Prickly Pear

Legal Alerts for the Arizona Business Community

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Ken Witt and Isaiah Wilson, Editors

Arizona 2022 General Election Preview

By Marcus Osborn and Daniel Romm

Arizona voters will go to the polls on Tuesday, November 8, 2022; however, statewide early voting is already well underway (began October 12).

A significant amount of national attention is once again focused on Arizona this election cycle, especially the United States Senate race where incumbent Democratic Senator Mark Kelly is seeking a full six-year term.

In November 2020 Kelly won the special election to serve out the remaining two years of the late Senator John McCain's term. He is now facing Republican nominee Blake Masters in the general election.

While Kelly continues to lead in most polls, the outcome of this race is expected to be very close, and the result may determine which political party will control the U.S. Senate next year.

Additionally, there is a lot of focus on Arizona's gubernatorial election where Arizona Secretary of State, Katie Hobbs (D), faces off against former local television news anchorwoman, Kari Lake (R), in this very competitive race.

The projected outcome at this point is truly a toss-up. Most of the current polling data has this matchup at either dead even or at least within the margin of error. We will likely not know the result of this race until at least a few days after Election Day.

Arizona voters will also decide on a new secretary of state, attorney general, state treasurer, and superintendent of public instruction, each of whom is expected to make consequential decisions about elections, education, water, energy policy and more.

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Corporate Transparency Act ("CTA") Update: The CTA's Reporting Requirements Rule is Here

By Matthew Ditman

Early last year, Congress enacted the CTA—legislation that will create federal reporting requirements for millions of private companies that have never been required to disclose information about company ownership. If you are forming a company to (i) start a new business venture, (ii) operate as a holding company, (iii) acquire the assets of an existing company, or (iv) for any other purpose, there is a good chance that the CTA will impose reporting obligations on your company. On September 29, 2022 the Financial Crimes Enforcement Network ("FinCEN"), a division of the U.S. Treasury Department, issued its final rule implementing the CTA's beneficial ownership

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All 90 state legislative seats are also up for grabs this election cycle. Currently Republicans control both legislative chambers with razor-thin margins, 31-29 in the House, and 16-14 in the Senate. Due to redistricting, Republicans are likely to continue controlling both chambers with narrow margins; however, there is an outside possibility we could see a 15-15 split in the Senate.

There are also a number of competitive congressional races. Republicans are hoping favorable changes from redistricting can help them regain the majority in Arizona's U.S. House delegation.

Incumbent Democrats, Tom O'Halleran and Greg Stanton, are both facing serious challengers in their newly formed districts, that now slightly favor Republicans. Additionally, the congressional district which is currently represented by retiring Democratic Congresswoman Ann Kirkpatrick now leans in favor of the GOP.

With so much at stake, including 10 statewide ballot initiatives (the highest number of measures on the ballot since 2010), Arizona will be one of the most closely watched states on Election Night.

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information ("BOI") reporting requirements. This rule is the first of three that FinCEN will promulgate to implement the CTA. For a more thorough review of the CTA and its reporting requirements, please see our previous article on CTA essentials.

The final reporting rule sets forth (i) who must file a BOI report, (ii) what information must be disclosed in such a report, and (iii) when "reporting companies" must file their initial BOI reports with FinCEN. The final rule's requirements for the first two pillars remain largely unchanged from those contained in the 2021 Notice of Proposed Rulemaking. However, the final rule does not require reporting companies existing or registered at the effective date of the rule (specified below) to identify and report on their "company applicants." This is a sigh of relief for many "older" reporting companies who might have trouble finding the person who originally filed the documents that set up the company.

