SEC may invalidate the entire offering and require the company to return all the money it received from all the investors who invested in that particular offering. The company may even be subject to civil liability.

The burden of complying with the exemption's requirements falls on the company, not the individual investor, even if the company had nothing to do with an improper resale. It is no wonder that most securities attorneys have shied away from advising their clients to use an intrastate offering.

But with proper diligence, intrastate offerings can be done safely, by understanding the rules around state residency and the other requirements and then following the SEC's guidance and applying some standard elements of contract law.

DEFINITIONS FOR INTRASTATE OFFERINGS

Under its General Rules and Regulations Part 230.147, the SEC provides objective standards and detail on the conditions surrounding intrastate offerings, including requirements concerning the issuers, those they offer and sell their securities to, and subsequent resale of those securities (more here).

Subsection 4(c) of this Rule 147, Nature of the issuer, provides details on the issuer. Subsection 4(d), Offerees and purchasers, provides details on those who are offered the securities, those who purchase them, and what constitutes residency of the state where the offering is made. Subsection 4(e), Limitation of resales, defines the limitations on the resale of securities.

However, it is Subsection 4(f), Precautions against interstate offers and sales, that provides us with guidance on how to ensure the proper sale of securities and what the SEC expects the issuer to do to ensure their proper management. We will repeat the instructions here and provide additional steps that issuers can take to further safeguard their offerings.

> *§ 230.147 4(f) Precautions against interstate offers and sales*
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> *(1) The issuer shall, in connection with any securities sold by it pursuant to this rule:*
>
> *(i) Place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e) of this section;*
>
> *(ii) Issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities make a notation in the appropriate records of the issuer; and*
>
> *(iii) Obtain a written representation from each purchaser as to his residence.*
>
> *(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by paragraphs (f)(1) (i) and (ii) of this section.*
>
> *(3) The issuer shall, in connection with any offers, offers to sell, offers for sale or sales by*

it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of paragraphs (f)(1) (i) and (ii) and paragraph (f)(2) of this section.

Clearly, the SEC wants to make sure that any prospective purchaser is made aware of the offering's residency requirements. However, to further protect the offering company and all other participants, we would go further.

BEYOND THE SEC

1. We begin by checking with the state to determine what it requires as proof of residency. That could be a state driver's license, home ownership, a utility bill or other similar form of evidence. By following that guideline, the company begins to build a firewall to protect itself from the SEC claiming that someone is not a resident and thus overturning an offering. Its website and printed documentation should clearly state that the sale of the securities is limited to residents in that state and that no offer is being made to anyone not qualifying as a state resident.

2. The sale of the securities, and the purchase by the buyer, constitute a contract between the two parties. Contract law provides us with a means to go beyond just notifying the prospective buyer and allows us to bring the issue forward as follows.

When two parties enter into a contract, a number of elements automatically go along with the process and impact its legitimacy. For one, it is assumed that both parties fully disclose all relevant details so that both can enter into the agreement fully informed and consent to the terms and conditions presented.

If either party withholds key information that would materially change the conditions of the agreement (e.g., a substantive change that alters the nature of what is agreed to), then the party withholding that information is entering into the agreement under false pretenses. That has consequences that we will explore below. One test for this would be if the other party would unequivocally not enter into the agreement if they knew what was withheld.

Here is an example of how that might fit our circumstance. Let's say that a potential investor finds out about a particular offering and is not a resident of the state where the offering is being made but nevertheless provides the offering company with a written representation that he or she is a resident in order to buy the stock. If the company knew that the buyer was not a resident, it would not sell them the shares, so no contract would be consummated.

However, if the company did not know that the buyer was not a resident and inadvertently sold them the shares, the SEC would have the right to overturn not only that transaction, but the entire offering, a legal and financial catastrophe for the company. Lying by the buyer would have such severe consequences for the company that there is little doubt such an action would be considered as withholding material information in a manner that some states would even consider fraudulent. But companies can take several steps to avert this problem:

The company can not only make the declaration required by the SEC, but specifically address in writing in the purchase contract the extreme injury that misrepresentation on the part of a buyer could have on the company.

The contract can also state that such misrepresentation is grounds for either determining that the original contract is immediately null and void upon discovery (meaning canceled as though it never happened), or voidable[3] with legal action on the part of the company (varies by state law which applies).[4] In either case, the company can also include language stating that immediately upon discovery of such misrepresentation, the buyer agrees that the shares issued are immediately canceled and no longer represent an ownership interest in the company.

Void Contract

In the case of a void contract, the SEC would be hard pressed to claim a violation of its exemption rules since legally the contract never took place and thus the sale did not occur. They might try to make a case that an "offer" was made to an out-of-state resident, but the company could claim that its website and all relevant literature clearly states that the offering is only being made to residents of that state.

Voidable Contract

This may be a little more problematic. According to legal convention, a voidable contract is considered to have actually been established and later canceled by one party, in this case the company, when it discovers that the buyer was not a state resident. It would be helpful for the company to include in its purchase contract wording that states that misrepresentation of residency by a buyer is an automatically voidable breach of the contract and that the company need only notify the buyer of the discovery resulting in the cancellation of the contract, the shares and the forfeiture of the investment.

The shareholder further agrees to forfeit any investment as the minimal liquidated damages for the

material breach reflected in the misrepresentation, along with the option on the part of the company to pursue further damages against the buyer in civil court. Thus, if an out-of-state buyer succeeds in purchasing shares from the company and the company finds out about it, those shares are canceled and the buyer forfeits their investment.

The company can use a similar approach to dealing with the improper resale of shares to an out-of-state buyer. The contract can explicitly prohibit such transfers and call for the immediate cancelation of the shares in question if it is discovered that they have been improperly transferred to an inappropriate party and call for legal action that can be taken against the party initiating the transfer.

These steps can be further enhanced if the contract also calls for the issuing company and/or its transfer agent to approve all transfers, which includes some form of an affidavit by the seller and the buyer that they understand the conditions of residency and attest to being valid residents who can properly enter into the resale of the securities. The company or its transfer agent may also require that money from the transaction be held in trust and not given to the seller until the buyer provides the same kind of evidence that the company required of the original purchaser to prove their residency.

With the above steps, a company can greatly reduce its risk to a level similar to its exposure when conducting private placements of its securities, but with the benefit of reaching a much wider audience of prospective buyers and thus being able to raise the money it needs — the ultimate benefit of crowd-funded offerings..

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1. *See also http://tollefsenlaw.com/answers/The-Law/Securities/General-Solicitation.asp and http://en.wikipedia.org/wiki/Regulation_D_(SEC)*

2. *For examples, see this INC Magazine article "Off-the-Grid IPOs," for a practical example of a company in Virginia that made good use of intrastate offerings to provide owners of a private company with cash and an earlier INC Magazine article "A Scoop Of The Action" which tells the story of how Ben & Jerry's Homemade Inc. made a $600,000 public equity offering to Vermont residents to raise expansion capital for their fledgling business.*

3. *A voidable contract only becomes invalid if it is canceled by one of the two parties engaged in the contract.*

4. *See the article: "Difference Between Void and Voidable"*

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