



GEORGETOWN LAW



ASHOKA

SunFunder

Innovative Capital Raising: The Growth of a Solar Social Enterprise

This legal case study explores innovative capital raising models undertaken by SunFunder Inc., a social enterprise that provides solar power to developing countries. Topics discussed include:

- » Crowdfunding
- » Securities Regulation
- » Joining an Accelerator

Walter Alarkon and Valentin Riazanov, students at Georgetown University Law Center, prepared this case study for Ashoka. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

“If you think you’re too small to have an impact, try going to bed with a mosquito in the room.”

-- Dame Anita Roddick

INTRODUCTION

Ryan Levinson was a vice president at a large commercial bank when the notion that solar energy was too expensive finally began to change. In the early 2000s, solar energy cost three times as much as power from traditional sources such as coal, gas, and nuclear. But by 2007, renewable energy began to make sense. Federal and state tax incentives helped draw financing into the solar and wind market. Companies started to take advantage of new financing models that allowed them to host solar projects and use the energy produced without needing to buy the equipment. A few years later, solar panel manufacturers flooded the market with products based on new technologies. Solar power’s cost no longer doubled that of cheaper sources, and the gap was closing. Finally, solar energy made economic sense, and investors began to notice.

Levinson was part of a project finance team responsible for reviewing applications for solar power project investments. The team helped approve millions in financing for new solar projects across the United States. Some of the bank’s investments went to developers who would install solar panels on department store rooftops. Others went to far bigger projects—solar farms with the capability of producing 50 megawatts of energy, enough to power entire communities.

In the United States, solar power had been growing before—it doubled from 2001 to 2007. But this kind of growth was unprecedented. Solar capacity doubled from 2007 to 2009, even as the global economy was faltering. Capacity doubled again the next year, and then doubled a third time the year after that.

Solar power today still only accounts for less than one-half of one percent of U.S. power—far less than gas, coal, or nuclear. But the trend had become unmistakable: solar energy was finally on its way.

Levinson played a small-but-growing role in the maturation of the solar sector. In his previous job at a Washington, D.C. environmental think tank, he started as an intern and ended up working on greenhouse gas management policies for companies. At the bank, he worked on 200 solar power projects in the span of a few years. “Clean energy just became my professional passion,” he said. But, in 2011, as solar power continued to rise, Levinson tried something different. He told his employer he was taking a leave, to travel the world and to figure out what was next. “I wasn’t a corporate guy long-term,” said Levinson, who spent almost a year outside the United States, first in South America, then in Southeast Asia. “I’m more of a risk-taker. I was trained to be a very conservative banker, and I still have a lot of that with me, which is still helpful. But I didn’t really have in my mind what I could do next.”

What emerged from those travels is SunFunder Inc., a company that aims to finance solar projects. By finding money for solar power, Levinson is doing something similar to what he did before. But one thing that has changed is the type of solar projects he works on. Instead of approving financing to make electricity possible for communities in the United States, SunFunder’s projects are helping bring electricity to the developing world step by step, household by household. The other thing that has changed is how these projects are financed. SunFunder relies on small investments from hundreds of people motivated by the idea of providing clean power to far-flung communities that lack other energy sources. SunFunder has tapped the power of crowdfunding, and, by drawing on skills that Levinson learned working on larger solar projects, is crafting a whole new model of project finance to solve on-the-ground problems in developing countries.

“Clean energy just became my professional passion.”

-- Ryan Levinson

CROWDFUNDING EXPLAINED

Crowdfunding is a financing method in which a large group of individuals make relatively modest contributions to fund a project, a business, or a philanthropic venture. The contributions are typically made through online websites, such as Kickstarter and Indiegogo, as well as through social media and social networking. Contributions generally come in three forms: donations, loans, and equity. Whether these forms of contribution are subject to SEC registration is a concern for many enterprises, as discussed in more detail below. In general, donations and loans that do not provide a return over the principal amount of the loan are not subject to registration, but equity contributions and loans that provide a financial return are subject to registration.