The final rule's most significant update, though, concerns when reporting companies must file their initial BOI reports with FinCEN. The rule's effective date is January 1, 2024, and reporting companies created or registered *before* that date will have until January 1, 2025 to file their initial BOI reports with FinCEN. Deviating slightly from the proposed rule, however, reporting companies created or registered *after* January 1, 2024 will have thirty (30) days after receiving notice of their creation or registration to file their initial BOI reports. This deadline was relaxed from only 14 days in the proposed rule. To help reporting companies navigate the BOI reporting process, FinCEN will publish BOI reporting forms that companies can use to comply with the reporting rule well in advance of the rule's January 1, 2024 effective date.

As noted above, the BOI reporting rule is just part one of three FinCEN rules for implementing the CTA. Moving forward, FinCEN will engage in additional rulemaking to (i) establish rules for who may access BOI and for what purposes, and what safeguards will be put into place to protect this sensitive information; and (ii) revise FinCEN's customer due diligence rule. BOI will include the sensitive personal information of the owners of small businesses. Names, addresses, dates of birth and drivers' license or passport numbers will be disclosed to FinCEN. To ensure the confidentiality of BOI, the agency intends to impose limits on who may access the information and training requirements for those authorized people, maintain a permanent system of standardized records and an auditable trail of each BOI request, conduct an annual audit, and follow other necessary or appropriate safeguards. Considering the magnitude and far-reaching effects of the CTA, building out a sufficiently secure database will surely prove to be a gargantuan task for FinCEN.

As the CTA continues to take form, Kutak Rock is keeping close tabs and will give you any needed updates on these regulations. If you have questions about how, if at all, the CTA will affect your business, or whether you will need to report under the CTA, please contact a member of Kutak Rock's Scottsdale Corporate & Securities Practice Group. You may also visit us at www.kutakrock.com

Reminder: Delaware Corporations Should Take Action to Shield Officers From Personal Liability for Breach of Fiduciary Duty Claims

by Ken Witt

As explained in our August 2022 Prickly Pear Newsletter, Delaware has adopted an amendment to the Delaware General Corporation Law (DGCL) that will permit corporations to protect certain senior corporate officers from personal monetary liability for breach of the fiduciary duty of care. Delaware corporations have been able to protect directors from such liability since 1986, and the amendment to the DGCL will extend this permitted "exculpation" to officers.

The officers who may be covered by the expanded exculpation include the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer, the company's most highly compensated executive officers identified in SEC filings and certain other officers who have consented to be identified as an officer and to service of process.

This additional protection of officers is not automatically effective. The certificate of incorporation of the Delaware corporation must be amended to include the exculpation of liability, requiring the approval of the board of directors and stockholders. Newly incorporated Delaware corporations may include the provision in the originally filed certificate of incorporation.

Here is new language that could be adapted for an amendment to your Delaware certificate of incorporation:

ARTICLE [ ]

A director or officer of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of his or her fiduciary duty as a director or officer, except for liability of (i) a director or officer for any breach of the director's or officer's duty of loyalty to the Corporation or its stockholders, (ii) a director or officer for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) a director under Section 174 of the Delaware General Corporation Law, or (iv) a director or officer for any transaction from which the director or officer derived any improper personal benefit or (v) an officer in any action by or in the right of the Corporation. If the Delaware General Corporation Law is amended after the filing of this Certificate of Incorporation to authorize corporate action further eliminating or limiting the personal liability of directors or officers, then the liability of a director or officer of the Corporation shall be eliminated or limited to the fullest extent permitted by the Delaware General Corporation Law, as so amended.

Any repeal or modification of the foregoing paragraph by the stockholders of the Corporation shall not adversely affect any right or protection of a director or officer of the Corporation existing at the time of such repeal or modification.

If you need assistance to amend the certificate of incorporation of your Delaware corporation to give effect to the exculpation of senior officers, you should consult with your Kutak Rock attorney, one of the attorneys listed on the back page or any attorney in Kutak Rock's Business, Corporate & Securities Practice Group.

