

## Innovative Financing for Community Businesses

### Case Studies of New Approaches at the New Hampshire Community Loan Fund and the Local Enterprise Assistance Fund

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#### Introduction

Business owners seeking to start or expand a small business have limited options for financing. They can go to a bank for a loan, but they may have trouble qualifying for the loan due to the age of the business, absence of collateral, lack of equity in the business, thin margins, or other factors. While online business lenders may offer faster response times and lower underwriting hurdles, they often do so in exchange for exorbitant rates and reduced ability to customize their financing or add broader value to the business beyond the money. Business owners could try going to venture capitalists for equity, but venture capitalists and angel investors will demand some control over the company and need an exit strategy, generally requiring that the company be sold. The company might also not have a fast enough growth curve to interest a venture capitalist. Raising money through a crowdfunding platform, such as Kickstarter, is another option. But until recently, crowdfunding has been limited to raising donations, not investments, through such strategies.

These options can be good for some business owners, depending on their business goals. But for many business owners, especially those who need growth capital but might like to maintain control and ownership of their businesses for the long-term, other forms of financing are needed.

In this perspectives brief, we look at two nonprofit “alternative business financiers” who have been broadening the financing options available for community-based businesses:

- **Vested for Growth**, a product of the New Hampshire Community Loan Fund, provides businesses with a range of debt/equity hybrid financing deal structures involving any combination of debt, royalty payments that share a percentage of sales revenue for a period of time or up to a pre-determined amount, and/or warrants to purchase stock in the company. Vested for Growth shapes its capital to businesses’ needs, pricing its investments in ways that balance risk and reward. 
- The **Local Enterprise Assistance Fund (LEAF)** in Boston, Massachusetts, combines its debt financing with Direct Public Offerings (DPOs) of subordinate debt raised directly by companies from local supporters. 

These options can help businesses grow while maintaining their current ownership structure and connections to the community.

Early results from both initiatives suggest that both the borrowing businesses and community lenders can succeed with these financing strategies: businesses are getting flexible financing while maintaining control of the company, and community lenders are earning returns that help to sustain their operations.

## Vested for Growth

### The Colors of Money: How Vested for Growth Helped One New Hampshire Business Grow

In 2009, even as the nation was in the grips of the Great Recession, Bob Goldstein and Stephen Singlar were ready to grow their company, Single Digits. The firm, which provides high-speed internet software and services to clients like hotels, hospitals, office buildings, and schools, had been successful since its founding in 2003. But the CEO, Bob Goldstein, recalled that in 2009, their “growth was being hampered from lack of access to the right kind of capital.”

Single Digits had been dependent on bank financing, but banks would only offer a loan to the business based on the personal credit of the two owners. Moreover, Goldstein noted that they “didn’t have the explosive growth that venture capital firms look for.” What Single Digits did have was “a sustainable growth model that just needed fuel.”

Goldstein and Singlar had an idea to acquire a local competitor to grow their business, but they needed \$2 million for the deal. “We had dozens of meetings with banks, angel investors, and venture capital firms,” said Goldstein. “We started to get some interest from venture guys, but the valuations felt predatory and would have left us without control.”

Then Goldstein met with John Hamilton of Vested for Growth. Vested for Growth put together a financing proposal for Single Digits, but more importantly at the time, “John helped us more clearly understand the kind of financing we needed,” Goldstein remembers. “He articulated the roles of banks, mezzanine debt, royalty finance, venture capital, private equity—he helped me find ‘the right color of money.’” Single Digits ended up finding a community bank willing to provide \$1 million of senior debt if the company could raise \$1 million of subordinate debt, which it was able to do by borrowing from family and friends.

Two years later, Single Digits saw another growth opportunity to expand its services to shopping malls. This time, Goldstein and Singlar knew where to go. “We went right to Vested for Growth.”

Vested for Growth partnered with Seed Venture Financing, another fund from Massachusetts, to provide another \$1.2 million of subordinate debt. The five-year, subordinated note carried an interest rate of

12 percent, and a warrant enabling Vested for Growth to purchase stock representing 0.63 percent of the company at any point over the following ten years, at a price of \$0.01 per share. The note provided flexibility on the timing of repayment to Vested for Growth if debt service coverage were to fall below the senior lender’s required ratio of 1.20. Goldstein said that the financing “helped us maintain a 25 to 30 percent per year growth rate without having to do a ‘Shark Tank’ type of deal where we’d be giving up a majority interest in the business.”

