

# CROWDFUNDING HUMAN CAPITAL CONTRACTS

*Max Vogel*<sup>†</sup>

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## INTRODUCTION

*“[W]e have to fundamentally rethink about how higher education is paid for in this country. We’ve got to shake up the current system.”*<sup>1</sup>

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<sup>†</sup> Articles Editor, *Cardozo Law Review*. J.D. Candidate (June 2015), Benjamin N. Cardozo School of Law; B.S.B.A., Boston University, 2012. This Note is current as of March 23, 2015. I would like to thank Professors Jeanne Schroeder and Elizabeth Goldman; the editors of the *Cardozo Law Review*; and my loving wife, Haley. All errors are my own.

<sup>1</sup> Megan Slack, *President Obama: ‘A Personal Mission,’* THE WHITE HOUSE BLOG (Aug. 20, 2013, 4:17 PM), <http://www.whitehouse.gov/blog/2013/08/20/president-obama-personal-mission>.

President Obama wrote these words sixteen months after signing into law<sup>2</sup> the Jumpstart Our Business Startups (JOBS) Act.<sup>3</sup> The JOBS Act, a piece of legislation championed for its twin goals of job creation and overall economic growth,<sup>4</sup> has the potential to “shake up” how students finance their higher education. In particular, Title III of the JOBS Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure (CROWDFUND) Act, will allow for the “crowdfunding” of securities.<sup>5</sup> Crowdfunding—a new concept predicated on older underpinnings<sup>6</sup>—is fundamentally about raising capital, typically in small denominations, from a large group of individuals: the “crowd.”<sup>7</sup> In fact, students have already leveraged the crowdfunding market to finance their higher education. For example, Jordan Elpern Waxman, an entrepreneur with ambitions to start his own craft beer company, chose to crowdfund his outstanding student debt.<sup>8</sup> However, Waxman—and others like him—cannot currently use the provisions of the CROWDFUND Act, as it has yet to be

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<sup>2</sup> *Jumpstart Our Business Startups (JOBS) Act*, U.S. SEC. & EXCHANGE COMMISSION, [www.sec.gov/spotlight/jobs-act.shtml](http://www.sec.gov/spotlight/jobs-act.shtml) (last visited Mar. 21, 2015) (President Obama signed the JOBS Act into law on April 5, 2012).

<sup>3</sup> Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)) [hereinafter JOBS Act]. The JOBS Act is an amendment to various sections of the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2012). *See, e.g.*, JOBS Act § 302(a) (“Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding . . .”). The Securities Act of 1933 and the Securities Exchange Act of 1934 are cornerstones of the federal securities laws. *See* Brian R. Cheffins, *Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century*, 51 AM. J. COMP. L. 473, 489 (2003) (“[P]rior to the enactment of the cornerstones of federal securities law, the Securities Act of 1933 and the Securities Exchange Act of 1934 . . .”). In general terms, the federal securities laws “proscrib[e] fraud[,] . . . requir[e] affirmative disclosure[, and] . . . establish[] a detailed and mandatory system of continuing, periodic disclosure with which ‘public’ companies must comply.” *See* JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION: CASES AND MATERIALS* 2 (12th ed. 2012).

<sup>4</sup> *See generally* JOBS Act, 126 Stat. 306 (“An Act [t]o Increase American job creation and economic growth”).

<sup>5</sup> *See* JOBS Act § 302 (crowdfunding exemption). The term “security” is statutorily defined in both the Securities Act of 1933 and the Securities Exchange Act of 1934. *See* 15 U.S.C. § 77b(a)(1) (2012); 15 U.S.C. § 78c(a)(10) (2012). However, subsequent case law has since clarified these statutory definitions. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946). For further discussion of what qualifies as a “security” within the context of the federal securities laws, *see infra* Part III.

<sup>6</sup> Namely, crowdsourcing and microfinance/microlending. For further discussion, *see* C. Steven Bradford, *Crowdfunding and the Federal Securities Law*, 2012 COLUM. BUS. L. REV. 1, 27–28 (2012) (“Crowdsourcing is, quite simply, ‘collecting contributions from many individuals to achieve a goal.’ . . . Microlending involves lending very small amounts of money, typically to poorer borrowers.”).

<sup>7</sup> *Id.* at 5 (“Crowdfunding, is, as its name indicates, funding from the crowd—raising small amounts of money from a large number of investors.”).

<sup>8</sup> *See* James Surowiecki, *The New Futurism*, NEW YORKER, Nov. 4, 2013, [www.newyorker.com/magazine/2013/11/04/the-new-futurism](http://www.newyorker.com/magazine/2013/11/04/the-new-futurism).

implemented by the Securities and Exchange Commission (SEC).<sup>9</sup> Consequently, since the federal securities laws currently forbid<sup>10</sup> any effort to crowdfund securities<sup>11</sup> without first adhering to the numerous statutory rules and regulations,<sup>12</sup> individuals, such as Waxman, must conduct their “crowdfunding” within a preexisting exemption of the federal securities laws, and not under the CROWDFUND Act.<sup>13</sup>

Waxman embarked on his crowdfunding journey by using the services of a website named Upstart.<sup>14</sup> Although it no longer offers such a service,<sup>15</sup> Upstart had created a platform over the Internet through which students and young entrepreneurs could crowdfund their student loans.<sup>16</sup> In return for the capital raised, however, these students and entrepreneurs had to remit back to their investors a fixed percentage of their income stream for a predetermined period of time.<sup>17</sup> This arrangement is referred to as a “human capital contract.”<sup>18</sup>

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<sup>9</sup> The SEC has been tasked with promulgating rules and regulations pursuant to the CROWDFUND Act. See JOBS Act § 302(c) (“RULEMAKING—Not later than 270 days after the date of this Act, the Securities and Exchange Commission . . . shall issue such rules as the Commission determines may be necessary or appropriate for the protection of investors to carry out [this Act].”). At present, only proposed regulations have been promulgated. See Press Release, SEC, *SEC Issues Proposal on Crowdfunding* (Oct. 23, 2013), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Uvjpf15kJMo> (“The Securities and Exchange Commission today voted unanimously to propose rules under the JOBS Act to permit companies to offer and sell securities through crowdfunding.”).

<sup>10</sup> *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm> (last visited Mar. 21, 2015) (“The [JOBS] Act requires the [U.S. Securities and Exchange] Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.”).

<sup>11</sup> For a discussion of whether or not Waxman’s activities qualify as a “security,” see *infra* Part III.

<sup>12</sup> Under the federal securities laws, all offerings of securities must either be registered with the SEC prior to issuance, or qualify for one of several exemptions, see *infra* note 13, that allow for issuers to conduct offerings without prior registration. See 15 U.S.C. § 77e(a) (2012) (“Unless a registration statement is in effect as to a security, it shall be unlawful for any person . . . to sell such security through the use or medium of any prospectus or otherwise . . .”). The CROWDFUND Act, once implemented, will be another exemption that issuers may rely upon.

<sup>13</sup> 15 U.S.C. § 77d (list of exempted transactions).

<sup>14</sup> See Surowiecki, *supra* note 8.

<sup>15</sup> See Dave Girouard, *Sunsetting Income Share Agreements on Upstart*, UPSTART BLOG (May 7, 2014), <http://blog.upstart.com/sunsetting-income-share-agreements-on-upstart/#.VJ3F5GoAIA>.

<sup>16</sup> See generally Tara Siegel Bernard, *Program Links Loans to Future Earnings*, N.Y. TIMES, July 20, 2013, at B1; Paul Sullivan, *A Financial Backer When a Parent’s Wallet Isn’t an Option*, N.Y. TIMES, June 8, 2013, at B5; Rachel Louise Ensign, *‘Crowdfunding’ College Costs*, WALL ST. J., Oct. 19, 2012, <http://online.wsj.com/article/SB10000872396390444657804578048461063769132.html>.

<sup>17</sup> See Surowiecki, *supra* note 8 (“In exchange [for capital from investors], [the students] pay some of what they earn over the next five or ten years . . .”).

<sup>18</sup> See MIGUEL PALACIOS LLERAS, *INVESTING IN HUMAN CAPITAL: A CAPITAL MARKETS APPROACH TO STUDENT FUNDING 1* (2004).

Although Waxman had access to the capital markets through websites such as Upstart—and a competitor, Pave<sup>19</sup>—he was, and still would be, limited by who could invest with him. Due to the stringent registration requirements imposed by the Securities Act of 1933,<sup>20</sup> some small issuers of securities—such as Waxman—are dissuaded from offering their securities publicly because of the prohibitively high legal fees associated with registering a security with the SEC.<sup>21</sup> As a result, these small issuers tend to limit their investors to “accredited investors”<sup>22</sup> in order to operate within the Regulation D exemption of the Securities Act of 1933.<sup>23</sup> However, by virtue of the fact that not everyone in the general public meets the threshold for accreditation, the pool of potential investors is significantly diminished when operating within the Regulation D exemption.<sup>24</sup>

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<sup>19</sup> See PAVE, [www.pave.com](http://www.pave.com) (last visited Mar. 21, 2015). Pave, like Upstart, no longer offers human capital contracts. *Id.* (only advertising traditional loans).

<sup>20</sup> See generally Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012). For an overview of the registration requirements under the Securities Act of 1933, see *Registration Under the Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/regs33.htm> (last visited Mar. 21, 2015) (“The SEC . . . require[es] . . . companies [to] disclose important financial information through the registration of securities.”) and *supra* note 12.

<sup>21</sup> See Bradford, *supra* note 6, at 5 (“Entrepreneurs seeking debt or equity financing through crowdfunding will often be selling securities, and securities offerings must be registered under the Securities Act of 1933 . . . unless an exemption is available. Registration would be prohibitively expensive.”); see also Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 880 (2011) (“For many small businesses, the cost of complying with applicable regulatory requirements outweighs the benefits associated with the proposed financing method.”).

<sup>22</sup> For the definition of “accredited investor,” see 15 U.S.C. § 77b(a)(15)(i)–(ii). The relevant portion here is part (ii), which states that “any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.” *Id.*; see also 17 C.F.R. § 230.501(a) (2013). For purposes of this Note, sections 5 and 6 of 17 C.F.R. § 230.501(a) are most applicable. Sections 5 and 6 detail how an individual can qualify for accreditation. One option for an individual includes having an “individual net worth, or joint net worth with that person’s spouse, [that] exceeds \$1,000,000,” excluding a primary residence. The other option is having “an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year . . .” 17 C.F.R. § 230.501(a)(6).

<sup>23</sup> See 15 U.S.C. § 77d(a)(5) (enumerating exempted transactions under the Securities Act of 1933, including “transactions involving offers or sales by an issuer solely to one or more accredited investors”); see also *Regulation D Offerings*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/regd.htm> (last visited Mar. 21, 2015). This is the exemption under which Upstart and Pave operated. See Siegel Bernard, *supra* note 16 (“Both Pave and Upstart allow only accredited investors to participate . . .”).

<sup>24</sup> See Alex Kantrowitz, *Peter Thiel, Eric Schmidt and Others Put \$5.9 Million into Company Which Lets You Invest in Humans*, FORBES, Apr. 22, 2013, <http://www.forbes.com/sites/alexkantrowitz/2013/04/22/peter-thiel-eric-schmidt-and-others-put-5-9-million-into-company-which-lets-you-invest-in-humans> (“With the investment money in hand, Upstart must now confront the fact that it is being forced to turn away the majority of would be backers due to legal restrictions. According to Gu, nearly 60 percent of people who sign up as backers are not accredited investors and thus, according to SEC regulations, cannot invest through Upstart. The

However, with the passing of the CROWDFUND Act, the regulatory environment surrounding crowdfunded offerings is set to become less restrictive.<sup>25</sup> The CROWDFUND Act<sup>26</sup> permits certain types of securities to be offered under a relaxed registration requirement.<sup>27</sup> And not only does the CROWDFUND Act soften the registration and disclosure obligations, but it allows nonaccredited investors—or retail investors<sup>28</sup>—to contribute capital to these specified offerings.<sup>29</sup>

This Note explores the CROWDFUND Act and whether it will increase access to the capital markets for issuers looking to crowdfund securities. More specifically, this Note focuses on whether the provisions of the CROWDFUND Act will allow students to crowdfund their education—primarily through the use of human capital contracts—or if the CROWDFUND Act’s requirements pose too high a burden on issuers of human capital contracts. Part I develops a background of the crowdfunding industry, as well as a detailed understanding of the CROWDFUND Act. Part II chronicles the human capital contract—its origins, its operation, and the positive and negative consequences associated with its implementation. Part III analyzes the issue of whether human capital contracts should be classified as “securities” for the purposes of the federal securities laws. Classification of human capital contracts is critical, because if they are not “securities,” issuers of human capital contracts need not concern themselves with the requirements of the federal securities laws. Part IV discusses how crowdfunding human capital contracts under the CROWDFUND Act will affect a prospective student’s decision to enter into a human capital contract rather than a traditional student loan. Lastly, Part V proposes how students can overcome the statutory burdens imposed by the CROWDFUND Act in order to cost-effectively crowdfund human capital contracts. Students can achieve this objective by “pooling”

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actual number of backers Upstart is turning away is likely larger said Gu, as the number does not include those who don’t bother signing up after reading of the restriction.”).