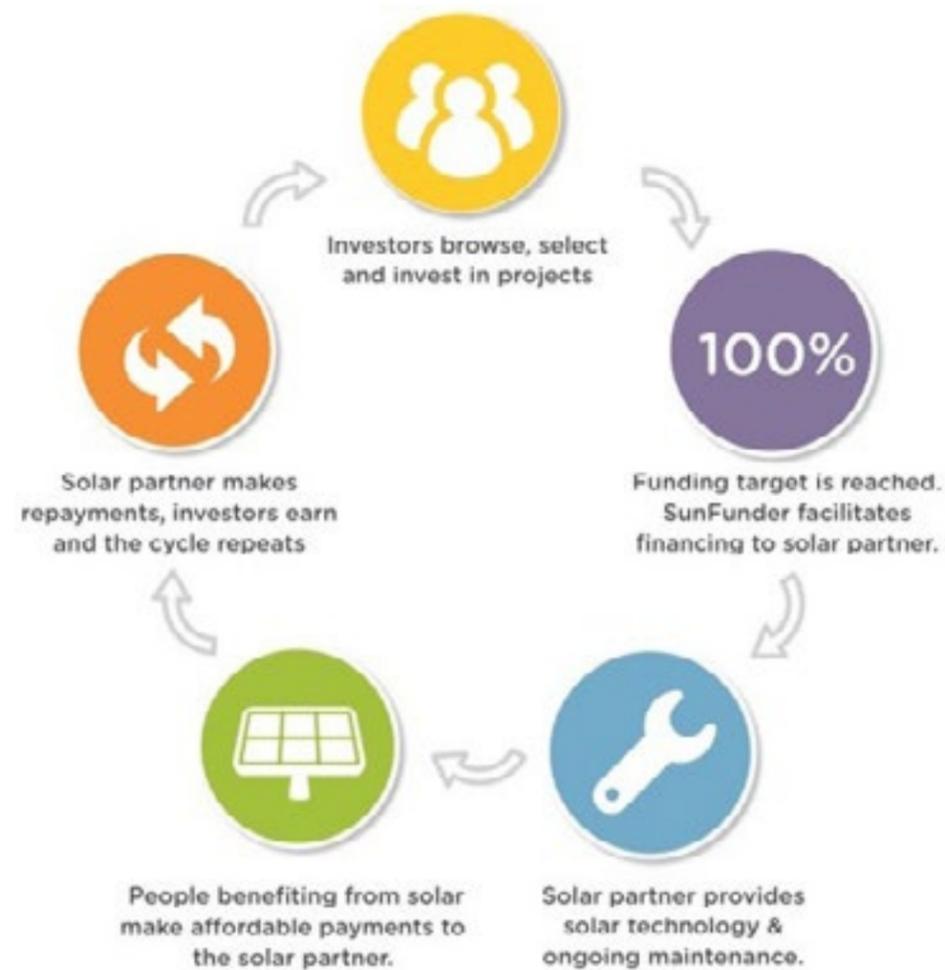
For years, small-scale, developing-world solar projects were not feasible. Thanks to the kind of crowdfunding model used by SunFunder, they are becoming a reality.

The traditional model for financing an energy project requires that project developers persuade investors, such as investment banks, to give them the millions of dollars needed to build and operate the project. To get investor to make this jump, developers need to identify and evaluate all of the project’s risks and returns. Investors need to know: Can the project obtain government permits? Is there sufficient demand for the power? Does the project company have the expertise to run the project? This due diligence process comes with costs, which are sometimes large enough to determine the type of solar projects that get funded. Small-scale projects are often viewed as too risky and too small for traditional investors; the high, fixed due diligence costs of the project’s early stages and the risk of low returns make small projects not worthwhile. The only viable projects for these investors are those that produce enough power for several communities and thus produce enough revenue to pay back loans and allow project sponsors to recoup start-up costs and obtain some profit.

The odds of obtaining bank financing for a solar power project become more remote when the project is located in a developing country, as SunFunder’s are. “It’s not worth doing,” said Tonio DeSorrento, who represented SunFunder when he was an attorney at Orrick, Herrington & Sutcliffe, LLP. “There’s no way to get liens. There’s also issues of local law and international enforceability.” Furthermore, many developing countries lack necessary infrastructure for building a large project—like easy road access to project sites—and the necessary expertise for operating it. To large investors, overcoming these hurdles seemed too daunting to even try.

SunFunder, however, is proving that the old model is not the only one. SunFunder’s crowdfunding model is opening the door to projects that larger investors have not touched. Under the crowdfunding approach, a few hundred people finance a new solar project by investing a few dollars at a time. The money, once it adds

up, goes to purchases of small-scale solar lighting and mobile phone charging products for communities in Africa and Asia. These projects may not be the powerful 200 megawatt coal-fired plant, but they provide power that is much needed—power that happens to be cleaner and locally operated to boot.



“What really blew me away was that the economics worked,” Levinson said. It works for several reasons. For starters, crowdfunding investors and SunFunder are comfortable with the risks that come with a small project in a developing country. SunFunder’s financiers are not traditional investors, which primarily measure success via profits. SunFunder’s financiers are individual investors with a broader social motive, one that involves providing clean energy to communities that have little energy to begin with. The difference

between traditional investor and SunFunder investors is seen in the type of instruments provided; while traditional financing such as loans provides enough returns so that investors receive a profit, investments in SunFunder cannot provide for profits. In agreements with its investors, SunFunder expressly rules out the possibility of financial returns above principal to investors. The return for these investors is the ability to promote clean energy in areas that need it.

