

RAISING CAPITAL: STRUCTURING A SECURITY

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I. Executive Summary

We discuss the offer and sale of securities often in this series, and have noted that securities can be debt or equity in the issuing company (“Issuer”). What we haven’t discussed yet is how an Issuer decides what type of security to sell, how to create that security, and in what ways different kinds of securities can be combined in a single securities offering, whether private, in either a private placement or sale to identified investors or lenders; or public, in an Initial Public Offering or “IPO,” or in a secondary offering. We’ll do that here. We’ll also assume familiarity with our client advisories “Raising Capital through Private Placements,” its Appendix 1 Exemption Chart; “How to Handle an Initial Coin Offering”; “SPACs are Back: An IPO and Private Equity Alternative”; and “Forming Crypto/Digital Asset Funds” all available for download along with other resources at [Kurtin PLLC Raising Capital](#).

II. Types of Securities

Securities are intangible assets and evidence of some rights that can be asserted against the Issuer; a stock certificate, though tangible, is evidence of the ownership of an equity security, not the security itself. The same goes for a bond or debenture, evidence of ownership of a debt security, not the security itself. Securities are not tangible assets, like a car, a house or a collection of baseball cards, and the sale of such tangible assets is not the sale of a security. Nor are all intangible assets securities. For example, an intellectual property right, like a copyright, patent, or trademark, is not a security, and the sale of an intellectual property right is not the sale of a security just as sale of a baseball card collection is not.

In the U.S., an offering is of a security if it exhibits the hallmarks of a security pursuant to the classic *Howey* test, named after a 1946 U.S. Supreme Court case¹: being an “investment contract” as required by s. 2(a)(1) of the Securities Act of 1933 (the “Securities Act”) by reason of being a contract for the (1) investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others. If the offering is of a security, it is regulated in its initial issuance and in resales or exchanges by the U.S. securities regulator, the Securities and Exchange Commission (“SEC”).

¹ SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Five main types of securities are generally considered securities under the Howey test: (A) Debt Securities, (B) Equity Securities, (C) Convertible Securities, (D) Derivative Securities, and (E) Asset-Backed Securities. To those five must now be added a sixth more recent type: (F) Digital Tokens or Digital Coins.

- A. Debt Securities. A Debt Security is a loan, a promise by Issuer to repay the purchaser of the security, a lender, a fixed amount of borrowed principal plus interest by a set term or maturity date, after which they must be redeemed by Issuer. The Debt Security instrument can take three basic forms: (i) long-term notes (notes with a maturity date of less than 9 months are generally considered commercial paper and not securities at all pursuant to a carve-out in s. 3(a)(3) of the Securities Act); (ii) bonds, long-term collateralized Debt Securities which may be issued by corporate or government Issuers; and (iii) debentures, long-term Debt Securities not backed by collateral. Bonds and debentures typically have a longer term than notes, usually five years or more. In addition to the Securities Act, certain Debt Security issuances must also comply with the Trust Indenture Act of 1939, which requires Debt Securities with a value of more than \$50 million to have a trustee appointed to protect security holders' interest and comply with other provisions. Unlike equity securities, Debt Securities do not dilute the Issuer's equity ownership. The interest paid by Issuer on Debt Securities, formerly all deductible and a major advantage of issuing debt, is now only partially deductible owing to the 2017 Tax Cuts and Jobs Act, but the lowering of the corporate interest rate to a flat rate of 21% from up to 39% previously has mitigated the impact from loss of the deduction.
- B. Equity Securities. Equity Securities, unlike Debt Securities, represent a fractional ownership share in the Issuer, the reason Equity Securities are often called "shares" and their holders "shareholders." They are an identifiable percentage of ownership of the Issuer and grant a right to dividends, a share of the proceeds upon sale of the Issuer, or residual value upon liquidation of the Issuer after payment of creditors. They also confer voting rights, at least at an annual meeting of shareholders, to elect board of directors members, and otherwise. An Issuer may pay dividends to its shareholders out of its profits but need not unless required to do so by its corporate charter. Typically, as a matter of state corporate law, dividends may only be paid if doing so would not make the Issuer insolvent. Shareholders may also benefit from an increase in the shares' value if they subsequently resell their shares, a "capital gain." Equity Securities come in two main varieties: "Common Shares," and "Preferred Shares," which have various "preferences" compared to the Common Shares and which are therefore generally priced higher than Common Shares. For example, a preferred shareholder might be entitled to the preference of being paid back its equity before common shareholders in the event of the Issuer's liquidation (but after creditors are paid). Preferred Share attributes may be

heavily negotiated, whereas Common Shares are usually simple percentages of Issuer's value. It is more common for an Issuer to have multiple classes, or at least series, of Preferred Shares than Common Shares. While Preferred Shares are classified as an Equity Security, they have many attributes of Debt Securities, such as a fixed interest rate, less volatility (owing to the liquidation preference), the afore-mentioned liquidation preference of being paid before Common Shareholders are paid, and others. Preferred Shares generally seek a less risky investment than Common Share purchasers and are in some ways more like debt lenders than equity shareholders.