<sup>25</sup> See *Raising Capital Online: The New Thundering Herd*, ECONOMIST, June 16, 2012, <http://www.economist.com/node/21556973> (“America’s recent Jumpstart Our Business Start-ups (JOBS) Act is raising hopes that crowdfunding will also transform the way in which firms raise capital. Duncan Niederauer, the boss of NYSE Euronext, claims that, properly done, it ‘will become the future of how most small businesses are going to be financed.’”).

<sup>26</sup> JOBS Act, Pub. L. No. 112–106, tit. 3, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)).

<sup>27</sup> *Id.* This section of the JOBS Act has been codified at 15 U.S.C. § 77d-1(b) (“Requirements for Issuers”).

<sup>28</sup> A “retail investor” is effectively someone who is not “accredited.” For the definition of “accredited investor,” see *supra* note 22.

<sup>29</sup> There is no mention of an “accredited investor” requirement in 15 U.S.C. § 77d(a)(5) (the “crowdfunding” exemption).

themselves together in a limited liability company (LLC) and sharing the costs associated with issuing human capital contracts.

## I. CROWDFUNDING

### A. *The Crowdfunding Industry*

#### 1. Why Crowdfunding?

Crowdfunding makes possible what was once an insurmountable obstacle<sup>30</sup> for young entrepreneurs by allowing those with an idea—or a dream—to solicit funds from a large pool of potential investors.<sup>31</sup> In these circumstances, when one large investor is unlikely to assume all the risk in a startup, crowdfunding plays a critical role.<sup>32</sup> Allowing many investors to contribute a small sum will presumably promote increased access to capital financing.<sup>33</sup> As crowdfunding occurs primarily on the Internet, the benefits of crowdfunding become even more apparent.<sup>34</sup> The high costs of reaching out to investors generally create considerable difficulty for the average startup entrepreneur.<sup>35</sup> Often, a burgeoning entrepreneur will reach out to friends and family first to raise capital.<sup>36</sup>

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<sup>30</sup> The cost of capital for startup companies is often high given the risky nature of their enterprises. See Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 121 (2010) (“Because startup companies are new ventures operating outside of established markets, investing in them involves substantial uncertainty, information asymmetry, and agency costs. These costs limit the pool of investors willing to invest in startups and increase the cost of capital to the entrepreneur.”).

<sup>31</sup> See Tanya Prive, *What is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy> (defining crowdfunding as “the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet” (internal quotation marks omitted)).

<sup>32</sup> Large angel investors are increasingly difficult to attract. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1461 (2013). Thus, reaching out to many smaller investors might result in more capital raised.

<sup>33</sup> A smaller monetary outlay per investor will impact how much risk a single investor is willing to assume. See Patrick Collins & Josh Stampfli, *Managing Private Wealth: Matching Investment Policy to Investor Risk Preferences*, 126 BANKING L.J. 923, 929 (2009) (“Intuitively, the slope of the investor’s risk aversion equals the rate at which the investor is willing to trade risk for return.”). Some high-risk assets in any investor’s portfolio can increase overall portfolio diversity. See, e.g., Michael D. Floyd, Comment, *Junk Bonds: Do They Have Value?*, 35 EMORY L.J. 921, 964 (1986) (“[H]igh-risk, high-return securities may have a place in an appropriately diversified institutional investment portfolio.”).

<sup>34</sup> See Bradford, *supra* note 6, at 5 (“[T]he transaction costs associated with raising small amounts from a large number of investors would have made crowdfunding unworkable, but the Internet has significantly reduced those transaction costs.”).

<sup>35</sup> See *id.*

<sup>36</sup> See Schwartz, *supra* note 32, at 1461 (“[F]inancing for fledgling firms is generally obtained from the so-called ‘three Fs’: ‘family, friends, and fools.’”).

However, one can hardly expect every entrepreneur to satisfy his capital needs exclusively from peers and close relatives.<sup>37</sup> Thus, crowdfunding allows the average entrepreneur to raise capital from a large investor pool that is looking for interesting new investments, yet have no prior relationship with the entrepreneur and may not live in the same state, or even country, as the entrepreneur.<sup>38</sup>

## 2. Structure of Crowdfunding

Crowdfunding can be structured in many different ways—equity, debt, donations, rewards, royalty, and income. Equity crowdfunding allows accredited investors to invest in business startups and in return receive an ownership stake in the business.<sup>39</sup> At present, outside of the Regulation D exemption (and other narrow exemptions),<sup>40</sup> the federal securities laws do not permit equity crowdfunding.<sup>41</sup> Debt crowdfunding allows investors to extend loans to companies and individuals through the use of an Internet-based platform.<sup>42</sup> Donation crowdfunding, where a wide swath of people funds charitable causes, helps many individuals in developing countries.<sup>43</sup> Reward crowdfunding allows investors to provide funds to startups in exchange for a reward, generally first rights to the product being developed.<sup>44</sup> Reward

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<sup>37</sup> See Andrew A. Schwartz, *Old Enough to Fight, Old Enough to Swipe: A Critique of the Infancy Rule in the Federal Credit Card Act*, 2011 UTAH L. REV. 407, 430 (2011) (“[M]any potential entrepreneurs have neither significant personal savings nor a ‘rich Uncle Joe.’”).

<sup>38</sup> See Schwartz, *supra* note 32, at 1475 (“The CROWDFUND ACT . . . will allow ordinary non-accredited investors to take a chance and invest in the unregistered securities of a stranger’s startup.”).

<sup>39</sup> For an example of a platform that facilitates equity crowdfunding, see FUNDERSCLUB, <https://fundersclub.com/how-it-works> (last visited Mar. 21, 2015) (“FundersClub is a new type of venture capital platform. . . built around a unique online marketplace that allows accredited investors to become equity holders in FundersClub-managed venture funds—which then fund pre-screened, private companies.”).

<sup>40</sup> See 15 U.S.C. § 77d (2012).

<sup>41</sup> An entity looking to issue equity (or debt) must comply with the registration requirements of the Securities Act of 1933. See *supra* note 20.

<sup>42</sup> For an example of a debt crowdfunding platform, see LENDING CLUB, <https://www.lendingclub.com/public/more-efficient-model.action> (last visited Mar. 21, 2015) (Lending Club allows its “members to directly invest in and borrow from each other. . . [thereby] avoid[ing] the cost and complexity of the banking system. . .”). Lenders Club caters to individuals seeking a loan, while websites such as Kiva focus more on lending to further a mission. See KIVA, <http://www.kiva.org/start> (last visited Mar. 21, 2015).

<sup>43</sup> See WATSI, <https://watsi.org/faq> (last visited Mar. 21, 2015) (“Watsi is a global crowdfunding platform [for healthcare] that enables anyone to donate as little as \$5 to directly fund life-changing healthcare for people in need.”).

<sup>44</sup> For examples of reward crowdfunding websites, see Kickstarter, KICKSTARTER, <http://www.kickstarter.com> (last visited Mar. 21, 2015), and Indiegogo, INDIEGOGO, <http://www.indiegogo.com> (last visited Mar. 21, 2015).

crowdfunding has developed into a means of preselling new products, while obtaining capital at an early stage of development.<sup>45</sup>

The newest forms of crowdfunding—royalty and income—are somewhat similar. In royalty crowdfunding, investors provide capital to new businesses and, in exchange, receive a fixed percentage of the company's revenue stream over an agreed upon time period.<sup>46</sup> Similarly, in income crowdfunding, investors provide capital to an individual, and, in return, receive a fixed percentage of the individual's income stream for a specified period into the future.<sup>47</sup>

Two websites—Upstart and Pave—recently attempted to make income-based crowdfunding a reality. On each website, the investors—or “backers”—provided funds to individuals they found investment-worthy based on each individual's online profile.<sup>48</sup> In exchange, backers received a fixed percentage of the individual's income stream for a fixed period of time—typically either five or ten years.<sup>49</sup> Each website relied on its own statistical model to assess the potential income stream of each individual and compute an individualized “funding rate.”<sup>50</sup> Based on the model's prediction and the individual's funding rate, backers could decide whether to invest.

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<sup>45</sup> For example, one Kickstarter campaign, the Pebble Watch, raised over \$10 million during its campaign. Pebble Watch's campaign was typical of reward crowdfunding in the sense that it promised “investors” incremental rewards proportionate to the level of “investment.” For example, for \$115, one can receive one black watch, while for \$125, one can receive a watch in any color. See *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER, <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android> (last visited Mar. 21, 2015).

<sup>46</sup> For one example of a royalty crowdfunding platform, see Bolster, BOLSTR, <https://bolstr.com/how-it-works> (last visited Mar. 21, 2015) (“The Revenue Share investment structure is designed to help businesses raise growth funding from investors, while maintaining equity, and making monthly payments that are proportional to gross sales volume. This means that you never get squeezed during seasonal sales cycles.”).

<sup>47</sup> See Ensign, *supra* note 16 (“[Investors] can loan money to a specific . . . [individual] in exchange for a portion of his or her income for [a fixed period of time].”).

<sup>48</sup> See Sullivan, *supra* note 16 (“The investors, or backers as they are called . . .”); see also Siegel Bernard, *supra* note 16 (“[Upstart and Pave] are also ushering the most promising candidates onto their programs, often with big entrepreneurial plans or causes that are likely to catch investors' attention.”).

<sup>49</sup> See Ensign, *supra* note 16 (“[Backers] can loan money to a specific recent graduate in exchange for a portion of his or her income for the next 10 years.”). Upstart and Pave earn a profit by collecting origination fees. See Alison Griswold, *A Group of Investors Is Buying a Stake in the Next Generation of Geniuses*, BUS. INSIDER (Feb. 22, 2014), <http://www.businessinsider.com/upstart-and-pave-investing-in-human-capital-2014-2> (“Upstart collects 3% of what students raise up front and charges an annual 0.5% on investments to backers. Pave takes 3% off what . . . [individuals] raise and then 1.5% of each payment.”).

<sup>50</sup> See Griswold, *supra* note 49 (“[T]he operational key to the[] success [of Upstart and Pave] lies in the funding algorithm.”). For example, an individual's funding rate would dictate that for every \$5,000 raised from backers, the individual would need to remit 1% of his income for five years.

However, unlike a traditional loan, the backers were not guaranteed any return.<sup>51</sup> This naturally created a high level of risk for backers, as they could not predict with certainty what career path their investees would follow.<sup>52</sup> To mitigate this risk, both websites encouraged and facilitated a mentor-mentee relationship between backer and individual.<sup>53</sup>

B. *The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure (CROWDFUND) Act*

President Barack Obama signed into law the CROWDFUND Act on April 5, 2012.<sup>54</sup> However, the CROWDFUND Act is not self-executing and, as of this writing, it has not been implemented by the SEC.<sup>55</sup> Rather, the SEC has only promulgated proposed regulations.<sup>56</sup> Thus, the SEC currently forbids reliance upon the CROWDFUND Act as an exemption from the federal registration requirement.<sup>57</sup>

Once the SEC issues final regulations under the CROWDFUND Act, the federal securities laws will, under certain conditions, permit equity crowdfunding.<sup>58</sup> However, until the SEC finalizes the CROWDFUND Act regulations, a company looking to raise capital through the public offering of equity shares still must file a registration statement with the SEC.<sup>59</sup> This registration process can prove to be

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<sup>51</sup> See Siegel Bernard, *supra* note 16. On Pave, “[b]orrowers don’t pay anything if annual income falls below 150 percent of the federal poverty line.” On Upstart, “[p]eople earning less than \$30,000 annually are not required to make payments, but the repayment term extends a year.”).

