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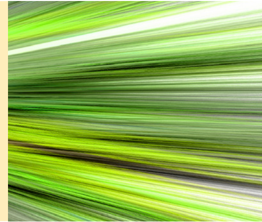

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# Taking Advantage of the JOBS Act: How a Company Can Raise Fresh Capital Without Subjecting its Directors and Officers to Suits.

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The purpose of the recently passed Jumpstart Our Business Startups Act, also known as the JOBS Act, is to make it easier for companies to raise capital—the life blood of high-growth start-ups. This Act is good news for smaller companies that want to raise capital. It also inevitably raises personal liability concerns for directors and officers of the companies raising capital. Properly addressed, however, these concerns do not have to evolve into actual problems for directors and officers.

This paper will describe the new opportunities afforded by the JOBS Act and the new and enhanced risks that directors and officers face. The paper will then enumerate specific ways to protect directors and officers and the companies they serve so that management and the board can turn to the real task at hand: raising money for and running the business.

## NEW OPPORTUNITIES

The JOBS Act lowers the cost of capital by making it easier for small companies to raise money, for private companies to remain private longer than they otherwise might, and by lowering the regulatory hurdles a company faces on the way to going public.

**Crowdfunding.** The JOBS Act specifically authorizes "crowdfunding," a new mechanism for raising capital. Within certain defined parameters, private companies will now be allowed to solicit broadly for small amounts of investment capital. In the past, federal securities law prohibited widely advertising the opportunity to invest in a private company. Social media and other evolutions in the marketplace, however, have led to the concept of allowing increased numbers of individuals—including unsophisticated investors of limited means—to invest small amounts of money in a private company. The JOBS Act now offers a path for crowdfunding to happen legally.

**Staying Private Longer.** Plenty of companies do not want to be a public company, or are frankly not ready to handle the reporting and other obligations incumbent upon a public company. However, under the old regime, a company with 500 or more securities holders was forced to become a registered public company—and thus subject to all the burdensome public disclosure filings of public companies. The magic 500 threshold was especially easy to cross for companies that had been in business for a while and had made equity grants (for example, option grants) to their employees. The JOBS Act gives most companies[2] the ability to stay private longer by raising the registration threshold from 500 securities holders to 2000 securities holders (or 500 unaccredited investors[3]). Perhaps most importantly, excluded from the securities holder count are folks who hold securities as a result of crowdfunding, so long as the crowdfunding stays within certain strictly defined parameters.[4] Also

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[2] *Banks and bank holding companies have slightly different rules.*

[3] *Under the Securities Act of 1933, an "accredited investor" is a classification of investors that has a certain defined level of assets.*

[4] *These parameters include the limitation that the crowdfunding transaction be conducted through brokers or funding portals that meet certain defined specifications; that certain information—including certain financial information—be filed with the SEC; that all securities sales (whether through crowdfunding or otherwise) within the preceding 12-month period are not more than $1 million; and that the aggregate amount sold to any investor (whether through crowdfunding or otherwise) within the preceding 12-month period does not exceed "(i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000." JOBS Act Section 302.*

excluded from the count are securities held as a result of an employee stock compensation plan that is not itself subject to registration.

*Going Public Sooner.* The upside of being a public company, of course, is enhanced access to capital. Thus, high-growth start-ups have complained bitterly as first Sarbanes-Oxley and more recently Dodd-Frank have imposed ever more regulatory burdens on public companies. The JOBS Act addresses some of these issues by affording certain "breaks" to companies that meet the definition of an Emerging Growth Company (EGC)[5] and continue to maintain that status.[6]

Perhaps one of the most notable of these breaks afforded to EGC's is the ability to file an initial registration statement—and get comments back from the SEC—on a confidential basis, and thus out of the harsh light of public scrutiny. Another benefit to going through the IPO process as an EGC is that the normal restrictions on pre-offering communications with accredited investors and qualified institutional buyers are relaxed, allowing the EGC to receive feedback from investors that would not otherwise be available. In addition, the normal restrictions on investment banks concerning publication of research on a company going public are relaxed if that company is an EGC. Other significant breaks include:

- No independent auditor attestation of internal controls over financial reporting pursuant to section 404(b) of the Sarbanes-Oxley Act;
- Requiring only two years of audited financials in a registration statement;
- Complying with new U.S. GAAP pronouncements only when they become applicable to private companies; and
- No requirement for the vote on executive compensation as would otherwise be required by Dodd-Frank.

## NEW RISKS

There are, of course, risks that come with raising capital via the JOBS Act. First, consider that under the pre-JOBS Act regime, a company was more likely to be sued within the first few years of going public than later as a more mature company.[7] Financial restatements for newly public companies are, unsurprisingly, especially worrisome given their high correlation to law suits against directors, officers, and their companies.[8] Many fast growing private companies are not well-practiced in the difficult art of closing the books and completing an audit within the unforgiving timeline required of publicly traded companies.