Even more important to SunFunder’s model is the demand for clean, cheap, and reliable power. In towns in Zambia, Kenya, and the Philippines—where SunFunder has already financed solar projects—the need for such power is great; residents there are used to relying on power production that involves expensive kerosene and diesel. SunFunder’s small-scale solar projects reduce this reliance by providing cheap and clean sources of electricity to light homes and charge mobile phones. With residents willing to pay for this new source of power, SunFunder’s projects can quickly earn back the money spent. “It’s a major upgrade from kerosene in terms of safety and quality,” Levinson said.

Because of this high demand, the investing costs for a small solar project may be lower for investors willing to take the risk. SunFunder’s investments can be repaid in one to three years, or even just a matter of weeks. These repayment periods are far shorter than the 10- or 20-year repayment term seen in traditional project finance loans for larger projects. There is another benefit of this high demand for power: the financing for these projects in developing countries does not need government subsidies, unlike many larger projects in both developing and developed nations.

“There didn’t really seem to be any companies focused on doing that,” Levinson said. “That’s really where I thought, all right, with my background and interest, if I was to potentially start a solar company, I could start one dedicated to this space.”

SunFunder’s model is not a panacea. Not all investors are like SunFunder donors, a fact that limits the pool of capital available for these projects. And not all projects are for SunFunder; bringing power to large

swaths of countries will still involve traditional financing. But SunFunder, just by virtue of showing that new types of solar projects can be successful, is helping expand the potential for solar energy elsewhere. These successes show that the project risks that used to ward off traditional investors may not be as great as once thought.

CONSIDERING SECURITIES LAWS: MAKING AN IMPACT WHILE FOLLOWING THE RULES

SunFunder is breaking the rules. But its success would not have happened if it did not find ways to comply with some of those rules as well. Like other innovative start-ups, SunFunder has had to figure out how to work within federal regulations for raising money. It is often a struggle for new companies to attract investors while simultaneously following securities laws. Unless a start-up carefully plans its growth, complying with securities laws means registering with the Securities and Exchange Commission, a process that quickly becomes prohibitively expensive for all but the wealthiest or well-funded entrepreneurs. As a result, many start-ups seek exemptions from SEC registration.

SunFunder is not subject to securities registration because it does not give investors a financial return in excess of their principal. Instead, investors receive “Impact Points,” which are credits that can only be reinvested in future SunFunder projects. This approach is consistent with the goals of its socially minded investors, who are driven not by profits but by the chance to make a real-world impact. Under this Impact Points system, the company has raised money for new projects in three different countries without running afoul of securities laws. To understand why this works, a brief look at the federal securities laws is necessary.

The Securities Act of 1933 prohibits sales of securities not registered with the SEC. More specifically, the law prohibits any person from selling or offering a security unless a registration statement has been filed. The purpose of the registration statement is to get companies that offer securities to disclose information about themselves and their products so that investors can evaluate the investment and the risks involved.

But this registration process only applies to products that are securities. A “security” is an investment; the most common examples are stocks and bonds. The ’33 Act and the Securities Exchange Act of 1934 set out what qualifies as a “security” with a list of specific financial instruments—such as stocks, bonds, debentures, and notes—and generic catchall terms—such as evidence of indebtedness and investment contracts. These instruments are considered securities unless the “context otherwise requires.” Therefore, one must generally determine whether instruments that fall into enumerated categories, such as “notes,” are actually not securities, and whether other instruments may be securities under catchall categories like “investment contract.”

Only certain kinds of notes are securities.¹ The statute specifically excludes notes with a maturity of nine months or less. In *Reves v. Ernst & Young*, the United States Supreme Court explained that a note with a maturity over nine months is presumed to be a security unless it resembles certain kinds of notes that are commonly not considered a security, such as notes secured by a mortgage on a home. For situations that are less clear, the Court laid out four factors: 1) whether the lender is primarily interested in making a profit, 2) how the instrument will be traded, 3) the reasonable expectation of the investing public, and 4) the existence of another regulatory scheme reducing the risk of the instrument.

The statute also treats as securities “investment contracts,” a broader catchall term for unorthodox financial instruments. In *Securities and Exchange Commission v. W.J. Howey Co.*, the Court said that an investment contract is a security if there is an investment of money due to an expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party. Unlike the *Reves* test, the *Howey* test does not involve a weighing of multiple factors; instead, each of the elements of *Howey* is required to be met in order for the instrument to be a security.