<sup>52</sup> See Griswold, *supra* note 49 (“The backers have no control over how . . . [the individuals] use the funds they raise . . .”).

<sup>53</sup> See Siegel Bernard, *supra* note 16 (“[T]he investors, who clearly want to see their human investments succeed, often double as mentors.”).

<sup>54</sup> See *Jumpstart Our Business Startups (JOBS) Act*, *supra* note 2.

<sup>55</sup> The SEC has not adhered to the deadline set by Congress for promulgating regulations under the CROWDFUND Act. See JOBS Act, Pub. L. No. 112–106, § 4A(c), 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)) (“RULEMAKING—Not later than 270 days after the date of enactment of this Act, the Securities and Exchange Commission . . . shall issue such rules as the Commission determines may be necessary or appropriate for the protection of investors to carry out [this Act].”).

<sup>56</sup> See Press Release, *SEC Issues Proposal on Crowdfunding*, *supra* note 9.

<sup>57</sup> See *supra* note 10. For a discussion of the proposed regulations and their impact on human capital contracts, see *infra* Part IV.

<sup>58</sup> See JOBS Act §§ 301–305.

<sup>59</sup> See 15 U.S.C. § 77e (2012) (“It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.”).

incredibly onerous and expensive for companies.<sup>60</sup> Thus, many companies choose to remain privately held rather than bear the expense of offering equity shares to the public.<sup>61</sup> Therefore, to equity crowdfund<sup>62</sup> from the public at large—without registering prior to the public offering—is a clear violation of the federal securities laws.<sup>63</sup> Accordingly, the CROWDFUND Act carves out an exemption from the existing securities laws in order to permit, in certain limited circumstances, equity crowdfunding without having to comply with the full force of the registration requirement.<sup>64</sup>

The CROWDFUND Act primarily creates an add-on to the existing list of exempted transactions, previously enacted in the Securities Act of 1933.<sup>65</sup> The CROWDFUND Act sets forth restrictions on the issuer, the investor, and the statutorily required intermediary. With respect to the issuer, the aggregate amount of securities sold to all investors may not exceed \$1,000,000.<sup>66</sup> As for the investor, the aggregate amount of equity that a single investor may purchase from all crowdfunded offerings during a twelve-month period depends on the annual income or net worth of the investor in question.<sup>67</sup> Lastly, as to the intermediary, only a broker or funding portal<sup>68</sup> that is in compliance

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<sup>60</sup> See C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 602 (1996) (“The cost of making a registered securities offering includes (1) the direct expenses of preparing, filing, and distributing the required disclosure documents, (2) the commissions and fees paid to underwriters and others selling the securities, (3) the delay associated with registration, (4) the costs of maintaining the government registration system, and (5) other miscellaneous costs associated with registration.”).

<sup>61</sup> *Id.* at 604 (“Some attorneys claim that the costs of an exempted private placement are ‘only a fraction of the cost of an initial public offering.’”).

<sup>62</sup> See *supra* note 39 for the definition of “equity crowdfunding.”

<sup>63</sup> That is, a violation of the registration requirements. See generally *Registration Under the Securities Act of 1933*, *supra* note 20.

<sup>64</sup> See JOBS Act, Pub. L. No. 112–106, §§ 301–305, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)).

<sup>65</sup> See 15 U.S.C. § 77d.

<sup>66</sup> See 15 U.S.C. § 77d(a)(6)(A) (“[T]he aggregate amount sold to all investors by the issuer . . . [may not be] more than \$1,000,000.”).

<sup>67</sup> If an investor’s annual income or net worth is less than \$100,000, the aggregate amount of equity that may be sold to this investor is the greater of \$2,000 or 5% of the annual income or net worth of the investor. See 15 U.S.C. § 77d(a)(6)(B) (“[T]he aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, . . . [can] not exceed—the greater of \$2,000 or 5 percent of the annual income or net worth of such investor . . .”). However, if the investor’s annual income or net worth is over \$100,000, the aggregate amount of equity that may be sold to the investor is 10% of the investor’s annual income or net worth, so long as the aggregate amount does not exceed \$100,000. *Id.* (“[T]he aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, . . . [can] not exceed—10 percent of the annual income or net worth of such investor . . . not to exceed a maximum aggregate amount sold of \$100,000 . . .”).

<sup>68</sup> For the definition of “funding portal,” see 15 U.S.C. § 78c(a)(80) (“The term ‘funding portal’ means any person acting as an intermediary in a transaction involving the offer or sale of

with the Securities Act of 1933 may conduct the offering.<sup>69</sup> Funding portals, a new creation of the CROWDFUND Act, may only serve as an intermediary in crowdfunded offerings.<sup>70</sup>

These provisions seek to strike a balance between two competing goals of the securities laws. On the one hand, the securities laws are designed to prevent fraud.<sup>71</sup> On the other, the drafters of the securities laws understood the need for capital formation, as it is essential to our economy.<sup>72</sup> Thus, when drafting the CROWDFUND Act, Congress attempted to create a new means of raising capital while hoping to keep instances of fraud at a minimum.<sup>73</sup> Yet, achieving such a delicate balance is always easier accomplished in theory than in practice. Many critics of the JOBS Act believe that this legislation opens up the floodgates for fraud due to the relaxed disclosure and registration requirements.<sup>74</sup> Other critics, however, take the opposite view and posit that the disclosure and registration requirements have not been relaxed enough, and that even crowdfunded offerings will still be prohibitively expensive.<sup>75</sup> Until the SEC finalizes rules with respect to the CROWDFUND Act, uncertainty will persist as to the effectiveness of this legislation.<sup>76</sup>

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securities for the account of others . . . that does not—(A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.”).

<sup>69</sup> See 15 U.S.C. § 77d(a)(6)(C) (“[T]he transaction . . . [must be] conducted through a broker or funding portal that complies with the requirements of section [4A(a) of the Securities Act of 1933] . . .”).

<sup>70</sup> See 15 U.S.C. § 78c(a)(80) (“The term ‘funding portal’ means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to [the CROWDFUND Act] . . .”).

<sup>71</sup> See generally COFFEE & SALE, *supra* note 3, at 1–9 (discussing the goals of securities regulation).

<sup>72</sup> *Id.*

<sup>73</sup> See *Jumpstart Our Business Startups (Jobs) Act*, *supra* note 2 (“We look forward to hearing the public’s views as we write rules that both facilitate capital formation and promote investor protection.”).

<sup>74</sup> See, e.g., *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearings Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 8 (2011) (statement of John C. Coffee, Professor, Columbia Law School) (“[Early stage] issuers are in effect flying on a ‘wing and a prayer,’ selling hope more than substance. Precisely because of this profile, however, such offerings are uniquely subject to fraud, and some issuers will simply be phantom companies without any assets, business model, or real world existence.”).

<sup>75</sup> See, e.g., Andrew A. Schwartz, *Keep it Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 43 (2013).

<sup>76</sup> *Id.*

## II. HUMAN CAPITAL CONTRACTS

The financial arrangement between backer and individual can, in general terms, be classified as a “human capital contract.” In essence, a human capital contract is exactly as described by the operations of websites such as Upstart and Pave. A human capital contract allows an individual to obtain financing for his higher education by selling the right to a fixed percentage of his future earnings for a set number of years.<sup>77</sup> Human capital contracts have been touted as the possible solution for student loan debt in the United States.<sup>78</sup> Milton Friedman wrote about their benefits<sup>79</sup> and, in the 1970s, Yale University experimented (albeit unsuccessfully) with a program designed to use human capital contracts as an alternative to traditional student loans.<sup>80</sup>

The positive and negative consequences of human capital contracts are numerous. For individuals, human capital contracts offer the freedom to pursue an otherwise unfeasible career path given the financial constraints of student loan debt.<sup>81</sup> Yet, individuals take a risk that their loan payments may, under certain circumstances, total less than the ultimate payout from their future income stream.<sup>82</sup> Thus, these individuals would, unintentionally, hinder their capital accumulation by entering into human capital contracts.<sup>83</sup>

From the perspective of the investor, a human capital contract might be an attractive investment given the likely high rate of return that accompanies it.<sup>84</sup> However, human capital contracts garner a high rate of return specifically because they are risky.<sup>85</sup> The investor may end up funding a student who decides to devote his life to serving the

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<sup>77</sup> See Nicholas Barr, *Foreword to PALACIOS*, *supra* note 18, at xix.

<sup>78</sup> See David Bornstein, *A Way to Pay for College, with Dividends*, OPINIONATOR (June 2, 2011, 9:43 PM), <http://opinionator.blogs.nytimes.com/2011/06/02/a-way-to-pay-for-college-with-dividends>.

<sup>79</sup> See MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 100–07 (1962).

<sup>80</sup> See *Yale to Erase Alumni Debts in 2 Loan Plans*, N.Y. TIMES, Apr. 13, 1999, at B7 (“For each \$1,000 borrowed from the university, the students pledged 0.04 percent of their future earnings for 35 years, or until the whole class paid off its aggregate debt, whichever came first.”). Yale’s two student financing programs—the Tuition Postponement Option and the Contingent Repayment Option—were partially the brainchildren of Milton Friedman.

<sup>81</sup> See generally Bornstein, *supra* note 78.

<sup>82</sup> *Id.* (“What happens when students are very successful? Some say, ‘Wow, this is awesome, I owe it to you guys, I’ll pay happily, in fact I’m going to become an investor’ . . . In other cases, they say, ‘This is much more than I planned to pay. This is unfair. Let’s renegotiate.’” (internal quotation marks omitted)).

<sup>83</sup> That is, these students ultimately pay more than under a traditional student loan.

<sup>84</sup> Dave Girouard, founder of Upstart, stated that one investment “projected about an 8 percent annual return after fees.” See Sullivan, *supra* note 16.

<sup>85</sup> See Collins & Stampfli, *supra* note 33 and accompanying text.

needy—a profession that likely commands only a minimal salary.<sup>86</sup> Moreover, the availability of these contracts may be limited to those students who express an interest in a high-paying career.<sup>87</sup> Thus, the entire basis for instituting a human capital contract infrastructure would be undermined by the imbalance between students who need funds at a favorable rate and investors who are looking to maximize the return on their investment. Websites such as Upstart and Pave claimed to overcome this problem by promoting a mentor-mentee relationship between investor and individual.<sup>88</sup> Purportedly, this relationship allows mentors to groom and mold the individuals they invest in to ensure—at least to some degree—that the individuals pursue a lucrative field upon graduation.<sup>89</sup>

### III. IS A HUMAN CAPITAL CONTRACT A SECURITY?

#### A. *What Is a Security?*

To fall within the regulatory framework of the federal securities laws, an investment must be classified as a “security.” Both the Securities Act of 1933 and the Securities Exchange Act of 1934 provide statutory definitions of the term “security.”<sup>90</sup> Both definitions are, however,

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<sup>86</sup> See Bornstein, *supra* note 78 (“I’ve met many students who say they would love to spend a number of years after they graduate working for a social-purpose organization . . . but many of them end up going the corporate route because of their loans.”).

<sup>87</sup> See *id.* (“Economists have argued that human capital contracts would fall prey to the problem of ‘information asymmetry.’ The contracts are priced based on projections of a student’s future earnings—drawing in part on information that students provide themselves. For obvious reasons, students who say they want to go into banking will be asked to pay a lower percentage of future income than students who say they want to go into teaching. But what is to stop a student who secretly wants to become a teacher from pretending that he wants to become a banker?”).