Overview Of ESG Legislation

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By Marc Lieberman, Christina Poletti and Christina Ribble

Environmental, Social, and Governance (***"ESG"***) investing refers to the practice of utilizing a set of social rather than pecuniary factors to vet potential investments. Typically, ESG investors eschew investment in companies doing business in industries they believe impair the climate, increase violence, or fail to prioritize social and ideological interests—such as fossil fuel companies, arms manufacturers, or businesses lacking diversity. ESG investors comprise a significant portion of the industry; in 2021 alone, $500 billion was invested in ESG-oriented investment funds.

Trustees of pension plans owe an unwavering duty of loyalty to the members and beneficiaries of their plans, and several state attorneys general have opined that a plan trustee's duty of loyalty outright prohibits investment decisions based on any factor other than promoting the economic interests of the plan. Many states are using this interpretation of existing fiduciary duties to justify divestment of assets from certain investment managers based on ESG views.

> A complex legal landscape is forming. In some states, ESG principles are prerequisite investment criteria, while in others there are outright prohibitions against the state...

As such, a complex legal landscape is forming. In some states, ESG principles are prerequisite investment criteria, while in others there are outright prohibitions against the state entering into financial contracts with companies that "boycott" certain industries that are generally thought to be contrary to the furtherance of ESG policies, such as fossil fuels.

The divide between the two approaches continues to grow as more states weigh in on the merits of ESG investing, with many states enacting measures to combat ESG driven investing. The dichotomous legislation does not end at the state level, and many investment managers are waiting on a ruling from the White House after the U.S. Department of Labor sent a final rule for review on October 7, 2021 that would, if accepted, allow retirement plan fiduciaries to consider ESG principles in their investment decisions. The final rule is expected to be release-d late December of this year.

The following summarizes the status of laws enacted to date.

I. Anti-ESG Legislation

A number of states have enacted, or are considering enacting, laws prohibiting government agencies from ESG-driven investment, as follows:

a. Anti-Firearms Measures

A number of states have passed or introduced legislation prohibiting investments that discriminate against firearms manufacturers or suppliers. The states which have passed such legislation include Texas, South Dakota, and Wyoming. Arizona, Indiana, Kentucky, Louisiana, West Virginia, and Missouri are considering such legislation.

b. Anti-Fossil Fuels or other Energy Measures

Other states have passed or introduced legislation prohibiting investments that discriminate against fossil fuel developers or energy companies. The states which have passed such legislation include Utah, Kentucky, Ohio, Oklahoma, Texas, Tennessee, and West Virginia. The states considering passage of such legislation include Alaska, Idaho, Indiana, Louisiana, Minnesota, South Carolina, and Utah.

On October 19, 2022, attorneys general from 14 states sent civil investigative demands to the country's six largest banks, requesting information about the banks' involvement in climate-based initiatives. The demands allege that such strategies are an attempt to prevent fossil fuel companies from accessing financial services and that the banks' ESG policies are damaging to the energy industry.

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c. Anti-Social Motivation Measures

To date, 13 states have adopted anti-ESG regulations in the form of state laws, investment resolutions, attorney general opinions, and state Treasurer opinions: Arizona, Idaho, Indiana, Florida, Kentucky, Louisiana, North Dakota, Oklahoma, Texas, Pennsylvania, South Carolina, Utah, and West Virginia. It would come as no surprise to see similar laws enacted by more states, particularly Republican- governed states, in short order.

Such legislation and executive decrees typically require that investments made by government agencies be based on pecuniary factors and not motivated by societal goals.

As a recent example, in August 2022 the Florida Board of Administration issued a directive that all investment decisions of the Florida Retirement System must be based on pecuniary factors rather than in furtherance of social, political or ideological interests.