- C. Convertible Securities. Convertible Securities can come in various types, but usually mean either a Debt Security that is convertible into an Equity Security at a certain rate upon the occurrence of certain events, or a Preferred Share Equity Security that converts into a Common Share Equity Security, again at a certain rate upon the occurrence of certain events. Like Debt Securities, Convertible Securities issued as debt generally do not dilute the Issuer's equity unless or until converted, which is why you will often see corporate capitalization tables calculated with Convertible Securities shown on an "as converted" basis, so that the effects of full potential dilution are shown. Often, for example, a Debt Security will be issued to a lender willing to fund a company's operations until a financing round, when the Debt Security converts into an Equity Security in the financing, usually at a discount to other investors in the round. As another example, Preferred Shares in an Issuer may be convertible into Common Shares at the time of an IPO or a sale. Convertible securities come in types with differing attributes that are often heavily negotiated. A conversion feature of a Convertible Security may be convertible at the security holder's option, or it may be subject to "mandatory conversion," in which case the security holder does not have an option when the conversion-activating event occurs. A Convertible Security may feature both mandatory and optional conversion features. Securities having both debt and equity attributes like convertible debt or convertible Preferred Shares are sometimes called "hybrid" securities.
- D. Derivative Securities. A Derivative Security derives its value from that of an underlying security. Common Derivative Securities include "Options" and "Warrants," which give the holder the right, but not the obligation, to exchange the Derivative Security for the underlying security, and therefore play the market with the Issuer's shares after acquisition. For example, a Preferred Share might be bundled with a Warrant to buy additional shares at a given price, which the Warrant holder will only exercise if the price, often called the "Strike Price" or "Exercise Price," is lower than the security's fair market value. When different securities, such as a Preferred Share and a Warrant, are sold in the same offering, they are usually referred to as a "Unit" of those securities, with the offering circular or prospectus identifying each security in the offered Units and their respective attributes. Options

are usually classified as “call” options, giving the Option holder the right, but not the obligation, to buy more shares from the Issuer by a certain date at the Exercise Price or Strike Price, presumably because the shares to be purchased have become worth more than the Strike Price at which the Option holder is buying them (such options are called “in the money,” while shares worth less than the Strike Price are called “underwater” and presumably won’t be exercised by the Option holder. By contrast, “put” Options (less common) give the Option holder the right, but not the obligation, to *sell* its shares to Issuer, and the dynamics are reversed: the Option holder will only want to exercise the put Option if the market value of shares in the Issuer has gone down from the Strike Price at which the Option holder has the right to sell them back.

- E. Asset-Backed Securities. Asset-backed securities are the result of a “securitization” process, whereby a bundle or basket of assets, which may or may not be securities themselves, are sold as a single security, whether as debt or equity. Examples are baskets of mortgages, baskets of insurance policies and similar assets. Investors would not be able to make reasonable investment decisions on the likelihood of a single, or even several, mortgages defaulting or life insurance policies having to pay out, but bundled in large baskets, the law of large numbers means that the predictability required for informed investment decisions can be attained. The securitized assets can even be sliced up in “tranches” (French for “slices”), in which, for example, a tranche from the basket of mortgages deemed at higher risk of default can be sold to investors who have a higher appetite for risk, and who are paid a “Risk Premium” (they pay a lower price) than investors in a tranche of mortgages with less risk of default.
- F. Digital Tokens. Finally, though their classification as securities is in flux, different types of Digital Tokens or Digital Coins have been classified as securities and are likely to continue to be. Among the most common types of Digital Tokens are “Utility Tokens,” “Security Tokens” or “Currency Tokens.” Security Tokens, those clearly exhibiting the *Howey* test hallmarks of securities, are the most likely to be regulated as such. Utility Tokens, issued to gain access to a particular platform, project or service, functioning as a kind of scrip, but not exchangeable for other platforms, projects, or services; and Non-Fungible Tokens, or “NFTs,” such as a digital work of art or collectible, are less likely to be regulated as a security. Currency Tokens, “Cryptocurrencies,” whether pegged to and functioning as a derivative of an underlying asset, such as the U.S. dollar (called a “stablecoin” because the peg is intended to reduce volatility), may be treated as a security or commodity, depending on the Cryptocurrency’s attributes. For example, Bitcoin and Ethereum have so far been regulated as commodities, but other Cryptocurrencies have been regulated by the SEC as securities. See our “How to Handle an Initial Coin Offering,” available at [Kurtin PLLC Raising Capital](#).

III. How to Create and Issue a Security

A. Security Structuring. Sometimes, the choice of what type of security or securities to offer is forced on the Issuer. Debt may not be available, or founders may refuse dilution of their equity. In circumstances like those, use of Derivative Securities and Convertible Securities can enable the Issuer and its legal, financial, and accounting advisers to get creative with what securities can be offered as well as what the private or public market will bear. Those decisions made, the Issuer board of directors and/or shareholders must authorize the issuance of the security. If new shares, or a new class or series of shares, must be authorized for the issuance, that task should be front-loaded, as should structuring any Issuer subsidiary to be the securities-issuing entity (if Issuer is not a corporation, but a limited liability company, or “LLC,” the equity securities are called “Membership Interests”; if a limited partnership, or “LP,” the equity interests are called “Partnership Interests”). Legal advisors must create the security in documentary form, if a documentary security instrument is needed (less and less common for Equity Securities, which may be certificated but which are often just evidenced by the subscription agreement and cap table), or for the blockchain, in case of a Digital Token issue, and the offering circular or prospectus must be prepared. When potential investors appear, the Issuer must do due diligence to confirm their eligibility to invest in the offering, and if the investors meet that test, sign them to a subscription agreement for the securities they have purchased.

B. Types of Securities Offerings. As we stated, an offering and sale of securities can be either public or private. A public securities offering requires registration with the SEC pursuant to s. 5 of the Securities Act, a process that is expensive, time-consuming, and burdensome, not least of which is due to the ongoing SEC reporting requirements post-issuance. Offers and sales of securities must be registered unless an exemption from registration is available, in which case the offering is a private placement (as opposed to a simple sale to one or a few already identified investors, such as to a venture capital firm). For a review of the principal Securities Act exemptions from registration, see “Raising Capital through Private Placements” and its Appendix 1 Exemption Chart, available for download along with other resources at [Kurtin PLLC Raising Capital](#).

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