<sup>88</sup> See Siegel Bernard, *supra* note 16. This problem is also supposedly overcome by calculating an appropriate funding rate, see *supra* note 50, for each individual. See MIGUEL PALACIOS, CATO INST., HUMAN CAPITAL CONTRACTS: “EQUITY-LIKE” INSTRUMENTS FOR FINANCING HIGHER EDUCATION 9, available at <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa462.pdf> (“[I]nvestors must pay special attention to pricing each contract accurately, making use of as much information about the student as possible. If they succeed in doing this, the price offered will seem reasonable to each student, and potential high- and low-income earners will find human capital contracts equally attractive.”).

<sup>89</sup> *Id.* For students who do not pay back their investors despite an ability to do so, the human capital contract can convert into a traditional loan.

<sup>90</sup> However, these definitions read more like a laundry list of transactions that qualify as a security, rather than actually identifying the common characteristics that generally comprise a security. See, e.g., 15 U.S.C. § 77b(a)(1) (2012) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or

qualified by the ever-broad statement that these definitions apply “unless context otherwise requires.”<sup>91</sup> Yet the most ambiguous term in both definitions, and the one that has drawn the most attention from courts and legal scholars, is the “investment contract.”<sup>92</sup>

The leading case on the interpretation of “investment contract” is *Securities & Exchange Commission v. W.J. Howey Co.*<sup>93</sup> The U.S. Supreme Court began its analysis in *Howey* by noting that although “investment contract” is not statutorily defined under federal law, many state “blue sky” laws<sup>94</sup> contain the same terminology, which state courts have interpreted broadly.<sup>95</sup> The Court found that Congress intended to incorporate this judicially created standard for “investment contract” into the Securities Act language.<sup>96</sup> Following the prevailing standard of the state courts,<sup>97</sup> the Supreme Court articulated its own definition of “investment contract.”<sup>98</sup> In the Court’s interpretation, an “investment contract” is a “contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.”<sup>99</sup> The Court stressed that this standard is a flexible one, not to be construed as static by any means.<sup>100</sup>

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group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security,’ or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”). The definitional language in the Securities Exchange Act of 1934 is substantially similar to the definition in the Securities Act of 1933. See 15 U.S.C. § 78c(a)(10).

<sup>91</sup> See 15 U.S.C. § 77b(a); see also 15 U.S.C. § 78c(a).

<sup>92</sup> See Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. CORP. L. 307, 308 (2000) (“[T]here have been no fewer than 792 cases decided and over 300 law review articles written in which either the ‘33 or ‘34 Act definition of a security has played a prominent role.” (footnotes omitted)).

<sup>93</sup> 328 U.S. 293 (1946).

<sup>94</sup> “Blue sky” laws are the state securities laws. See Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 229 (2003) (“They are known as ‘blue-sky’ laws, purportedly because one of their supporters claimed that many securities salesmen were so dishonest that they would sell ‘building lots in the blue sky.’”).

<sup>95</sup> See *Howey*, 328 U.S. at 298 (“The term ‘investment contract’ . . . had been broadly construed by state courts so as to afford the investing public a full measure of protection.”).

<sup>96</sup> *Id.* (“By including an investment contract within the scope of s[ection] 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims.”).

<sup>97</sup> See *id.* (“An investment contract thus came to mean a contract or scheme for ‘the placing of capital or laying out of money in a way intended to secure income or profit from its employment.’” (citing *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920))).

<sup>98</sup> *Howey*, 328 U.S. at 298–99.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* (“[This standard] embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”).

### B. Applying the Howey Test

Legal scholars have previously entertained the question of whether certain crowdfunding transactions fall within the purview of the federal securities laws.<sup>101</sup> However, only one author has considered whether human capital contracts<sup>102</sup> are a “security” under the *Howey* test.<sup>103</sup> This author, despite articulating a cogent argument for classifying human capital contracts as “investment contracts,”<sup>104</sup> failed to mention one counterargument that may cast doubt on the certainty of such a classification. This doubt, which relates to the third *Howey* element—expectation of profit, revolves around whether investors in human capital contracts, many of whom are social entrepreneurs,<sup>105</sup> are truly motivated by profit, and not by some virtuous, nonfinancial agenda.

Several cases subsequent to *Howey* have elaborated on the “expectation of profits” standard. In *United Housing Foundation v. Forman*,<sup>106</sup> the U.S. Supreme Court stated that “profits” can be construed in two ways: as capital appreciation or as a share of earnings.<sup>107</sup> The *Forman* Court also stressed that the “expectation of profits” must be the overarching motivation for investing.<sup>108</sup>

In the context of human capital contracts, the “expectation of profits” is somewhat unclear. Some investors might genuinely be motivated by a financial return. Others, however, might view such an agreement as a quasi-charitable donation. Thus, whether an “expectation of profits”—and not altruism—is the primary motivation is the critical question.<sup>109</sup> In the case of *Upstart and Pave*, some investors

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<sup>101</sup> See generally Bradford, *supra* note 6; Heminway & Hoffman, *supra* note 21.

<sup>102</sup> As defined in Part II.

<sup>103</sup> See Sarah M. Kinsman, Notes and Comments, *Sponsorship Investments: A New Way to Fund Your Education*, 34 U. LA VERNE L. REV. 189 (2013) (concluding that human capital contracts are “investment contracts” within the meaning of the federal securities laws).

<sup>104</sup> *Id.* at 202–07.

<sup>105</sup> For the definition of “social entrepreneurship,” see Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board’s Decisions to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 624 (2007) (“Social entrepreneurship is a growing, dynamic movement which is gaining respect among the younger generation of tomorrow’s tech and business leaders as well as with long existing, publicly-held corporations. These leaders don’t talk about shareholders; they talk about the community; they talk about growth; they talk about sustainability.”).

<sup>106</sup> 421 U.S. 837 (1975).

<sup>107</sup> *Id.* at 852 (“By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors’ funds.”).

<sup>108</sup> *Id.* (“In such cases [i.e., when there is an expectation of profits] the investor is ‘attracted solely by the prospects of a return’ on his investment.”).

<sup>109</sup> See Heminway & Hoffman, *supra* note 21, at 899 (“[I]n the case of crowdfunding websites or crowdfunded ventures that offer both non-financial benefits and financial return, the satisfaction of the *Howey* test may depend upon whether the primary purpose of the arrangement is affording funders preferential access to goods or services, offering them emotional satisfaction,

admit to having altruistic motives.<sup>110</sup> However, because the essence of a human capital contract involves a financial return to the investor, altruistic motives likely do not counteract the true reality—that is, investors have an “expectation of profits,” even if they do not mind that such profit might never materialize. Therefore, while a reviewing court or the SEC might differ on this issue, the conservative approach would be to presume that the primary motivation is profit centered. Consequently, although there remains some ambiguity with respect to the third *Howey* element, in all likelihood, all elements of the *Howey* test are satisfied and, therefore, human capital contracts should be regarded as “investment contracts” and, thus, securities.

#### IV. HUMAN CAPITAL CONTRACTS AND THE CROWDFUND ACT

Human capital contracts almost certainly qualify as securities.<sup>111</sup> Thus, an issuer of human capital contracts must register them with the SEC,<sup>112</sup> or qualify for an exemption under the federal securities laws.<sup>113</sup> The newest exemption under the securities laws is the CROWDFUND Act.<sup>114</sup> How the CROWDFUND Act will impact the viability of human capital contracts from a capital raising perspective and whether issuers of human capital contracts can adopt a statutorily compliant and cost-effective legal construct to capture the benefits of the CROWDFUND Act is the crux of this Note’s inquiry.

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presenting them with an opportunity to contribute to the public good, or providing them a financial return.”).

<sup>110</sup> See, e.g., Sullivan, *supra* note 16. One investor “said he did not have high expectations for a return,” but he decided to invest “after talking to his wife . . . about how hard it was for young entrepreneurs to get started.” *Id.* Another investor “backed 20 people with \$500 each, simply because she wanted to help young people” and because she “liked the prospect of receiving a good return for doing it but considered it fairly high-risk.” *Id.* For yet another example, see Dwyer Gunn, *Investing in Human Capital, One Person at a Time*, FREAKONOMICS (Feb. 1, 2013, 9:28 AM), <http://freakonomics.com/2013/02/01/investing-in-human-capital-one-person-at-a-time>. According to one investor:

I wanted to be a part of something that was innovative and helpful. I would say my expectations are very small, not to say that I don’t expect big things from my Upstarts. I do. I just try not to get caught up in what is in it for me. Way more exciting to watch and help when needed and know in my heart that it is the right thing at the right time. What goes around, you know? I like the idea of supporting hard workers who believe in who they are. They are already hugely successful and ahead of most by having the confidence to put themselves out there with Upstart.

*Id.*

<sup>111</sup> See *supra* Part III.

<sup>112</sup> See *supra* note 20.

<sup>113</sup> See *supra* note 13.

<sup>114</sup> Enacted on April 5, 2012. See *supra* note 2.

The CROWDFUND Act limits the amount an issuer can raise in a twelve-month period to \$1 million.<sup>115</sup> While this may be a limiting factor for many startup companies, it is unlikely that such a threshold would handcuff students looking to fund their higher education.<sup>116</sup> Thus, human capital contracts might be perfectly suited to fit within the regulatory scheme envisioned by the CROWDFUND Act. Similarly, from the investor's perspective, the limit on how much capital each investor can contribute is likely not to be a hurdle either.<sup>117</sup> As the average student debt of graduating undergraduate students is under \$30,000,<sup>118</sup> even a contribution of \$5000<sup>119</sup> can be a sizable portion of the funds each student is looking to raise. Therefore, at first glance, the CROWDFUND Act appears well suited to issuers of human capital contracts.

However, Congress, in enacting the CROWDFUND Act, sought to deter fraudulent activity within the crowdfunding realm.<sup>120</sup> As such, individuals—operating as business organizations<sup>121</sup>—seeking to

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<sup>115</sup> See 15 U.S.C. § 77d(a)(6)(A) (2012).

<sup>116</sup> The most expensive undergraduate institution in the United States is Columbia University, at a total tuition of \$51,008 per year. See Kelsey Sheehy, *10 Most, Least Expensive Private Colleges and Universities*, U.S. NEWS & WORLD REP. (Sept. 9, 2014, 9:00 AM), <http://www.usnews.com/education/best-colleges/the-short-list-college/articles/2013/09/10/10-most-least-expensive-private-colleges-and-universities>. Columbia's yearly tuition multiplied by four years of undergraduate education equals \$204,032. Thus, even a student looking to fund the most expensive undergraduate education would fall well within the \$1 million threshold laid out by the CROWDFUND Act.

<sup>117</sup> See 15 U.S.C. § 77(d)(a)(6)(B); see also *supra* note 67.

<sup>118</sup> In 2013, the average student debt was \$27,300. See COLLEGEBOARD, TRENDS IN STUDENT AID 4 (2014), available at <http://trends.collegeboard.org/sites/default/files/2014-trends-student-aid-final-web.pdf>.

<sup>119</sup> See 15 U.S.C. § 77(d)(a)(6)(B). Five thousand dollars is the maximum contribution allowed for investors with an annual income under \$100,000. This is because investors may invest up to 5% of their annual income.

<sup>120</sup> The “DF” in CROWDFUND is an acronym for “detering fraud.”