Also, in a letter issued in August of 2022, 19 state attorneys general accused an investment advisor focusing on ESG principles of "us[ing] the hard-earned money of our states' citizens to circumvent the best possible return on investment."

d. Ordinary Business Purpose Limitation

The foregoing anti-ESG laws and policies create a complex legal minefield for companies pursuing ESG investment strategies. However, it should be noted that many of these laws include a so-called "ordinary business purpose limitation." For example, the Texas divesture law applies to companies that "boycott energy companies"—defining boycott as actions done "without an ordinary business purpose." The divestiture statutes enacted in Kentucky, Oklahoma, West Virginia, and proposed in Indiana, Idaho and South Carolina all contain a similar limitation. Therefore, we presume that arguments will arise, and indeed are currently arising, that "ordinary business purpose" includes taking a forward-looking position with respect to climate risks and future energy transitions, which, in the long term, may generate better financial outcomes.

II. Pro-ESG Legislation

While the majority of states that have addressed ESG considerations legislatively have enacted laws or issued executive orders combatting socially motivated investing, a number of states have embraced socially motivated investing, or are considering implementation of such legislation, as follows:

a. Laws Allowing Consideration of ESG Implications

Multiple states, including Oregon, Connecticut, Illinois, Maryland, and Maine, have enacted legislation allowing consideration of ESG factors in the investment decision-making process. These states also promote implementation of sustainable investment policies, and Maine's law is designed to divest from industries like fossil fuels.

State pension funds in California, New Jersey, New York, and Oregon follow similar policies. For example, New Jersey's policy requires that fund managers engage in an ESG analysis of factors that present material business risks and opportunities, including carbon gas emissions, climate change, work force diversity, human rights, fair wages, etc.

Massachusetts, Nevada, New Jersey, New York, Pennsylvania, Rhode Island and Vermont are considering implementing legislation with ESG-favored investment guidelines, many related to gun control and firearm measures.

While no other states have enacted similar legislation, the Treasurers of Maine, Nevada, Delaware, New Mexico, Illinois, Wisconsin, Massachusetts, California, Rhode Island, Vermont, Washington, Oregon, Colorado, as well as the New York City Comptroller, have criticized anti-ESG legislation, arguing that consideration of ESG factors will result in better long-term growth.

III. Conclusion

There is a widening division between states regarding ESG investing. Some states vehemently oppose it, citing the need to consider only what monetary gain may come out of the investment, while others see ESG-driven investment as an opportunity to promote societal and environmental goals in tandem with future financial considerations.

The jury is still out who will win the argument.

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Raising Capital for Your Start-Up

by Colson Franse and Ken Witt

Raising capital is a precarious process navigated by many start-ups. This article gives an overview of capital-raising structures, available securities exemptions, and some of the pitfalls to avoid in the process.

The following chart summarizes the most common capital structures. Be aware that there are tax and securities consequences for all options, and we encourage you to engage experienced legal counsel along with accounting and tax assistance.

Capital Structures	
Equity/Equity Hybrid	
SAFE	**SUMMARY:** Convertible security forms that have some combination of valuation cap, discount rate, and/or MFN clause. **PROS:** More issuer friendly than convertible note because it has no maturity date or interest. **CONS:** Tax uncertainty – IRS has not settled whether a SAFE is debt or equity.
KISS Equity	**SUMMARY:** Convertible security form that has a valuation cap and discount rate. **PROS:** More issuer friendly than a convertible note because it has no interest or repayment. **CONS:** Tax uncertainty – IRS has not settled whether a SAFE is debt or equity; automatic conversion to preferred stock at maturity using Series Seed Documents; more investor rights.
Preferred Stock	**SUMMARY:** Selling part of your company on more investor-favorable terms than common stock, such as liquidation, conversion, and voting. **PROS:** No-debt financing (though usually carries a dividend). **CONS:** Dilutive and comes with more investor rights; higher legal fees and the investor(s) and founders must agree on valuation.
Common Equity	**SUMMARY:** Selling part of your company. **PROS:** No-debt financing; unlike preferred stock, no senior liquidation preference. **CONS:** Dilutive, may change control of company; investor(s) and founders must agree on valuation.
Debt/Debt Hybrid	
Senior Debt (Revolving Loans/ Term Loans)	**SUMMARY:** Collateralized by tangible assets, has an interest rate, short-term maturity date, and strict amortization. **PROS:** Retain ownership in your company. **CONS:** Restrictive covenants and usually requires guarantees by founders.
Mezzanine Debt	**SUMMARY:** 2nd lien term loans. **PROS:** Retain ownership in your company and limited or no amortization; more flexible covenants. **CONS:** Requires positive cash flows, warrants, high interest rates.
Convertible Note	**SUMMARY:** Debt (accrues interest and has maturity date) but is set to convert to equity for a discounted price (15%+) in the future. **PROS:** Avoids the valuation issues associated with the sale of stock and has lower transaction costs. **CONS:** If the note does not convert to equity before the maturity date, the note will have to be paid back plus interest or you may default.
KISS Debt	**SUMMARY:** Convertible security form that has a valuation cap, discount rate, accrues interest, and has a maturity date. **PROS:** Founders and investors should be able to agree to the form and then only need to agree on valuation cap and discount rate. **CONS:** Tax uncertainty and more investor friendly terms including information rights and automatic conversion at maturity date.