¹ A note, or a promissory note, is generally a written statement of debt, specifying the amount owed, the repayment terms, and other information. For purposes of the securities laws, only certain kinds of notes are considered securities.

STEERING CLEAR OF SECURITIES LAW: IMPACT POINTS

To avoid having to register with the SEC, SunFunder carefully considered how it would raise capital. The idea that emerged was using “Impact Points.” Under this system, an investor receives returns up to the principal she invested. For any returns beyond principal, the investor receives Impact Points in lieu of cash. Impact Points are virtual dollars that can only be used for one purpose: reinvestment in future projects with the same company. For example, a SunFunder investor who invests money in a solar project in Zambia will be able to recoup her principal investment as the project generates revenue. Any additional revenue generated by the Zambia project will be distributed to the investor in the form of Impact Points. These Impact Points can only be used for other projects sponsored by SunFunder, such as a solar project in Kenya. The financial importance of this system is that it allows the company to raise capital from investors not seeking a financial return, thereby avoiding classification as a security and being subject to costly registration requirements.

The SEC seems to have embraced the idea that such profit-free instruments are not securities. In October 2010, a company seeking to facilitate lending by members of the public to finance specific art projects requested a No-Action Letter from the SEC Division of Corporate Finance. The No-Action Letter request outlined how this company, Poplogix, planned on helping the artists secure loans. In November 2010, the SEC released a No-Action Letter that confirmed that under the facts presented, the Division would not recommend enforcement action to the Commission.

In its request, Poplogix proposed establishing a website where artists would submit project proposals and their desired loan amount. The loans would be made through the website and there would be no limits on the principal amount of any loan. The artists would include the desired loan terms in their project descriptions on the website and communicate with the lenders to establish terms for the loans. Under no circumstances, however, could the lenders receive anything of tangible value in connection with the loan except the repayment of principal. The artists could neither provide lenders with financial returns, such as interest, nor anything of non-financial tangible value over and above the principal amount of the loans,

such as free artwork, free admission to performances, or free art lessons. Poplogix would charge the artists fees for participating in the website, which would be based on factors not yet determined.

Poplogix argued that the loans were not securities if the SEC applied the Supreme Court’s *Reves* test.

1. *Was the lender primarily interested making a profit?* Not here, Poplogix said. The lenders would only be entitled to principal, and profit could not be interpreted so broadly as to encompass inner satisfaction upon benefiting the arts in the absence of any accompanying tangible or economic benefit.
2. *Would the instrument be widely traded?* No, because the notes were not transferable, Poplogix argued.
3. *Would the investing public expect profits?* No, because the notes would not be advertised as investments, and disclaimers would provide that no return over principal was available.
4. *Was there another regulatory scheme to reduce the instrument’s risk?* Poplogix admitted that there was no other scheme applicable to the loans, but it urged that this factor was not dispositive.

Poplogix also argued that its loans were not securities under the *Howey* investment contract test. According to Poplogix, because there would be no return over principal there could be no expectation of profits.

If Poplogix’s loans were not securities, then neither are the investments made by SunFunder’s investors. The benefit from the Impact Points system “is not financial in any way,” DeSorrento explained. “What [investors] are getting are emotional and moral returns. That shouldn’t be regulated or taxed.” This is key, as the absence of any financial return over principal for SunFunder investors is evidence that the investors do not have a profit motive. Without a profit motive, the investors are not buying securities.

The Impact Points business model has enabled SunFunder to grow rapidly in its first year. But as the company expands and attracts new investors, it may find that the Impact Points system is too restrictive. While impact investors may provide adequate capital for the current SunFunder projects, SunFunder may need to attract investors in the future who expect a financial return or additional benefits in order to do even more. “Crowdfunding is a tool and not the definition of who we are,” Levinson said. Other types of securities offerings would also allow SunFunder to remain exempt from securities registration. One option would be private placements, which are offerings made primarily to accredited investors, a group that includes individuals with annual incomes exceeding \$200,000.² Private placements are exempt from registration on the theory that the information disclosed via registration is not necessary when investors are sophisticated enough and have enough information to protect themselves. A second option would be small offerings—ones that do not exceed \$5 million—which are exempt under specific circumstances. A third option is intrastate securities offerings—those by an issuer to residents in the same state.

“What [investors] are getting are emotional and moral returns. That shouldn’t be regulated or taxed.”
-- Tonio DeSorrento

² As defined by the SEC, an accredited investor is an individual with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. Accredited investors also include those with individual net worth or joint net worth with a spouse that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person. Institutional investors such as banks and pension funds also qualify as accredited investors.