<sup>121</sup> For purposes of the CROWDFUND Act, the individual must operate not as an individual, but as a business organization. See 15 U.S.C. § 77d-1(f)(1); see also Regulation Crowdfunding, 78 Fed. Reg. 66,428, 66,551 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pt. 200 et al.) [hereinafter Regulation Crowdfunding] (“The crowdfunding exemption shall not apply to transactions involving the offer or sale of securities by any issuer that: (1) Is not organized under, and subject to, the laws of a State or territory if the United States or the District of Columbia . . .”); Regulation Crowdfunding, *supra*, at 66,448 (“Under the statute and proposed rules, an issuer must be a business organization, rather than an individual.”). For a discussion of what form of business organization is most suitable in this context, see Part V. Hereinafter, “individual” will be used to refer to an individual operating a “shell” business organization. However, since the business organization is technically the issuer and not the individual, all forthcoming references to “disclosure” will relate to the business organization and not the individual. Yet, as a practical matter, all investors will require the personal disclosure as well. Moreover, it is hard to posit that there has been adequate disclosure if the individual behind the business organization can evade personal disclosure. It seems plausible, based on the “business organization” requirement, that Congress and the SEC did not consider human capital contracts when enacting and proposing rules for the CROWDFUND Act.

capitalize on the provisions of the CROWDFUND Act must understand the costs associated with crowdfunding their student debt in this manner. One significant cost associated with raising capital via the CROWDFUND Act is the disclosure requirement.<sup>122</sup> Each issuer must satisfy a statutorily established level of financial reporting.<sup>123</sup> The level of financial reporting depends on how much capital the issuer seeks to raise.<sup>124</sup> Thus, a student looking to fund his education must, at the outset, decide how much to raise and in how many offerings.<sup>125</sup> For example, a student may want to raise the entire cost of his four-year tuition upfront, or conversely, conduct a new offering before each academic year. This decision may have serious practical consequences for the student. For a student looking to fund the entirety of his four-year undergraduate degree at a private institution, the cost for all four years might often exceed \$100,000.<sup>126</sup> The \$100,000 threshold has special significance under the CROWDFUND Act as the levels of disclosure differ depending on whether the threshold is crossed.<sup>127</sup> For offerings below \$100,000, the issuer must provide only an income tax

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Additionally, creating the business organization of choice might require legal assistance, which certainly will come at a cost. However, depending on the complexity of the business organization, cost of creation will vary. Nevertheless, all human capital contracts contain the same basic components and thus once the first human capital contract is executed, every successive issuer can freely imitate the legal structure of the original. Moreover, this Note's proposal, *see infra* Part V, will identify a method for reducing these legal costs even further.

<sup>122</sup> *See generally* Regulation Crowdfunding, *supra* note 121, at 66,552–54 (Requirements for Issuers: Disclosure Requirements).

<sup>123</sup> *Id.* at 66,553.

<sup>124</sup> *Id.*

<sup>125</sup> This decision also impacts the funding rate for the student. *See supra* note 50. If the student chooses to raise new capital after each year of school, the student's funding rate may change depending on his success in school, as well as any change in anticipated career path. Conversely, a student may choose intentionally to raise all necessary funds at the outset in order to hedge against an increase in the funding rate. Additionally, the student would be able to invest the capital obtained at the outset for the period until the capital is needed to pay tuition.

<sup>126</sup> *See* Sheehy, *supra* note 116 (“The average tuition and fees at private schools was \$31,381 in 2014–2015, according to data collected by U.S. News.”). Four years of private college at an average cost of \$31,381 equals \$125,524 in total. However, the calculus changes for public schools. In the fall of 2015, over eighteen million students are projected to enroll in an undergraduate institution. *See Table 105.20: Enrollment in Educational Institutions, by Level and Control of Institution, Enrollment Level, and Attendance Status and Sex of Student*, NAT'L CENTER FOR EDUC. STAT., [http://nces.ed.gov/programs/digest/d13/tables/dt13\\_105.20.asp](http://nces.ed.gov/programs/digest/d13/tables/dt13_105.20.asp) (last visited Mar. 21, 2015). Approximately seventy-five percent of those students are expected to enroll in a public school, where average tuition—including fees, room, and board—was \$15,022 for the 2012–2013 academic year. Four years at a public school would total, on average, approximately \$60,000. *Id.*; *see also* *Fast Facts*, NAT'L CENTER FOR EDUC. STAT., <http://nces.ed.gov/fastfacts/display.asp?id=372> (last visited Mar. 21, 2015).

<sup>127</sup> *See* 15 U.S.C. § 77d-1(b)(1)(D)(i)–(iii) (2012).

return from the most recent fiscal year and financial statements<sup>128</sup> that have been certified by the principal executive officer.<sup>129</sup>

In the instance of a human capital contract, the student, acting as a business organization, would need to disclose his personal income tax return, as well as certify<sup>130</sup> his own financial statements.<sup>131</sup> As the student would be only a high school senior,<sup>132</sup> compiling his financial statements would be a simple task, as he likely does not have a complex mix of assets,<sup>133</sup> liabilities,<sup>134</sup> and equity.<sup>135</sup> For the balance sheet,<sup>136</sup> his assets would be any cash<sup>137</sup> or cash equivalents<sup>138</sup> in his, rather than his parents', name.<sup>139</sup> His liabilities would likely be non-existent<sup>140</sup> and,

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<sup>128</sup> Financial statements include a balance sheet, income statement, statement of cash flows, and statement of changes in owners' equity and notes. See Regulation Crowdfunding, *supra* note 121, at 66,553.

<sup>129</sup> See 15 U.S.C. § 77d-1(b)(1)(D)(i); see also Regulation Crowdfunding, *supra* note 121, at 66,553. The principal executive officer must certify that the financial statements are true and complete in all material aspects. This requirement is similar to a key provision of the Sarbanes-Oxley Act of 2002. See 18 U.S.C. § 1350(a) (2012) ("Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission . . . shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer. . . [that certifies] that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.").

<sup>130</sup> According to the proposed rules, the student will certify as follows: "I, [identifying the certifying individual], certify that the financial statements of [identify the issuer] included in this Form are true and complete in all material respects. [Signature and title]." See Regulation Crowdfunding, *supra* note 121, at 66,554. This predetermined statement will be a portion of the Form C—Offering Statement. *Id.* at 66,553.

<sup>131</sup> Presumably, the student, in this case, would be the principal executive officer of the issuer. Thus, the student will only need to certify his own financial statements.

<sup>132</sup> The assumption here is that the student looking to enter into a human capital contract is a graduating high school senior and not an individual who took time off after graduating high school.

<sup>133</sup> Assets are resources with probable economic benefits obtained or controlled by an entity resulting from past transactions or events. See HOWELL E. JACKSON, ACCOUNTING AND FINANCE 3 (Foundation Press 2004).

<sup>134</sup> Liabilities are probable future economic sacrifices or economic benefits arising from present obligations to transfer assets or render services in the future as a result of past transactions or events. *Id.* at 5–6.

<sup>135</sup> Equity is the residual interest in assets of an entity after subtracting its liabilities. *Id.* at 6.

<sup>136</sup> A balance sheet is "[a] statement of the total assets and liabilities of an organization at a particular date, usually the last day of the accounting period. The first part of the statement lists the fixed and current assets and the liabilities, whereas the second part shows how they have been financed; the totals for each part must be equal." See OXFORD DICTIONARY OF ACCOUNTING 47 (4th ed. 2010).

<sup>137</sup> See CHARLES H. MEYER, ACCOUNTING AND FINANCE FOR LAWYERS IN A NUTSHELL 99 (5th ed. 2013) (defining cash as "currency and coins . . . checking accounts . . . savings accounts that are subject to withdrawal at any time, and negotiable checks not yet deposited or cashed").

<sup>138</sup> *Id.* at 99–100 (defining cash equivalents as "short term, high quality, highly liquid money market instruments with a maturity of three months or less[, where] [e]xamples of the [qualifying] types of items . . . include commercial paper, treasury bills, and money market fund securities").

<sup>139</sup> The student may have other personal property as well. A car is one example.

<sup>140</sup> Hopefully a high school senior has not assumed any debt at this point in his life—except for possibly credit card debt.

therefore, his equity would equal his assets.<sup>141</sup> His income statement<sup>142</sup> would be simplistic as well. Aside from a few part-time positions, the student will likely not have any appreciable income.<sup>143</sup> Similarly, the statement of cash flows<sup>144</sup> would be easily compiled based on his income, if any, and any income tax paid during the reporting period.<sup>145</sup> Lastly, for the statement of changes in owner's equity and notes,<sup>146</sup> he will only need to report any non-income capital obtained during the reporting period, such as gifts.<sup>147</sup> In sum, preparation of financial statements for a high school senior looking to enter into a human capital contract would not be overly burdensome.

However, if the student is looking to raise all four years of tuition upfront, the student may trigger more stringent disclosure requirements. Specifically, if the student seeks more than \$100,000 in a single offering (but less than \$500,000), he must provide investors with financial statements that have been reviewed by an independent public

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<sup>141</sup> Equity is equal to assets minus liabilities. This is known as the fundamental equation of accounting. Jackson, *supra* note 133, at 6–7 (2004).

<sup>142</sup> See MEYER, *supra* note 137, at 7 (“The income statement, also called the statement of results of operations, sets forth the primary components of net income or loss for the year. It is a ‘flow statement’ in that it reports the income for a period of time, typically one year, ending on the date of the related balance sheet. The primary components of the income statement are revenues, expenses, gains, and losses.”).

<sup>143</sup> If the student can be claimed as a dependent and the student's earned income is less than \$5,950, the student need not file an income tax return. See INTERNAL REVENUE SERV., 1040A INSTRUCTIONS (2014), <http://www.irs.gov/pub/irs-pdf/i1040a.pdf>.

<sup>144</sup> See MEYER, *supra* note 137, at 12–14 (“[The statement of cash flows] provides detail about the changes in the business' cash balance for the period covered by the income statement . . . . The statement of cash flows is divided into three main parts. The first section shows cash flow from operating activities . . . . The second section in the statement of cash flows is the cash flow from investing activities . . . . The third section is the cash flow from financing activities.”).

<sup>145</sup> As explained above, the statement of cash flows consists of three parts: operating, investing, and financing. See *supra* note 144. Operating activities include “the cash generated by the primary income producing activities of the business (cash received from the sale of products or services less the cash paid out for extraordinary expenses incurred in generating the sales as well as interest and tax payments).” MEYER, *supra* note 137, at 12. Thus, a high school student need only calculate his current income and any taxes paid on that income. Unless he has also purchased investments (such as stocks or bonds) during the reporting period, he will not have any entries for investing or financing activities. Investing activities are defined as “cash flow from the purchase and sale of operating assets (buildings, machinery, patents, etc.) and the purchase and sale of investments (buying and selling stocks and bonds, making loans, and receiving payments on loans).” *Id.* at 13. Financing activities include “amounts received from issuing debt instruments or selling stock and amounts paid out to repay loans or repurchase stock. It also includes amounts paid out as dividends on a corporation's stock, but not the amount paid as interest on loans . . . .” *Id.* at 14. A cursory reading of the descriptions of investing and financing activities elicits the impression that a high school senior likely does not have to concern himself with these portions of the statement of cash flows.

<sup>146</sup> See MEYER, *supra* note 137, at 11 (“The statement of owners' equity summarizes the changes in the owners' equity accounts for the period covered by the income statement.”).

<sup>147</sup> See *id.* (“The beginning balance of owners' equity is set forth followed by any additional amounts invested by the owners, the net income or loss of the business for the period, and any distributions to the owners that reduce owners' equity.”).

accountant.<sup>148</sup> Now, in addition to the difficulty of initially compiling the requisite financial statements, students must hire an independent<sup>149</sup> public accountant<sup>150</sup> to review<sup>151</sup> their financial statements. Enlisting a public accountant—not an insignificant cost<sup>152</sup>—could easily make raising money under the crowdfunding exemption cost ineffective. However, obtaining a public accountant to conduct a financial statement review may still make economic sense in the instance of a student looking to raise approximately \$200,000.<sup>153</sup> If the student in this scenario decided to borrow money to fund his education, the origination fee<sup>154</sup> on those loans might equal, or surpass, the cost associated with hiring an accountant to review his financial statements.<sup>155</sup> If origination fees on the total student loan reached two

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<sup>148</sup> See 15 U.S.C. § 77d-1(b)(1)(D)(ii) (2012) (“[Issuers with] target offering amounts of . . . more than \$100,000, but not more than \$500,000, [must provide] financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures established by the Commission, by rule, for such purpose.”).

<sup>149</sup> To qualify as independent, see 17 C.F.R. 210.2-01 (2012) (“The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.”).

<sup>150</sup> See *id.* (“The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.”).

<sup>151</sup> See Regulation Crowdfunding, *supra* note 121, at 66,553 (“[F]inancial statements [must be] reviewed by a public accountant who is independent of the issuer, using the Statements on Standards for Accounting and Review Services issued by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants . . .”).