With Vested for Growth’s financing in hand, Single Digits went on to grow revenues from \$9 million in 2011 to \$12 million in 2012. At that point, Goldstein and Singlar were ready for the big time—they successfully raised \$10 million from Tudor Growth Equity. The firm continued to pay Vested for Growth on term, and since 2011 has added 111 jobs to its payroll. In the first quarter of 2017, Tudor Growth Equity exited and was replaced with funding from Bregal Sagemount, a private equity firm.

Goldstein highlighted the role of Vested for Growth: “There was a space in time, between personally guaranteed bank debt and Tudor Growth Equity, where we needed the funding from Vested for Growth. I didn’t realize it at the time, but when we started building our business I didn’t truly understand all the different flavors of debt and equity. Vested for Growth helped me to understand all those pieces.”

### Development of the Vested for Growth Concept

Vested for Growth’s mission is to “widen the economic winners’ circle” by helping businesses grow while employing and investing in the futures of all employees, including those on the front line.

John Hamilton, Managing Director of Vested for Growth, said his team came up with the idea of expanding the financing options for New Hampshire businesses by talking to bankers and businesses. Mainstream bankers told him that there were times when they would be working with a business that they liked, but couldn’t invest in it due to regulations or bank policies. Hamilton also saw a pattern in the post-recession landscape. “There were good banks making loans, and equity investors, but not much in between,” he said. “What was needed was risk tolerant capital—there were good growth plans getting shelved because the business

owner would get turned down by a bank and say, 'I don't want equity where I have to give up control or ownership.' And so they shelved their growth plans. We wanted to give businesses a second option of living out their growth plan by having capital that would fill that gap—capital that could be risk tolerant without asking businesses to give up control or ownership.”

By providing flexible financing to these businesses, Vested for Growth helps to retain and create better jobs for all employees, including those without four-year college degrees.

The team set about building a business model that differentiates Vested for Growth from other financiers in the following ways:

- Having private capital through the New Hampshire Community Loan Fund gives Vested for Growth the flexibility to shape its financing to businesses' needs by offering a range of options that fill the gap between pure debt and pure equity products. This includes royalty financing and debt with stock warrants, which allow owners to retain control of the company. Having a customizable range of financial products means that Vested for Growth allows CEOs to make the best choice for their companies, as opposed to having to fit into one type of deal structure.
- Recognizing that businesses that invest in their front-line employees, especially in a tight labor market, outperform their peers. A good way to create better-quality jobs is to help businesses that hire lower-income people discover profitable ways to improve their recruitment, retention and workplace cultures. Vested for Growth encourages companies to engage their employees so that the workers understand how their job is connected to the business's bottom line and how their ideas can add value to the customer. A variety of progressive management methods can achieve this outcome, but each must be appropriate to the business's size, stage, and industry sector, as well as the company's leadership style. It may include profit sharing, “open book management,” financial-literacy training, or cross-training to support skill-based pay. Hamilton said that “the powerful part is that this is a ‘win/win’ strategy that leads to the growth of the business, because it helps create a more-engaged and-committed employee who, in turn, is able to develop more loyal customers.”
- Combining financing with a variety of customized business-education options, including the formation of advisory boards, participation in CEO peer groups, and connections to expert business coaches to support the company's success.
- Focusing on companies with \$1 million to \$30 million in revenue and deals of \$1 million or less. Vested for Growth believes that this market is underserved by institutional investors. While it is traditionally territory for angel investors, these investors are largely focused on early-stage or start-up companies and often limit themselves to the high-tech field and companies that are considered hyper-growth.
- Focusing on earning steady returns from companies with solid growth plans—as opposed to “chasing gazelles,” as Hamilton describes the venture capital strategy of buying companies with explosive growth—then selling them to new owners. Based on its financial modeling, Vested for Growth set a goal of least four deals a year with an average size of \$200,000 and an average return of 15 percent, which allows it to cover its expenses on a self-sufficient basis (without dependence on grants). This pricing is relatively inexpensive compared to pure equity. Since both royalties and interest are tax-deductible expenses, after-tax financing expenses to businesses would be in the range of 12 to 14 percent.

### How It Works

The kind of financing Hamilton envisioned exists on Wall Street. It is called mezzanine financing. Hamilton said that the problem in mezzanine funding is that it is “easy to get in big bites of \$300 million dollars, but not if you want \$300,000.” Vested for Growth set about finding a way to “bring mezzanine financing from Wall Street to Main Street.”

