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Board of Contributors: Crowdfunding offers great opportunities for financing — but poses pitfalls

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For the past 80 years, companies seeking to raise capital from investors have been forced to go through the expensive and arduous process of registering and selling securities, or using a private offering that could only reach limited investors. Now the Jumpstart Our Business Start-Ups (JOBS) Act is changing that by opening an entirely new option — crowdfunding.

Harnessing the social power of the Internet and the financial demands of small businesses, crowdfunding soon may be a major avenue for small business to obtain much-needed financing.

How it Works

As outlined in the JOBS Act, companies seeking crowdfunding must register with financial portals — special websites developed for seeking financing through crowdfunding. Likewise, prospective investors also must register through the website. If the investor likes a particular investment, the portal will connect the two.

For companies seeking investors, these portals vastly broaden the number of investors they can potentially reach. And, for investors, these portals give them much greater access to startups with great potential.

There are some limits provided by the new law and by proposed Securities and Exchange Commission regulations.

This includes limits on how much can be raise and invested. A company only can raise $1 million using crowdfunding during any 12-month period.

An investor whose income or net worth is less than $100,000 can invest no more than $2,000 or 5 percent of their net worth, whichever is greater. For those earning more, the limit is 10 percent of their annual income or net worth, with an upper limit of $100,000. These limits refer to the total invested in all crowdfunding investments during any 12-month period.

There are also regulations on advertising and financial disclosures. While companies can advertise, they can only do so to direct potential investors registered with the portal.

Companies must disclose the issuer's name, legal status, address and website; the names of the issuer's directors and officers and of each person holding more than 20 percent of its equity securities; a description of the issuer's business and its anticipated business plan; and, depending on the size of the company, the information one might need to be certified by the principal officer, reviewed or audited by a CPA firm.

There are regulations for the portals, too. Portals must register with the SEC, become members of a national securities organization and are responsible for significant parts of the compliance process. They cannot offer investment advice, recommendations or compensate its employees based on the volume of sales on its site.

Protection

The JOBS Act also aims to protect investors from potential fraud.

Investors who purchase a security in a crowdfunding transaction have a rescission right — the right to recover the entire investment, with interest — if the issuer made any material misstatement, whether orally or in writing, or if the issuer omitted some material information from the offering documents. For this purpose, the term "issuer" includes: the issuer's directors or partners, the issuer's principal executive officer or officers, principal financial officer and controller or principal accounting officer, and any other person who offers or sells the security.

Liability is personal and not just limited to the company.

Getting a Jumpstart

For companies interested in taking advantage of crowdfunding as a way to finance the business, now is the time to start laying the groundwork.

Start by asking why anyone would want to invest in the company and identify the exit plan.

And ask yourself whether the company ready for life as a public company. Does management really want to communicate regularly and openly with its investors and handle the telephone calls and emails from frustrated investors? Will it impact business if competitors are able to download the disclosure documents?

There will also be many practical issues to consider, such as ensuring that the financial statements and tax returns are in order and sufficient to meet the requirements applicable to the offering. And the company will need to examine its capital structure.

For example, if the company is a Subchapter S corporation or taxed as a partnership, it likely will need to become a Subchapter C corporation. The company also might need to authorize more shares, review its bylaws to ensure they are adequate and make sure the indemnification provisions for officers and directors is adequate.

There are many considerations, but this important opportunity should be examined by any small business looking for financing in today's tough market.

Crowdfunding promises to be a major new avenue for financing. But there are many potential hurdles and pitfalls. It is critical that prospective issuers consult with competent legal professionals before taking the plunge.

Linda Worton Jackson is the co-founder of Salazar Jackson, a Miami-based firm that serves individuals and businesses with all of their business needs, from acquisitions and sales to financial crisis, general litigation and financing. For start-up and emerging companies, Linda offers innovative guidance on fundamental structuring and finance issues, employment issues, and general corporate guidance.