<sup>152</sup> According to one source, the cost of having your financial statements reviewed could cost anywhere from \$4000 to \$20,000. See *Should You Pay for Audited Financial Statements?*, BUS. OWNER, <http://www.thebusinessowner.com/business-guidance/accounting/2009/07/should-you-pay-for-audited-financial-statements> (last visited Mar. 21, 2015) (“Obtaining a review for a small or midsize private company might cost between \$4,000 and \$20,000, depending on the audit firm, geographic location and complexity of the subject business.”).

<sup>153</sup> This may apply in a situation where the student planned on attending Columbia University at a cost of \$51,008 each year for four years. See *supra* note 116 (total cost of a four-year undergraduate education at Columbia University is \$204,032).

<sup>154</sup> For the definition of origination fee, see *What Are Origination Services? What Is an Origination Fee?*, CONSUMER FIN. PROTECTION BUREAU, <http://www.consumerfinance.gov/askcfpb/155/what-are-origination-services-what-is-an-origination-fee.html> (last visited Mar. 21, 2015) (“An origination fee is what the lender . . . charges the borrower for making the . . . loan.”).

<sup>155</sup> On Stafford loans, the origination fee is only one percent of the amount borrowed. However, the maximum a student may borrow through Stafford loans is capped at \$31,000–\$57,500, depending on whether the student is a dependent or independent. See *Unsubsidized Stafford Loan*, EDVISORS, <http://www.staffordloan.com/stafford-loan-info/unsubsidized-student-loan.php> (last visited Mar. 21, 2015). As such, other types of loans may have higher origination fees.

percent, a student might be indifferent between the cost of having his financial statements reviewed and originating student loans.<sup>156</sup> Thus, depending on a student's given circumstances, the requirement of having a public accountant review the financial statements may not be overly burdensome.

Another cost associated with operating under the crowdfunding exemption is the requirement of ongoing reporting.<sup>157</sup> Each year, an issuer must disclose updated financial statements and an annual report to its investors and the SEC.<sup>158</sup> This requirement imposes a cost on issuers similar to that of the initial disclosure requirement. Additionally, this reporting requirement might last until the human capital contract is fully satisfied.

Issuers relying on the crowdfunding exemption are also faced with the cost of enumerating all the material risks associated with the offering at issue.<sup>159</sup> The first issuer to develop this list of material risks will bear most of the cost, because once developed, the list will not likely change from issuer to issuer.<sup>160</sup>

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<sup>156</sup> Two percent of \$200,000 equals \$4000, which is the lower end of the spectrum of costs for hiring a public accountant to review financial statements. Considering the relative simplicity of a high school senior's financial statements, it is fair to assume that the cost of reviewing these financial statements will likely be on the lower end of the price scale, if not below the \$4000 mark, as this estimate was given for a small business, which in all likelihood is more complex financially than a high school senior.

<sup>157</sup> See 15 U.S.C. § 77d-1(b)(4) (2012); see also Regulation Crowdfunding, *supra* note 121, at 66,554.

<sup>158</sup> See 15 U.S.C. § 77d-1(b)(4); see also Regulation Crowdfunding, *supra* note 121, at 66,554.

<sup>159</sup> See Regulation Crowdfunding, *supra* note 121, at 66,552 ("A discussion of the material factors that an investment in the issuer speculative or risky . . ."). This requirement is similar to that of the disclosures necessary in the context of a public offering. See 17 C.F.R. § 229.503(c) (2012) ("Where appropriate, provide under the caption 'Risk Factors' a discussion of the most significant factors that make the offering speculative or risky. . . . The risk factors may include, among other things, the following: (1) Your lack of an operating history; (2) Your lack of profitable operations in recent periods; (3) Your financial position; (4) Your business or proposed business; or (5) The lack of a market for your common equity securities or securities convertible into or exercisable for common equity securities.").

<sup>160</sup> See 17 C.F.R. § 229.503(c), *supra* note 159. However, the regulations instruct issuers to "not present risks that could apply to any issuer or any offering." *Id.* However, these regulations, while persuasive guidance in the CROWDFUND Act context, are not binding, as they are not promulgated pursuant to the CROWDFUND Act legislation. Other human capital contracts risks include, but are not limited to, the student not finishing school, not obtaining a well-paying job, not attempting to find employment, imprisonment, default, bankruptcy, and death. Moreover, another important consideration from a risk standpoint is that many students may only raise a few thousand dollars in a given offering. As such, if fraud happened to present itself, the investor may not have any legal recourse given the high cost of legal assistance. The diminutive nature of an average claim may itself be a hindrance to recouping lost investments. Thus, this risk is important to disclose at the outset. One author also concludes that human capital contracts evoke four major risks: (1) legal uncertainty; (2) public risk; (3) investment risk; and (4) default. For further explanation, see PALACIOS, *supra* note 18, at 113–20. Additionally, the Private Securities Litigation Reform Act of 1995 (PSLRA) may also be an impediment to investors seeking remedies for alleged fraudulent offerings. For example, the PSLRA mandates a heightened pleading standard for securities fraud. See Private Securities Litigation Reform Act of 1995, 15 U.S.C.

Issuers under the CROWDFUND Act are also required to produce a business plan.<sup>161</sup> In the human capital contract context, a student's business plan would simply be a statement articulating the student's college of choice, major of study, anticipated career goals,<sup>162</sup> and the intended uses of the proceeds raised through his offering.<sup>163</sup> The proposed regulations allow the issuer to state multiple intended uses, thus giving a student the flexibility to outline several different educational and career paths.<sup>164</sup> Relatedly, the student must determine whether or not his offering will have voting rights<sup>165</sup> attached.<sup>166</sup> In every instance, the student will opt to raise capital without voting rights attached, as one of the cornerstone features of the human capital contract is the student's ability to pursue any life decision he desires.<sup>167</sup>

One last cost connected with crowdfunded offerings is the restriction on advertising.<sup>168</sup> Intuitively, if no one is aware of the

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§ 78u-4(b)(2) (2012) (“[Plaintiffs must] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”); *see also* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

<sup>161</sup> A business plan can be defined as “[a] detailed plan setting out the objectives of a business over a stated period, often three, five, or ten years. . . . For new businesses it is an essential document for raising capital or loans.” *See* OXFORD DICTIONARY OF FINANCE AND BANKING 54 (3d ed. 2005).

<sup>162</sup> The statutory and regulatory mandate does not specify the content of a business plan. *See* 15 U.S.C. § 77d-1(b)(1)(C); *see also* Regulation Crowdfunding, *supra* note 121, at 66,552. Thus, the student here has significant leeway in shaping the contours of his business plan.

<sup>163</sup> *See* 15 U.S.C. § 77d-1(b)(1)(E) (“[A] description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount.”); *see also* Regulation Crowdfunding, *supra* note 121, at 66,552.

<sup>164</sup> *See* Regulation Crowdfunding, *supra* note 121, at 66,552 (“If an issuer has identified a range of possible uses, the issuer should identify and describe each probable use and the factors impacting the selection of each particular use.”). Note that the proposed regulation employs the word “should” and not “must,” thus permitting even more flexibility in this aspect of the issuer’s required disclosure.

<sup>165</sup> Voting shares have been defined as “[s]hares in a company that entitle their owner to vote at the annual general meeting and any extraordinary meetings of the company[, where] [s]hares that carry voting rights are usually ordinary shares, rather than A shares or debentures[, and] [t]he company’s articles of association will state which shares carry voting rights.” *See* OXFORD DICTIONARY OF FINANCE AND BANKING, *supra* note 161, at 427.

<sup>166</sup> *See* Regulation Crowdfunding, *supra* note 121, at 66,552 (“A description of the ownership and capital structure of the issuer, including . . . whether or not such securities have voting rights.”).

<sup>167</sup> *See* AN EXECUTIVE BRIEFING ON FINANCING HUMAN CAPITAL, at vi (Elizabeth F. O’Halloran et al. eds., 2004) (“[T]he human capital investor has no direct influence on the students: they are free to choose a field of study, an educational institution, and a career path.”); *see also* Patricia H. Werhane, *The Ethics of Human Capital Contracts*, in AN EXECUTIVE BRIEFING ON FINANCING HUMAN CAPITAL, *supra*, at 42–43 (noting that “the implication of indentured servitude lingers in the term *human capital contracts*”); *cf.* Joshua Davis, *Meet the Man Who Sold His Fate to Investors at \$1 a Share*, WIRED (Mar. 28, 2013, 6:30 AM), <http://www.wired.com/2013/03/ipo-man/all> (detailing the story of a man who sold shares in himself *with* voting rights, where his rationale was described as the following: “I figured they’d make good decisions for me, since they had money on the line and wanted to see their investment appreciate”).

<sup>168</sup> *See* 15 U.S.C. § 77d-1(b)(2); *see also* Regulation Crowdfunding, *supra* note 121, at 66,555.

student's offering and, thus, no one invests, the likelihood of meeting the student's target offering amount becomes increasingly low. However, the proposed regulations do permit issuers to release a "notice"<sup>169</sup> that will direct potential investors to the funding portal.<sup>170</sup> And in fact, the definition of "notice" is rather broad and can include much of the pertinent information with respect to the offering.<sup>171</sup> Nevertheless, the issuer may only convey objective information on the notice.<sup>172</sup>

## V. PROPOSAL

The ultimate question to be resolved is whether the process of entering into a human capital contract is too onerous on the student in terms of complying with the provisions of the CROWDFUND Act.<sup>173</sup> This Note concludes that the process is, in fact, too onerous but proposes a solution to alleviate some of the burden.

Each year, prospective college students face the decision of how to finance their continuing education.<sup>174</sup> Many students weigh two traditional avenues: federal or private loans.<sup>175</sup> Generally, however, the vast majority of students choose federal loans.<sup>176</sup> Thus, in order to qualify for federal loans, students must complete a Free Application for

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<sup>169</sup> See Regulation Crowdfunding, *supra* note 121, at 66,555.

<sup>170</sup> For the definition of "funding portal," see *supra* note 68.

<sup>171</sup> See Regulation Crowdfunding, *supra* note 121, at 66,555 (stating that the notice may include information such as "the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period").

<sup>172</sup> See Regulation Crowdfunding, *supra* note 121, at 66,555. However, the restriction on communication with potential investors is relaxed when conducted through communication channels established by the funding portal. *Id.*

<sup>173</sup> This includes not only the substantive provisions outlined in Part IV, but also the technical requirement that each issuer operate as a business organization, not as an individual. See Regulation Crowdfunding, *supra* note 121, at 66,551. This Proposal addresses the concerns raised by both.

<sup>174</sup> See *Student Loans: Choosing a Loan That's Right for You*, CONSUMER FIN. PROTECTION BUREAU, <http://www.consumerfinance.gov/paying-for-college/choose-a-student-loan/#o1> (last visited Mar. 21, 2015) ("Key Questions: I have to borrow money for school. What are my options?" (internal quotation marks omitted)).

<sup>175</sup> *Id.* (comparing side by side the costs and benefits of federal loans versus private loans).

<sup>176</sup> *Id.* ("For most borrowers, federal student loans are the best option."); see also Rohit Chopra, *Student Debt Swells, Federal Loans Now Top a Trillion*, CONSUMER FIN. PROTECTION BUREAU (July 17, 2013), <http://www.consumerfinance.gov/newsroom/student-debt-swells-federal-loans-now-top-a-trillion> ("The Consumer Financial Protection Bureau estimates that outstanding debt is approaching \$1.2 trillion as of May 2013. We also estimate that student loans guaranteed or held by the federal government have now crossed the \$1 trillion mark."). Based on this data, approximately eighty-three percent of students choose federal loans over other types of loans, including private loans.