The way in which Vested for Growth accomplished this goal was to develop a suite of financing tools that blend debt and equity characteristics:

- **Debt with royalty financing** involves a company providing debt payments plus a percentage of its gross sales as a way of repaying an investment. For example, Vested for Growth helped entrepreneur Stephane Anglade purchase and grow Comstock Industries, a precision machine shop in Meredith,



New Hampshire, when its founder decided to sell. Vested for Growth provided an unsecured investment of \$400,000. The investment carried an interest rate of 8 percent. On top of that interest rate, Comstock Industries also agreed to pay a royalty of 0.25 percent of the monthly gross sales of the company, until its aggregate royalty payments to Vested for Growth totaled \$150,000 or until 5 years after the loan closed, whichever came sooner.

To promote its mission, Vested for Growth also provides a “good driver” discount, whereby a portion of the royalty payment is rebated if the company achieves a different stretch goal every year related to employee engagement. Under this program, Anglade and Vested for Growth worked together to identify a goal of increasing participation in Comstock Industry’s 401(k) plan from 20 percent to 50 percent. By achieving the goal, Comstock received a refund of 25 percent of the royalty payments it was making to Vested for Growth. Anglade said that they got “a good recruiting tool from having the best 401(k) plan out there.” Anglade also appreciated that under Vested for Growth’s financing structure, there is no prepayment penalty on the loan.

- **Debt with equity warrants** involves a company providing stock options as a way of sharing upside with an investor, who will also charge some interest rate to provide a floor for their return. Vested for Growth’s investment in Single Digits is an example of such a deal.
- **Debt plus royalty and warrant financing** contain elements of both of the options above. An example is a \$500,000 subordinated debt investment Vested for Growth provided to VXI, a headset manufacturer in Rollinsford, New Hampshire, in 2009. The investment carried a fixed interest rate for five years, a royalty payment of 0.25 percent of monthly gross sales, and stock warrants for a small percent of the company. Tom Manero, former CFO of VXI, said, “We would not have been able to raise this financing from a bank—our senior lender had already extended as much as they could do within their normal parameters. We talked to other alternative lenders and mezzanine providers—but they could not be flexible or creative with their financing. Vested for Growth had more patient capital, was easier to work with, and more flexible.” VXI paid off the loan in 2012, and was sold to a competitor in October 2016.

**FIGURE 1. VXI EMPLOYEES AT WORK**



Photo courtesy of NH Community Loan Fund

**Pure Royalty** is another approach that includes no debt or fixed monthly payment. All the return comes as a percentage of revenue paid monthly until the aggregate of all payments equals the multiplier (such as 1.5 to 3 times the original investment). This is particularly useful in mergers and acquisitions in which there is some short-term uncertainty. This “shock absorber” allows a business to pay in accordance to how well it is performing. This also helps when the company is so optimistic about its future growth of sales that it wants to cap the overall return.

These innovative offerings accompany more traditional business loans and investments that the New Hampshire Community Loan Fund makes, including subordinate and senior debt, and pure equity investments.

Vested for Growth works with business owners to determine the best way to structure the financing to meet their goals while providing a return that matches the level of risk in the investment.

For example, one client, Rustic Crust, anticipated fast growth in sales and profits through natural foods retailers for its ready-made pizza crusts, pizza sauces, and flatbreads. Rather than share royalties or stock warrants with Vested for Growth, Rustic Crust preferred to structure a debt offering with a higher interest rate reflecting the risk-adjusted return that Vested for Growth needed to make the deal work. Overall, Hamilton said, Vested for Growth’s goal is to “provide a suite of financing tools so that a company can create its own future based on its own agenda,” rather than having to bend to the interests of outside investors.

Vested for Growth's offerings are varied and flexible. As such, Vested for Growth works with business owners at the outset of any project to explore all the financing options and structure the best deal. "As happened at first in the case of Single Digits, sometimes that may even mean a financing structure that doesn't involve Vested for Growth," notes Hamilton, "but we are still happy to help."

Additional business education may include referrals to a network of specialized consultants, help in building advisory boards, connections to peer groups of other business leaders in similar industries, growth plan analysis to refinance, and risk evaluations. Stephane Anglade of Comstock Industries said that the biggest advantage of working with Vested for Growth "was not the financing, it was the other ways that Vested for Growth helped me—connecting me to people in the community, inviting me to join a peer group of business owners, and helping me qualitatively improve the 401(k) plan."