There is no doubt SunFunder has had some early success. Once a pro bono client of law firm Orrick, SunFunder has grown to the point where it is a paying client. The company has been featured in The New York Times and other high-profile publications. And, most importantly, SunFunder has been able to raise financing for 10 solar projects in five different countries. But even with this auspicious start, SunFunder knows it has more work to do, particularly in finding the financing to enable further social impact. SunFunder is now doing what many other start-ups are hoping to do: joining an accelerator.

Accelerators and their close cousins, incubators, are organizations that seek to jumpstart the growth of new companies. They do this by providing start-ups with tools they would have trouble getting on their own—meetings with deep-pocketed investors, mentorship arrangements, and cheap office space near like-minded companies who may end up as business partners. Accelerator programs last for a few months. Incubator programs last longer, taking a company through the start-up phase. But joining comes at a cost to the company: typically a 3 to 6 percent equity stake. Thus, for any company considering an accelerator program, one question that must be asked is: *Are the benefits worth it?*

SunFunder recently joined San Francisco-based accelerator Hub Ventures. One major reason was to gain access to new investors. “We’re still raising seed money,” Levinson said. “It hasn’t been easy, although we’re having some success. I don’t think it’s ever easy for a first-time entrepreneur.” Hub Ventures’ program offers chances to meet possible investors through informal gatherings like lunches and dinners and more formal events such as “Investor Day.” Even if these meetings do not immediately lead to more capital, entrepreneurs may benefit from learning what investors want to see in a start-up.

Accelerators also provide access to a staff knowledgeable about the issues that start-ups tend to face. Each Hub Venture participant will get office hours with staff who have been on the entrepreneur side or on the investment side. These staff members help sharpen the skills that each successful entrepreneur needs to develop. Staff members ask more than just, “How’s the business going?” said Levinson. “It’s questions

about the business model. A big part of it is learning about customers and talking about customers. They ask us to go out every week and have 10 to 20 discussions with customers to figure out our products and who our customers are and what you care about.”

After a start-up has decided to seek an accelerator, it must also ask: *Which one should we join?*

SunFunder specifically chose Hub Ventures out of the more than 1,200 U.S. accelerators or incubators because of its focus on social impact. Other Hub Venture start-ups include a developer of technology to convert human waste into energy, a trading market for excess potable water, and a maker of low-cost medical devices for the developing world. Each accelerator has its own mission; for instance, Y Combinator, a Silicon Valley accelerator that counts start-up successes Dropbox, reddit, and Airbnb among its alumni, seeks to grow companies very quickly. But SunFunder was looking for something else.

“We’re not about getting as big as possible as fast as possible,” Levinson said. “It’s helpful to be a part of a program where the people running the program and the investors connected to it are a little more impact oriented and patient, and not just focused on making money.”

This social impact focus is built into the program. The investors who show up at Hub Ventures events are impact investors, such as foundations. Hub Ventures staff also teach skills that social enterprises should have, such as how to communicate in a way that piques the interest of these investors. Even just finishing the Hub Ventures program comes with benefits; it burnishes a company’s public reputation for being socially minded.

“They’re highly connected to the whole impact investment community,” Levinson said. “There’s the validation of being part of Hub Ventures, the actual connections we get, and having these people vouch for us.”

By rethinking the boundaries of solar financing, SunFunder has quickly figured out how to bring efficient, safe energy to places where traditional energy companies have been unwilling or unable to go. SunFunder is now looking to expand its reach by updating its capital raising model and working with an accelerator, all while keeping its focus on its core mission of making a social impact.



<http://www.youtube.com/watch?v=EoNqhy3Fv-M>



ASHOKA INNOVATORS FOR THE PUBLIC

FURTHER INFORMATION

This case study was produced for Ashoka by law students at Georgetown University Law Center as part of credit-bearing classwork during the Spring 2013 semester. This case study seeks to illuminate the way in which laws can be navigated and employed for the benefit of social enterprise.

Please contact socialenterprise@law.georgetown.edu with questions or comments.

- » Visit www.sunfunder.com for more information about SunFunder.
- » Visit www.ashoka.org for more information about Ashoka.
- » Visit www.socialenterprise-gulaw.org for more information about social enterprise at Georgetown University Law Center.
- » Visit sec.gov/info/smallbus/qasbsec.htm for a guide on how small businesses can raise capital in compliance with federal securities laws.

GEORGETOWN LAW

600 New Jersey Avenue, NW

Washington, D.C. 20001

socialenterprise@law.georgetown.edu

www.law.georgetown.edu