Federal Student Aid (FAFSA).<sup>177</sup> Consequently, for students considering human capital contracts as an alternative to federal loans, the utility of crowdfunding human capital contracts under the CROWDFUND Act hinges on whether the cost<sup>178</sup> to students of initially complying with the statutory requirements is less than that of filing a FAFSA (and other costs associated with traditional loans).<sup>179</sup>

To overtake federal loans as the predominant source of higher education financing, crowdfunded human capital contracts will have to overcome switching costs<sup>180</sup> and network effects<sup>181</sup> associated with the higher education financing market. In terms of switching costs, the student will need to expend time and effort educating himself about the specific features of the human capital contract, given their relative obscurity.<sup>182</sup> Conversely, most high school seniors are already sufficiently familiar with the concept of a loan that no in-depth explanation is necessary. But even assuming the student can grasp the functionality of a human capital contract without much difficulty, the cost of complying with the statutory and regulatory requirements in order to actually effectuate a crowdfunded human capital contract offering may be more than a student can bear. Yet, filing a FAFSA is also notoriously difficult and complex.<sup>183</sup> Thus, a student who is already

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<sup>177</sup> See *Student Loans: Choosing a Loan That's Right for You*, *supra* note 174 (“You must complete this form to be eligible for any federal student loans or grants.”).

<sup>178</sup> For a review of the costs associated with crowdfunding human capital contracts under the CROWDFUND Act, see *supra* Part IV.

<sup>179</sup> Note that even if the cost of crowdfunding human capital contracts is greater than that of traditional loans, students may be willing to pay a premium to capture the advantages offered by a human capital contract.

<sup>180</sup> See *Switching Costs*, INVESTOPEDIA, [http://www.investopedia.com/terms/s/switching\\_costs.asp](http://www.investopedia.com/terms/s/switching_costs.asp) (last visited Mar. 21, 2015) (“The negative costs that a consumer incurs as a result of changing suppliers, brands or products. Although most prevalent switching costs are monetary in nature, there are also psychological, effort- and time-based switching costs.”); see also Paul Klemperer, *Markets with Consumer Switching Costs*, 102 Q.J. ECON. 375, 375 (1987) (“In many markets consumers face substantial costs of switching between brands of products that are ex ante undifferentiated. There are at least three types of switching costs: transaction costs, learning costs, and artificial or contractual costs.”).

<sup>181</sup> See Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 357 (2006) (“The economic benefits associated with everyone using the same system are known as network effects or network externalities. When all conform to the same system, transaction costs are reduced. . . . Because of the widespread positive external benefits of the network, no private entity can fully capture these benefits, which means that private organizations will underinvest in the creation of benefits from [certain] practices . . .”).

<sup>182</sup> See Klemperer, *supra* note 180, at 375 (“The learning required to use one brand may not be transferable to other brands of the same product, even though all brands are functionally identical.”). In the context of human capital contracts, the student is aware that federal loans and human capital contracts are functionally equivalent in the sense that they both serve the ultimate purpose of funding the student’s education. However, there are learning costs associated with switching between functionally identical products, as is the case here.

<sup>183</sup> See EDITORIAL: *FAFSA Requirement Unnecessary Burden*, FIUSM.COM (Aug. 24, 2011), <http://fiusm.com/2011/08/24/editorial-fafsa-requirement-unnecessary-burden> (“The [FAFSA]

actively seeking out alternative financing strategies may be inclined to go the proverbial “extra mile” in order to enter into a human capital contract.<sup>184</sup> In fact, when reflecting on the costs of human capital contracts mentioned previously, the foremost one was the initial disclosure requirement, as well as the ongoing one.<sup>185</sup> But, to a rational decisionmaker, when measuring the costs associated with (1) filling out the FAFSA each year, (2) participating in entrance, financial awareness, and exit counseling,<sup>186</sup> and (3) adhering to school-specific financial aid deadlines,<sup>187</sup> the cost of a human capital contract is unlikely to be materially greater than that of a federal loan.

However, because of the network effects associated with federal loan financing, human capital contracts will not be able to overcome the arguably low switching costs in this area. For example, all institutions of higher education are familiar with the concept of federal student loans, and even have personnel on staff to assist students who are experiencing difficulty with the process. Yet, given the fact that human capital contracts have not yet emerged as a well-known alternative to federal loans,<sup>188</sup> most colleges are presumably not equipped to handle students’ issues relating to human capital contracts. Moreover, while there are companies that provide FAFSA assistance to students who need additional support,<sup>189</sup> no equivalent companies exist with respect to human capital contracts.<sup>190</sup> Inertia will also play a critical factor in determining whether students will choose human capital contracts over federal loans.<sup>191</sup> Thus, at present, the costs associated with crowdfunding human capital contracts are too burdensome to convince students to leave the federal loan market for the human capital contract one.

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form, which requires parental tax and income information for dependents, can be difficult for college students to complete without sufficient time and preparation.”).

<sup>184</sup> Note also that parents may play an active role in assisting their children with this process.

<sup>185</sup> See *supra* Part IV.

<sup>186</sup> See *What You Need*, STUDENTLOANS.GOV, <https://studentloans.gov/myDirectLoan/whatYouNeed.action?page=counseling> (last visited Mar. 21, 2015) (detailing the ways in which to complete all three types of counseling).

<sup>187</sup> See, e.g., *Office of Student Finance*, YESHIVA UNIVERSITY, <https://www.yu.edu/osf> (last visited Mar. 21, 2015) (“New students must apply by February 1, 2015, and continuing students by April 15, 2015.”).

<sup>188</sup> Both Upstart and Pave no longer even offer human capital contracts. See *supra* notes 15 and 19.

<sup>189</sup> See, e.g., STUDENT FINANCIAL AID SERVICES INC., <http://www.fafsa.com> (last visited Mar. 21, 2015).

<sup>190</sup> However, accountants and lawyers will likely fill this void and capitalize on the uptick in crowdfunded offerings.

<sup>191</sup> See Michael H. Ryan, *Competition and Price Regulation in the Market for Public Long-Distance Telephone Services*, 41 MCGILL L.J. 169, 195 (1995) (defining “customer inertia” as “the propensity of customers to remain with the incumbent carrier even when competitors offer more advantageous prices and other terms of service”).

However, this Note proposes that human capital contracts can succeed in light of the costs associated with offering securities under the CROWDFUND Act if students group together to create economies of scale in the offering process. As noted previously, offerings under the CROWDFUND Act that range between \$100,000 and \$500,000 must have accompanying financial statements that have been reviewed by a public accountant.<sup>192</sup> Therefore, if students can pool themselves together to create one entity,<sup>193</sup> they can have combined financial statements.<sup>194</sup> Thus, if the student pool, in aggregate, totaled an offering less than \$500,000, the cost of financial statement review would be spread across several students.<sup>195</sup> The students, however, would need a platform upon which they could meet each other and form pools.

Funding portals can serve this role. Funding portals can organize social media-type platforms for prospective students, all of who intend to finance their education through human capital contracts. The funding portals can structure the platforms to require students to form pools based on certain criteria, such as grade point average, SAT score, selected university, and anticipated career path.<sup>196</sup>

However, it is important to note that the funding portal will *not* become the issuer. The issuer will be the resulting business organization that holds, as assets, the human capital contracts of the student pool. The funding portal will simply facilitate pool formation. This structure would not run afoul of the provisions of the CROWDFUND Act because the funding portal is not taking a direct or indirect financial interest in the issuer. The funding portal will earn a profit solely through transaction fees associated with being the intermediary. The funding portal can also supplement its profit by providing services to assist students seeking to enter into human capital contracts.

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<sup>192</sup> See *supra* note 148.

<sup>193</sup> That is, the business organization mentioned *supra* note 121. See Regulation Crowdfunding, *supra* note 121, at 66,447, 66,551.

<sup>194</sup> The students' financial statements will be combined in the sense that the resulting entity's financial statements will need to be reviewed. Although the assets of the entity are only the human capital contracts of the students, see *supra* note 121, in order to satisfy the disclosure needs of the investors, the students' financial statements will need to be compiled and subsequently reviewed.

<sup>195</sup> Since the cost of reviewing multiple students' financial statements is only incrementally higher than the cost of reviewing just one, the associated accounting costs are, therefore, spread amongst the group of students. This holds true for each subsequent year in which the students must provide updated financial statements. Although the cost of financial statement review is a recurring cost not present in a traditional loan, many students may still be willing to pay this premium in order to enter into a human capital contract (given its advantages over a traditional loan).

<sup>196</sup> Or any other criterion that students or investors, through repeated market transactions, wish to have.

The best organizational structure to effectuate these student pools is the LLC.<sup>197</sup> The LLC provides investors with limited liability, pass-through taxation, and—most critically—flexibility.<sup>198</sup> In the crowdfunding context, potential investors will likely be strangers and geographically distant from each other<sup>199</sup> and, as such, limited liability is crucial. Presumably, no investor would contribute capital to these students if their personal assets were at stake.<sup>200</sup> Thus, the limited liability aspect of the LLC is a fundamental reason for choosing this form of business organization.

However, limited liability cannot be the determinative factor for choosing the LLC form, since the corporate form<sup>201</sup> also provides limited liability.<sup>202</sup> Rather, the LLC trumps the corporation because of its tax-advantaged status.<sup>203</sup> Instead of revenue being taxed twice, once

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<sup>197</sup> The limited liability company is “[a] company—statutorily authorized in certain states—that is characterized by limited liability, management by members or managers, and limitations on ownership transfer.” See BLACK’S LAW DICTIONARY 319 (9th ed. 2009). *But see* COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 69 (William T. Allen et al. eds., 4th ed. 2012) (“LLCs now can combine pass-through treatment for federal income tax purposes with limited liability, participation in control by members (without loss of limited liability), free transferability of interests, and continuity of life.”). Most LLCs formed in the United States are formed in Delaware. *Id.* at 69–70 (“Delaware . . . claim[s] roughly 8 percent of all LLCs formed in the United States during 2006, 42 percent of LLCs formed with five or more employees outside of their home state, and more than half of all LLCs formed with twenty or more employees outside of their home state—again in 2006. In 2012, an educated guess would be that Delaware’s percentage share in each of these niches of the LLC franchise market would have increased since 2006.” (footnote omitted)). The governing statute in Delaware for LLCs is the Delaware Limited Liability Company Act. See DEL. CODE ANN. tit. 6, §§ 18-101–18-1109 (2015).

<sup>198</sup> See generally J. DENNIS HYNES & MARK J. LOWENSTEIN, AGENCY, PARTNERSHIP, AND THE LLC IN A NUTSHELL 334–35 (5th ed. 2012).

<sup>199</sup> See *supra* note 7. Raising capital from the “crowd” implies a large pool of investors. Therefore, the likelihood that all investors are personally acquainted with each other is presumably infinitesimal. The same can be presumed for geographic location.

<sup>200</sup> Limited liability, defined as “[l]iability restricted by law or contract; esp., the liability of a company’s owners for nothing more than the capital they have invested in the business,” shields investors from personal liability, defined as “[l]iability for which one is personally accountable and for which a wronged party can seek satisfaction out of the wrongdoer’s personal assets.” See BLACK’S LAW DICTIONARY 997–98 (9th ed. 2009). However, under certain circumstances, wronged parties may be able to circumvent the limited liability of the LLC and “pierce the veil” in order to satisfy a judgment from the personal assets of the wrongdoer. For further discussion of this issue, see Robert B. Thompson, *Piercing the Veil: Is the Common Law the Problem?*, 37 CONN. L. REV. 619 (2005).

<sup>201</sup> Corporations, generally, can be defined as “[a]n entity (usu. a business) having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely . . .” BLACK’S LAW DICTIONARY 391 (9th ed. 2009).

<sup>202</sup> See David Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 EMORY L.J. 1305, 1309 (2007) (“Long the hallmark of corporate status, limited liability protects a corporation’s shareholders from personal responsibility for corporate obligations.” (footnote omitted)).

<sup>203</sup> See Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 567 (2007) (“The LLC allows private business owners to form a company . . . without incurring a second level of corporate federal income tax on the business entity’s earnings.”).

at the corporate level and then again at the individual level,<sup>204</sup> LLCs enjoy pass-through taxation treatment, which allows members<sup>205</sup> to collect payouts from the LLC and only pay taxes at the individual level. This feature of an LLC is ideal for the human capital contract because investors will be receiving payments remitted from the students to the LLC and then from the LLC to the investors. Avoiding double taxation is necessary to allow the market of crowdfunded human capital contracts to function cost effectively.