Hamilton emphasizes that "a good investor doesn't just provide capital—they work to make that company much more successful. That's why our investment is [often] structured as a percentage instead of interest—so we are truly in this together."

Business owners agree that Vested for Growth has been truly on their side. Tom Manero, former VXI CFO, said that "Vested for Growth had a very different focus from other lenders—they were much more focused on the long-term viability of the company and how they could support it. The number one thing for Vested for Growth was, 'Is the company doing well and taking care of its employees?' They wanted to get paid back, and the best way to accomplish that was to help businesses grow their companies by growing their people."

In the event of a default, Hamilton said that they "seek to first understand what caused the default and then to find a way to help the business to address the systemic issue so that it gets resolved and the right lessons are learned. This sometimes involves our enlisting value added business consultants or advisors to support the analysis and process. Doing this also helps alleviate senior lender concerns and they tend to be more patient as a result. Patience and flexibility is often key, and as long as the company is being diligent and focused, we find that to be useful."

## Results to Date

Since 2009, Vested for Growth has provided \$5.67 million to twelve companies, impacting 842 jobs and helping to create 338 new jobs. This statistic does not include traditional debt or equity investments in businesses by Vested for Growth's parent corporation, the New Hampshire Community Loan Fund, which has provided businesses with an additional \$12 million in the past three years through its Business Builder lending program. Overall, Vested for Growth has earned a 14.2 percent internal rate of return on its investments to date net of losses (before operating expenses and cost of funds).

Clearly, Vested for Growth is not the least costly funding source—bank debt is the best option for that—but business owners report that they received good value for their financing. Tom Manero of VXI said that "Vested for Growth was instrumental in helping the company to grow." Stephane Anglade of Comstock Industries noted that the process of negotiating the investment was more difficult and costly for him and his primary lender than expected, particularly around the risk mitigation of Vested for Growth's unsecured investment, but that Vested for Growth is "a very viable financing option, all of that said—in hindsight it was a good deal and the rate was fair."

As can be seen from the case studies, not all of the companies financed by Vested for Growth have stayed under local ownership. "We realize that companies can be sold and we don't prohibit that option when we invest," Hamilton said. "We do take steps to maximize the retention of good jobs. First, we do not use traditional equity in order to avoid adding any incentive or need for the company to sell. One of the best ways to keep the business rooted is to have the team operate at peak efficiency, outperforming their industry peers. This is where we focus our efforts after closing to reduce the likelihood that a new buyer would risk uprooting the team and undermine smooth operations. We also anticipate the possibility of a sale and advocate putting some structured incentive in place so that front-line employees share in the 'upside.' We do this through a variety of means, including severance/stock packages, etc. Given the tight labor market, we have found that it is easier to negotiate this into deals because it helps with retention."

Based on his experience financing Single Digits, Bob Goldstein recommends reaching out to a group like Vested for Growth. “If you have a solid business that is growing, it is always worth your time to have a conversation with a group like Vested for Growth—they will sit down with you for an hour or two and help you understand what financing structures are in the market where you fit. They’ll be honest with you—you never know with banks and venture capital whether they have your interests in mind or only their own.”

## Direct Public Offerings

### Direct Public Offerings: The Story of Wellspring Cooperative Corporation and the Wellspring Harvest Greenhouse

Wellspring Cooperative Corporation helps to incubate and grow worker-owned businesses in Springfield, Massachusetts, in partnership with large local employers, such as the University of Massachusetts, local public school systems, and Bay State Health, a regional hospital. Wellspring works with these “anchor institutions” to develop local, worker-owned businesses that meet their purchasing needs.

One such opportunity that Wellspring identified was an interest from the anchor institutions in purchasing local food. After reviewing several options for local food businesses, Wellspring identified the opportunity to develop a greenhouse that could grow fresh greens and herbs year-round. Wellspring developed a business plan for “Wellspring Harvest,” working with

a local hydroponic grower who helped with technical details and meeting with the anchor institutions and a local supermarket chain, Big Y, to determine the right mix of crops to grow. Fred Rose, co-director of the Wellspring Cooperative Corporation, recalls that one of the hardest parts of starting the business was “finding two acres of undeveloped, non-polluted, affordable land in Springfield—but we did it,” ultimately signing a purchase and sale agreement for a site owned by the Springfield Redevelopment Authority (SRA).