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Selling stock or some debt instruments will implicate state and federal securities laws. The following chart summarizes the most common securities exemptions.

Securities Exemptions		
No General Solicitation Allowed		
Reg. D Rule 506(b)	**Offering Limit (12 mo.):** None	**SEC Filing:** Yes, Form D
	Investors: Unlimited accredited and up to 35 sophisticated	
§4(a)(2)	**Offering Limit (12 mo.):** None	**SEC Filing:** No, but state specific filings
	Investors: Must not involve any public offering or distribution	
General Solicitation Allowed		
Reg D, Rule 506(c)	**Offering Limit (12 mo.):** None	**SEC Filing:** Yes, Form D
	Investors: Unlimited accredited investors and certain due diligence is required	
Rule 504	**Offering Limit (12 mo.):** $10 Million	**SEC Filing:** Yes
	Investors: Must follow in-state securities laws for issuer and investor(s)	
Reg A, Tier 1	**Offering Limit (12 mo.):** $20 Million	**SEC Filing:** Yes
	Investors: Accredited or non-accredited	
Reg A, Tier 2	**Offering Limit (12 mo.):** $75 Million	**SEC Filing:** Yes
	Investors: Accredited and limited non-accredited	
Regulation CF (crowdfunding)	**Offering Limit (12 mo.):** $5 Million	**SEC Filing:** Yes
	Investors: Non-accredited; subject to strict investment limits on regulated platforms	
Intrastate Rules, §3(a)(11), Rule 147, Rule 147A	**Offering Limit (12 mo.):** State Specific	**SEC Filing:** No, but state specific filings
	Investors: Must follow in-state securities laws for issuer and investor(s)	

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Some of the most common pitfalls are the failure to consider tax and securities consequences, giving up board control, agreeing to a non-dilution clause, saddling the start-up with debt without a clean exit, or agreeing to an investor's modification of standard forms without seeking legal advice.

A word on valuation: You may have heard the terms “pre-money” and “post-money” valuation. Here is a simple formula:

$$\text{post-money valuation} = \frac{\text{dollars raised}}{\text{\% equity ownership}}$$

So, if you raise $1 million for your business, and the investor receives 10% of the stock in your company the “post-money valuation” is as follows:

$$\frac{(\$1 \text{ million})}{(.10)} = \$10 \text{ million}$$

The “pre-money” valuation is simply the “post-money” valuation minus the dollars raised, or in this case, $10 million - $1 million = $9 million.

If you have questions, please contact the Scottsdale Corporate & Securities Practice Group.

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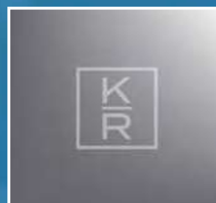

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