The last essential component of an LLC that makes it particularly attractive in this context is flexibility.<sup>206</sup> The LLC operating agreement,<sup>207</sup> which is drafted at the outset, can generally contain any provision that is agreed upon by the members of the LLC.<sup>208</sup> Thus, as here, when the LLC's intended operations are clearly defined, the LLC operating agreement can easily be tailored to the exact needs of its members.

The thrust of this Note's proposal is that the funding portal will assume the responsibility of helping students form LLCs tailored to each group of students formed on the funding portal's website. Because each human capital contract will be identically structured,<sup>209</sup> the funding portal will essentially be creating "off-the-shelf" LLCs that can be formed with ease. In order to overcome the switching costs and inertia discussed previously, it is imperative for the funding portal to assume this responsibility. Moreover, the funding portal is the least cost avoider<sup>210</sup> in this context. The students will not want to spend the capital

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<sup>204</sup> Corporations are fictional legal entities. See Allen, *supra* note 197, at 81 ("The corporation is considered a separate person in the eyes of the law.") For this reason, there are "two levels of tax on corporate profits": "[t]he first tax applies at the corporate level when profits are earned, and the second tax applies at the shareholder level when profits are distributed as dividends." See Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 519 (2009) (footnotes omitted).

<sup>205</sup> Members in an LLC are the equivalent of shareholders in a corporation. See Allen, *supra* note 197, at 68.

<sup>206</sup> See Miller, *supra* note 203, at 567 (The LLC "provides freedom from cumbersome corporate processes by offering unparalleled flexibility in management structure.")

<sup>207</sup> See DEL. CODE ANN. tit. 6, § 18-101(7) (2015) ("Limited liability company agreement" means any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business.")

<sup>208</sup> See Allen, *supra* note 197, at 70; see also DEL. CODE ANN. tit. 6, §§ 18-1101 ("It is the policy of this chapter [Construction and Application of Chapter and Limited Liability Company Agreement] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.")

<sup>209</sup> See *supra* note 121. The only differences will be the price at which each interest in the LLC is sold.

<sup>210</sup> See William Barnett II et al., *The Paradox of Coase as a Defender of Free Markets*, 1 N.Y.U. J.L. & LIBERTY 1075, 1086 (2005) ("[I]n liability cases, the Coasean judge is called upon to favor the party who can, at least cost, avoid the accident."). Although this is not a tort context, the logic still applies. The funding portal can form the LLCs at the least cost, and, therefore, the market will dictate that they will burden this cost.

forming an LLC, nor will investors who most likely intend to be passive. Thus, the funding portal can achieve efficiency in this market by developing a universal LLC form that is precisely tailored to the human capital contract.

The basic components of the LLC will need to be established at the outset, with subsequent refinement occurring after issues arise through market use. Most fundamentally, the LLC will be management managed, not member managed.<sup>211</sup> In the crowdfunding context, most investors will be passive investors who have neither the time nor the interest to manage an LLC.<sup>212</sup> Moreover, it would be imprudent to allow one of the students to manage the LLC for fear of losing control of each remitted payment from student to LLC and then from LLC to member.<sup>213</sup> Thus, a third party would need to assume the role of manager and perform the ministerial tasks of the LLC.<sup>214</sup> Under the CROWDFUND Act and its proposed regulations, funding portals may not engage in certain specified actions.<sup>215</sup> One part of the Act that states that funding portals cannot “hold, manage, possess or otherwise handle investor funds”<sup>216</sup> appears to pose a problem but, in actuality, the manager would not be dealing with *investor* funds, but rather funds belonging to the LLC. Not until the manager declares a dividend to the LLC members do the funds remitted by the students become *investor* funds.<sup>217</sup> Thus, another function of the funding portal would be to appoint a manager to oversee the operation of all the LLCs created through its crowdfunding operations.<sup>218</sup>

One of the ministerial tasks that the manager would supervise is the transfer of payments between the students and the LLC and the LLC to the investors/members. Since the LLC is a separate entity, there needs

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<sup>211</sup> See Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed Versus Manager-Managed Distinction in the Limited Liability Company*, 93 KY. L.J. 737, 737 (2004) (“The universe of limited liability companies (“LLCs”) is bifurcated into two species: LLCs that are member-managed and LLCs that are manager-managed.”).

<sup>212</sup> See *supra* note 6, at 5. Raising capital from the “crowd” implies a large pool of investors. Therefore, on a per investor basis, no investor will be willing to invest the time and energy in managing the LLC.

<sup>213</sup> Depending on how the payment system is configured, as well as how voting rights are allocated within the LLC, the manager of the LLC might have authority to alter the flow of payments.

<sup>214</sup> In practice, one person (or entity) would likely assume the role of manager for all LLCs formed through the funding portal. An entity that has perpetual existence would be more ideal than a person, who would have to be replaced upon death.

<sup>215</sup> See 15 U.S.C. § 78c(a)(80) (2012); see also Regulation Crowdfunding, *supra* note 121, at 66,555–56. The statute and regulation specifically refer to *investor* funds, not those of the issuer.

<sup>216</sup> See 15 U.S.C. § 78c(a)(80)(D).

<sup>217</sup> The funds still belong to and are owned by the LLC.

<sup>218</sup> Any prudent attorney might, however, want to seek a no-action letter from the SEC regarding the interpretation of this section of the CROWDFUND Act. Presumably, when drafted, no one foresaw this scenario.

to be a means of directing the LLC to collect and pay out the funds received from the students.<sup>219</sup> As the manager will not want to actively direct the LLC each time a payment is received or distributed,<sup>220</sup> the ideal payment system will be one that is automatic.<sup>221</sup> All parties involved could opt for a payment system, such as PayPal, that would administer an automatic payment schedule at established intervals. This would prevent needless administrative work to collect payments and redistribute them to the investors. However, the manager still plays a crucial role. If PayPal, or some other similar service used, ceases to exist, the manager needs the authority to replace the old system with an equivalent new one. Without the manager in place, payments would halt and investors would be dissatisfied.

Although the manager executes the ministerial functions, and will have authority to act within the parameters established at the outset in the operating agreement, members will retain limited voting rights<sup>222</sup> over certain core aspects of the LLC. For one, the members will have veto power over the choice of payment system. Thus, if the members disagree with the manager's selection, they have the right to veto that action. Another integral voting right retained by the members will be with respect to lawsuits initiated by the LLC. Like a corporation, an LLC can bring suit on behalf of itself.<sup>223</sup> However, instead of delegating the authority to the manager to determine when and who to sue, the

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<sup>219</sup> Normally, as in an asset securitization, a trustee will assume responsibility for the ministerial functions. See Peter F. Culver, *The Dawning of Securitization*, 8 PROB. & PROP. 34, 34 (1994) ("The basic structure of an asset securitization is not complex. A business with a pool of quality receivables (the Originator) transfers the receivables to a free-standing entity specifically created for the transaction. This entity, known as a "Special Purpose Vehicle," can be either a corporation or a trust . . . . If the Special Purpose Vehicle is a trust, it must be managed by an independent corporate trustee in a legal structure similar to bond financing."). Generally, a bank will be the trustee. See Pelma Rajapakse & Naomal Goonewardena, *Assignment of Mortgage Loans to a Special Purpose Vehicle in Securitization in Sri Lanka: With Some Reference to Australian Securitization Programs*, 28 BANKING & FIN. L. REV. 475, 478 (2013). However, given the low asset value of the LLC (less than \$500,000), paying a bank to perform managerial duties is likely not cost-effective.

<sup>220</sup> If this were the case, one manager might easily be overburdened by the number of LLCs that he has to manage and supervise.

<sup>221</sup> See Andrew Winerman, *The Law of Consumer Auto-Payments and Auto-Payment Failure: Reducing the Costs of Carelessness*, 17 VA. J.L. & TECH. 35, 36 (2012) ("[M]any consumers use automatic bill payment features that—following initial setup by the consumer—automatically pay various payees using either a bank account (directly or through a debit card) or credit card.").

<sup>222</sup> Establishing that vetoes and decisions must be reached by a supermajority vote is better than by a simple majority vote. See Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 940 (1996) ("By the 1980s, shareholder supermajority voting rules were being championed among American corporations as a way to protect minority shareholders . . . ."). In this situation, especially where investors are not acquaintances, the minority needs greater protection.

<sup>223</sup> See HYNES, *supra* note 198, at 333 ("The LLC is a separate entity, capable of suing and being sued . . . .").

members, upon a vote, can direct the LLC to sue one of the students, presumably for default of payments.<sup>224</sup> The manager will then initiate suit against the defaulting student.

One other area that needs to be considered at the outset is the ultimate dissolution<sup>225</sup> of the LLC. Per the CROWDFUND Act, an issuer<sup>226</sup> must satisfy an ongoing disclosure requirement.<sup>227</sup> However, the life of each human capital contract is not interminable like the life of an LLC.<sup>228</sup> Thus, according to the provisions of the CROWDFUND Act, an LLC is relieved of its ongoing disclosure obligation upon the occurrence of certain events, one of them being dissolution.<sup>229</sup> Since the life of each human capital contract may vary across the students in the group,<sup>230</sup> it can be agreed upon upfront that dissolution will occur upon the fulfillment of the final human capital contract (or some other triggering event in the situation where one or more students default on their obligations).<sup>231</sup>

As previously mentioned, all remaining drafting decisions can be resolved by use of standard terms, as these terms will likely have no bearing on human capital contracts specifically. If a standard term subsequently creates issues, the funding portal will make the appropriate amendments to its universal LLC operating agreement.

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<sup>224</sup> One other loophole around the problem of how the LLC will enforce the human capital contracts is to require each student to guarantee the contracts personally to each investor. This would create a direct link between investor and student, which would enable the investor to bring suit directly against the student in the instance of default.

<sup>225</sup> For a definition of dissolution, see BLACK'S LAW DICTIONARY 541 (9th ed. 2009) ("The termination of a corporation's legal existence by expiration of its charter, by legislative act, by bankruptcy, or by other means; the event immediately preceding the liquidation or winding-up process."); see also DEL. CODE ANN. tit. 6, §§ 18-1101 (2015) (Delaware statute governing the dissolution of an LLC).

<sup>226</sup> Here, the LLC.

<sup>227</sup> See *supra* Part IV.

<sup>228</sup> See Griswold, *supra* note 49 ("The [human capital] contracts themselves can be either five or 10 years in duration.").

<sup>229</sup> See Regulation Crowdfunding, *supra* note 121, at 66,551.

<sup>230</sup> Human capital contracts on Upstart vary between five or ten years. See *supra* note 228. Or, one student might be excused from payment for a period because of unemployment. See *supra* note 51.

<sup>231</sup> It should be noted that traditional student loans cannot generally be discharged in bankruptcy. See Amanda M. Foster, *All or Nothing: Partial Discharge of Student Loans Is Not the Answer to Perceived Unfairness of the Undue Hardship Exception*, 16 WIDENER L. REV. 1053, 1054 (2007) ("[P]eople are then often surprised to find that their student loan debts are not so easily discharged. Congress has determined that student loan debt may only be discharged when repayment 'would will [sic] impose an undue hardship on the debtor and' his dependents." (footnote omitted)). Whether the same is true for human capital contracts is unknown. For further examination of this issue, see Colleen Baker, *The Fate of Human Capital Contracts in Bankruptcy*, in AN EXECUTIVE BRIEFING ON FINANCING HUMAN CAPITAL, *supra* note 167, at 80.

## CONCLUSION

The CROWDFUND Act has the potential to alter the way students finance their higher education. Yet, the statutory requirements imposed on issuers create uncertainty as to the Act's effectiveness in this regard. Students assessing their financial aid options for college will need to carefully weigh the costs of borrowing money through traditional federal loans versus the costs of crowdfunding human capital contracts. In all likelihood, without the ability to spread any of the costs associated with crowdfunding human capital contracts, students will continue to primarily use federally funded student loans. That is, unless, as this Note proposes, funding portals assume the cost of facilitating student pools, in order to lower the costs for students. These portals can engineer "off the shelf" LLCs that can be specifically tailored to the crowdfunded human capital contract industry. If funding portals can successfully maintain such an operation, traditional student loans may begin to fall by the wayside.