There was just one hitch. Wellspring needed to raise \$900,000 to close on the land and build the greenhouse. The clock was ticking on this financing as well, since the SRA was only willing to tie up the land for a limited amount of time and required that Wellspring Harvest put down a \$5,000 non-refundable deposit per month to keep the purchase option alive. Rose reached out to LEAF, a nonprofit loan fund based in Boston whose mission is to “provide financing and development assistance to cooperatives and social purpose ventures that create and save jobs for low-income people.”

Gerardo Espinoza, the Executive Director of LEAF, was excited about the project. “There were a number of attractive elements,” he related, “it was a worker cooperative, the location was in Springfield in a low-income area, and the group had a social justice philosophy. Also, this was more than just one play—Wellspring is looking to develop many more worker co-ops in Springfield.” LEAF helped Wellspring to refine the business plan and delve into the numbers. Rose said that “LEAF really helped us think through the equity requirements and to connect to other lenders, understanding what we needed to raise.” LEAF and Coastal Enterprises Inc., another alternative financier, were willing to provide \$500,000 of senior debt to finance the project, but only if Wellspring could raise \$400,000 in subordinate financing still to raise for the project to go forward.

Wellspring had also worked in the past with a local investment advisor, Robert Zevin, who specializes in working with wealthy clients interested in “impact investing,” double-bottom-line deals where investors could receive a financial return while helping to generate a positive social impact for their community. Zevin believed that some of his clients might be interested in purchasing shares of preferred equity in the greenhouse business. However, as Wellspring and Zevin worked together to further assess interest from these prospective investors, Rose realized that they “would not raise enough equity to satisfy lenders.”

**FIGURE 2. LEAF-WELLSPRING COLLABORATION**



Photo courtesy of the Local Enterprise Assistance Fund



Espinoza had an idea for Wellspring. LEAF had provided loans to several other businesses in Massachusetts that had raised subordinate financing through a DPO. With a DPO, a company offers an investment directly to the public, instead of through a Wall Street intermediary. “We came in kicking and screaming, because this was new territory for us,” said Rose. “The DPOs we knew of, like Artisan Beverage—they had an existing base of customers who already liked their product, from whom they could raise the funds. We didn’t know how well it would go.” On the other hand, according to Rose, “it seemed like the only alternative.” Wellspring didn’t have relationships with angel investors or venture capitalists, but more to the point, it could neither pay these investors the returns they would have demanded, nor could it offer them decision-making power in what was to be a worker-run cooperative. “All of our lenders and investors are mission driven,” said Rose. “We didn’t know of other conventional lenders or investors who would do this deal.”

Wellspring worked with LEAF, DPO consultant Jenny Kassan, and Robert Zevin to devise and execute a capitalization plan for the needed subordinated financing. The idea was to raise two tiers of funds: \$150,000 in preferred equity and \$250,000 from a DPO of subordinated debt.

- The preferred equity would be raised from socially responsible investors—generally high-net-worth individuals working with investment advisors and wealth management firms. In general, the term “preferred equity” refers to an equity instrument that may take on some characteristics of debt. In this case, the preferred equity carried a fixed return for investors of 3 percent. For the first five years of the cooperative, the return would accrue to investors but not be paid out in cash. Starting in year five, Wellspring would pay back the investors out of its earnings—over time, replacing the preferred equity with worker-owned cooperative stock shares. During this five-year redemption period, the investors would receive a higher yield, of 6 percent, on their outstanding capital—thus providing the investors with a total internal rate of return over a ten-year period of about 4 percent. Beyond this return, preferred equity shareholders would receive a dividend if the co-op made income in excess of \$50,000 a year. The amount of the dividend would be one-third of the excess income over \$50,000, distributed equally among all preferred shares.

- The most junior financing in the deal structure would be a DPO of subordinated debt, marketed to small, retail investors as well as high-net-worth investors. The DPO investment would pay investors a return of 3 percent over a term of five years. However, investors would be required to write Wellspring to request to take out their money, otherwise the investment would roll over and remain in the company. Also, interest payments for the first two years of the loan would be deferred and paid to investors upon redemption of the note. The minimum investment was \$5,000 for qualified investors and \$1,000 for any investor. According to Amine Benali, Director of Strategy and Development at LEAF, the low return was “designed to target people or investors who wanted to express views toward the mission of the greenhouse, secondary to financial return.”