While the JOBS Act exempts EGCs from certain requirement that have been known to cause law suits—for example the "say on pay" provisions of Dodd-Frank—there is nothing in the law that mitigates the general liability risk that directors and officers face in terms of being a publicly traded company, especially when it comes to things like the integrity of a company's financial statements.

In addition—and relevant to both public and private companies—nothing in the JOBS Act lowers for EGCs the risk that directors and officers of all other companies face when it comes to the Section 10b5 provisions of the Securities and Exchange Act of 1934 or state corporate law. Moreover, as a result of taking advantage of the JOBS Act, an EGC may have a lot more shareholders able to bring a law suit. In addition, the Securities and Exchange Commission (SEC) will no doubt be interested in the accuracy of the disclosures made by companies using the JOBS Act to raise capital.

Finally, consider the new risks specifically presented by the newly authorized innovation of crowdfunding when it comes to liability for directors, officers, and the companies they serve. First, the JOBS Act is specific on the point that liability can arise if the disclosure surrounding a company's fund raising activities turns out to contain a material misrepresentation or omission.[9] Second, consider the strict parameters that a company must fall within in order to take advantage of crowdfunding. There is no doubt that the SEC will be looking for and bringing enforcement actions against scofflaws who attempt to circumvent the SEC's narrowly defined parameters for crowdfunding. Third, an inadvertent

[5] *An issuer qualifies as an Emerging Growth Company or EGC if it has revenues of less than $1 billion.*

[6] *A company can remain an EGC for the sooner of five years or the company has annual revenue exceeding $1 billion, achieves a market capitalization of more than $700 million, or issues more than $1 billion in non-convertible debt in a 3-year period.*

[7] *D&O Databox, Woodruff-Sawyers & Company's proprietary data base of director and officer-related litigation (2012).*

[8] *Ibid.*

[9] *JOBS Act Section 302*

violation of the crowdfunding rules could lead to counting all of the crowdfunders as regular securities holders. If this is the case, a company could find itself forced to register as a public company sooner than it had otherwise planned.

## PROTECTIONS & SOLUTIONS

Directors and officers of companies that decide to raise money via the JOBS Act can address their personal risk through: (1) corporate governance, (2) indemnification, and (3) Director & Officer Liability Insurance.

**Corporate Governance.** On the corporate governance side, even though the JOBS Act exempts EGCs from complying with all parts of Sarbanes-Oxley, management and especially the audit committee of EGCs will want to take action to ensure that they are confident in their companies' internal controls and accounting processes. Another important area of focus should be insider trading. Specifically, private companies using crowdfunding and EGCs will both have to ensure that their insiders fully understand things like insider trading and tipper/tippee liability much sooner than they otherwise might. Finally, EGCs will especially want to be sure that they have mechanisms in place that will allow information inside a company that needs to be disclosed to the public to surface in a timely way.

**Indemnification Agreements.** Officers and especially directors who decide to join EGCs as well as private companies that engage in crowdfunding should consider asking for a personal indemnification agreement. This is an agreement between a company and an individual that serves as the company's guarantee to do things like advance legal fees and pay settlements if the individual is sued in his or her capacity as a director or officer of the company.

**Director and Officer Liability Insurance.** Turning first to Director and Officer Liability Insurance ("D&O Insurance") for private companies, consider that all private company policies have some sort of exclusion for any public offering of securities. Policy wording in private company D&O policies varies significantly among insurers. Some public securities offering exclusions may be so broad as to not cover fundraising activities that private companies might undertake pursuant to the JOBS Act, such as crowdfunding. Private companies doing any kind of fund raising need to pay careful attention to the public securities offering exclusion in their D&O policy to ensure that it is not overly broad.

Turning next to pricing, historically there has been a very large delta between the cost of D&O Insurance for public and private companies. Just recently, however, insurance carriers have started to raise rates for private companies as more and more of these companies have experienced litigation. The JOBS Act is likely to accelerate this litigious trend for private companies, which may result in increased premiums for private company insurance.

D&O Insurance premiums for publicly traded EGCs should be similar to those of other small public companies. Premiums for EGCs will be higher, however, if D&O Insurance underwriters believe that EGCs as a class or an EGC in particular is more likely to get sued, for example because internal controls and audit functions do not seem ready for public scrutiny.

Putting aside cost, the most difficult issue with D&O insurance is the scope of liability coverage it affords. Working with a skilled insurance broker who specializes in this type of insurance coverage is critical. When it comes to these highly customized contracts, being with the very best carrier is no guarantee of coverage. An experienced D&O insurance broker with deep claims experience, however, can negotiate on a company's behalf to obtain coverage provisions that will go a long way to protecting the personal assets of directors and officers, as well as the balance sheets of the companies they serve.

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Questions? Comments?

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*Woodruff-Sawyer is one of the largest independent insurance brokerage firms in the nation, and is an active partner of International Benefits Network and Assurex Global. For over 90 years, Woodruff-Sawyer has been partnering with clients to implement and manage cost-effective and innovative insurance, employee benefits and risk management solutions, both nationally and abroad. Woodruff-Sawyer is headquartered in San Francisco. For general information, call 800.675.4467 or visit www.wsandco.com.*