A DPO is a type of financial security, and as such is subject to federal and state securities regulations. “As a for-profit in Massachusetts,” noted Rose, “it would take us six months to go through the state securities registration process.” But the purchase and sale agreement Wellspring signed with the SRA for the land had an expiration date on it—Wellspring didn’t have six months to raise the money. Nonprofits, however, are exempt from federal securities law and from state securities law in Massachusetts, and investments in Wellspring Harvest would be furthering a charitable mission of creating jobs for low-income workers. “So we formed a nonprofit,” Rose related, “creating the Wellspring Investment Fund that we spun off as an affiliated nonprofit with the Wellspring Cooperative Corporation. This entity is what issued the DPO. That meant that our nonprofit was taking on financial responsibility for this investment. The board of our nonprofit would become accountable, so we did a lot of work to make sure the risks were manageable.”

Consultant Jenny Kassan prepared a detailed Prospectus for the DPO, describing the offer of unsecured promissory notes, the Wellspring Harvest business plan, and the anticipated social impacts. The Prospectus also reviewed risk factors and investor suitability issues, such as the fact that the notes were unrated, unsecured, and uninsured; investments were not liquid (no secondary market exists to sell one’s DPO investment in Wellspring Harvest to other investors); note holders would not exercise any

management control over the Wellspring Investment Fund or the Wellspring Harvest greenhouse business; and neither the federal Securities and Exchange Commission (SEC) nor state securities regulators had reviewed the offering. Due to the use of nonprofit exemptions from state securities laws, the offering was limited to investors in Massachusetts and Connecticut (state securities laws on nonprofit securities offerings can vary significantly). According to Espinoza at LEAF, the legal costs for Wellspring to put together the documentation were \$5,000.

While Zevin connected clients interested in the project with Wellspring to purchase preferred equity, Fred Rose and Wellspring's other co-director, Emily Kawano, set out to market their DPO. Rose said that "the individuals who did the DPO were much more local. Many of them were folks we knew who had an interest in local development; they were putting in their \$1,000 or \$5,000 to impact their community." Wellspring also had a number of events both in the Springfield area and in Boston with prospective investors.

At the end of six months, Wellspring had raised \$253,000 from forty-nine investors for its DPO, as well as \$150,000 in preferred equity. Two investors made large DPO purchases. One individual invested \$40,000, and a local foundation, The Beveridge Family Foundation, put in \$35,000. Beveridge's investment qualified as a "program related investment" that counted toward the foundation's charitable giving requirements. But Wellspring also had many investors participating at smaller levels: twenty-one investors at the minimum of \$1,000, and another twenty investors between \$1,500 and \$9,999. The median investment across all investors was \$2,000.

In May 2017, Wellspring realized that cost increases in the greenhouse site development required the business to raise an additional \$150,000 for operating capital. The Wellspring Investment Fund reopened the DPO to raise half of these funds, which are being matched by additional loans. As of mid-August 2017, 80 percent of these additional DPO funds have been raised.

Wellspring has become an enthusiastic supporter of public offerings based on its experiences over the past year. "We have been enormously impressed by the number of people who want to invest their money in making their community a better place," concluded Rose. "We never would have known that if we hadn't taken the risk to put together the DPO. This kind of subordinate debt is the key to financing community development projects and makes the whole rest of the financing possible."

## How DPOs Work

One way of understanding a DPO is by contrasting it with an Initial Public Offering (IPO), which is the way that companies raise money by selling stocks on Wall Street.

- One key difference between a DPO and an IPO is that no intermediary agencies handle the issuance of the investment opportunity—the company is reaching out directly to potential investors. Thus, the costs of intermediation are reduced—although the company also must then market the security itself, or obtain help to do so.
- A key advantage of approaching investors directly is that the terms of the DPO can be structured in such a way as to maintain control of the company. This advantage is especially important when the company is community-based or worker-owned and remaining that way is critical to the mission of the company, as was the case with Wellspring Harvest.
- As is clear from the Wellspring Harvest story, DPOs do not have to be issuances of stock. A DPO can be made of any kind of security—debt, equity, or debt/equity hybrids such as royalty notes, convertible debt, or debt with equity kickers (like warrants). A business can thus structure the terms of financing offered in a DPO in exactly the way that works best for its business plan.

Regulatory burdens can be significantly lower for a DPO. Generally, securities offerings are subject to a number of federal laws and regulations, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, Regulation D of the federal Securities Exchange Commission, and numerous other laws and regulations, as well as state "blue sky" securities laws and regulations. However, there are a number of factors that DPOs can take advantage of to achieve a smoother path to issuance.<sup>1</sup> These include:

- A nonprofit issuer can be exempt from both federal and state securities laws, depending on the regulations of the specific state they are in (as was the case for Wellspring Harvest).
- The Jumpstart Our Business Startups Act (JOBS Act) was passed in 2012 with SEC rules allowing "regulation crowdfunding" going into effect in 2016. The rules exempt companies from federal securities registration requirements when they sell



less than \$1 million of securities in a year, provided they meet certain other conditions, and permit individual investors with incomes of less than \$100,000 to invest up to the greater of \$2,000 or 5 percent of their annual income. A business may also obtain an exemption from federal securities laws if it limits its offering to just one state.

In all cases, businesses should still consult with professional legal advice to ensure that they structure their DPO properly to comply with applicable laws and regulations. Businesses will still need to take care to provide clear and adequate information to potential investors, and comply with anti-fraud laws and regulations.

Another way of understanding a DPO is thinking of it as “crowdfunding a security.” With the passage of the JOBS Act, as described above, this strategy is now a bona fide business financing option. Moreover, the JOBS Act also provides for the development of online platforms through which DPOs can be marketed, with guidance that the operators of such platforms must follow.

### Other Examples of DPOs

In New England, other companies using DPOs to raise capital have included (but are not limited to):

- Democracy Brewing, which is raising \$350,000 in preferred equity at a targeted 5 percent return through stock dividends, has a goal to purchase shares back from investors within five years.<sup>2</sup>
- Cero, a composting and recycling worker cooperative in Dorchester, Massachusetts, which raised \$340,000 from eighty-three investors, has investments ranging between \$2,500 to \$25,000.<sup>3</sup> LEAF was among the investors in this DPO.
- In Vermont, an initiative of VSECU Credit Union called “Milk Money” provides a platform for potential investors to view DPO offerings from Vermont companies.<sup>4</sup>

## Conclusion: Advice for Business Owners and Alternative Financiers

Business owners seeking to finance business start-up and acquisition should be aware of a broad range of different “colors of money” that are available to them. As they develop their capitalization strategy, owners should consider the following factors that can impact the appropriateness of different financing options:

- Their own goals vis-à-vis long-term ownership of the company versus eventual sale to new owners
- Goals for retaining control of the company, including whether the company envisions itself as a community-based or worker-owned business
- Degree of support and connections the company may have with prospective small investors in the community
- Willingness of the company to directly engage in marketing investment opportunities to the community
- Size of the investment needed
- Amount of the investment that can be covered through senior debt, given projected cash flow and valuation of the company
- Willingness of the company to share sales revenues or an ownership stake in the company as a way of obtaining growth financing
- Bandwidth of the company to engage in more complex legal work and deal structuring negotiations

Alternative financiers, such as nonprofit Community Development Financial Institution loan funds, can play important roles in broadening the palette of financing options available to community businesses. If supporting the growth of local community businesses is their mission, these financing organizations may want to consider:

- Developing hybrid debt-equity products to fill the needs for equity-like financing for businesses that are not good candidates for venture capital
- Building technical assistance capacity to help business owners sift through the range of financing options that are available to them and connect them with appropriate legal advice
- Helping to establish or partnering with platforms that can help companies market Direct Public Offerings

### Endnotes

1. For further discussion of Securities regulation issues, see the U.S. Securities and Exchange Commission website: <https://www.sec.gov/fast-answers>. An SEC factsheet on “regulation crowdfunding” is available at: <https://www.sec.gov/news/pressrelease/2015-249.html>. This report is not intended to provide legal advice. Businesses should obtain professional legal representation to ensure that they structure their DPO properly to comply with applicable laws and regulations.
2. Democracy Brewing, “Invest!” <http://www.democracybrewing.com/invest/>.
3. Cutting Edge Capital, “\$340,000 Raised by Composting and Recycling Worker Cooperative in Massachusetts,” <https://www.cuttingedgecapital.com/cerodpo/>.
4. Milk Money, <https://milkmoneyvt.com/>.

### About the Author

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