"Death by Expense" of Crowdfunding?

Nancy Fallon-Houle, Esq. www.nfhlaw.com and nfallon@nfhlaw.com

September 17, 2013

We ABA lawyers had a lively online discussion on Crowdfunding this past weekend of 9/13/13 through 9/16/13. My observation contributed to that discussion:

The Issuer's legal fee cost of doing a Crowdfunding equity deal through a Portal, and the cost of doing an Issuer's proper disclosure document (and the related due diligence), will likely cause "death by expense" of Crowdfunding offerings. This discussion is about equity deals, in which the Issuer is selling an ownership interest its company. Not to be confused with a business selling a pre-manufacturing subscription to a product or service through Crowdfunding, and not to be confused with a charitable organization seeking donations through Crowdfunding.

Crowdfunding equity offerings are public offerings to unsophisticated investors. Therefore, a disclosure document (and the underlying due diligence), is a necessity. Compliance with 10b-5 (anti-fraud rules), and disclosure of the "information material to the investment decision", is not eliminated by Crowdfunding rules. Statements made by the Issuer in a Crowdfunding deal are still required to be true, not misleading, and not missing any material facts.

Crowdfunding offerings are small capital raises by definition; however, the legal fee costs are not scalable to "small", simply because of the small amount of capital raised! In fact, the legal fee cost tends to be higher for smaller raises. Smaller raises are typically effected by unseasoned Issuers, who sometimes do their own intellectual property work without counsel, who form their own entities without counsel, and using parochial ideas about percentages of ownership; therefore often shooting legal holes in the investment. Small unseasoned issuers sometimes can even be loose cannons (from a legal standpoint), including on social media, and including comments about the offering that may possibly be illegal.

What law firms will be willing to represent Crowdfunding deals, given the high propensity for liability surrounding public investors, and the low propensity for Crowdfunded Issuers to have any cash to pay for the necessary legal work? Sprinkle with a high likelihood of "legal clean up" required, exacerbated by the Issuer proudly thinking, "All the legal work is done, we did it ourselves!"

Small issuers seem to believe that the Crowdfunding exemption eliminates the disclosure document. Or they are not aware that a disclosure document was required in the first place, under 10b-5. But we securities lawyers know that we have 10b-5 with which to contend, which triggers some form of proper disclosure document (and the related due diligence).

Accounting disclosure may even be required too, if the Issuer has had any operations, or financial transactions, or has issued previous shares, or if any material financial facts exist in the balance sheet, income statement, or statement of shareholders' equity.

Crowdfunding is not like VC funding under which the Issuer can take disclosure short-cuts because the professional VC investors can fend for themselves to obtain disclosure information. In Crowdfunding; however, there is an investor sophistication gap, and therefore a disclosure document "plug" required, between the pro VC investors, and everyday accredited investors (even if the statute ends up providing otherwise.)

In my view, an offering to everyday accredited investors triggers a disclosure document, of at least some type, under 10b-5, even if a doc is not required by the statute. Like the scenario of a private offering to all accredited investors, under a traditional Regualtion D Rule 506(b) exemption, under which a full disclosure document is not technically required, since all investors are accredited. However, I think most of us agree that, given 10b-5, some type of disclosure document is required, or highly advisable, in a non-VC, all accredited, deal, even though the investors are all accredited. Risky if no disclosure book at all.

I envision the same practice evolving for Crowdfunding deals, even if to all accredited investors. I can't imagine doing a public offering, even one where the issuer is raising small amounts of money with no disclosure book. Some type of disclosure book is a necessity, even if it is abbreviated. Seems that the cost of any proper disclosure book would amount to a significant portion of the raise, which in some cases would barely cover the legal fees.

Legal shortcuts, or disregard for legal, on disclosure, due diligence, IP, sensible corporate structure with logical percentages to founders and investors, and on tax planning to owners and investors; plus accounting shortcuts, or disregard for accounting, in the company books, all will make for a convoluted company foundation, into which unsuspecting investors buy.

The Issuer needs lawyers and accountants before they can even begin the Crowdfunding process, at a cost that few Crowdfunded issuers can afford.

This same phenomenon is why no one uses the Reg D 504 exemption, since a 504 offering must be registered in at least one state. Most state registrations require a full disclosure document and a registration and comment process, as well as "reviewed" financial statements, none of which are affordable to the small issuer. "Death by Expense" is what happened to Reg D 504.

Won't most of us securities lawyers advise our clients, "Sure we can do a Crowdfunding deal, but you will spend a huge portion of your raise on legal fees to do it correctly"? Won't most of us talk our clients out of doing a Crowdfunding deal (or at least discourage our clients from using competent securities law counsel.)

The legal cost and accounting cost of the following items can easily cause death by expense of Crowdfunding:

1. Disclosure Document and Due Diligence Cost, described above.

2. Accounting Cost of Financial Statements and shareholders' equity statements, so that investors understand what percentage they are buying and for how much. Even if the financials are not audited or reviewed, even if "compiled" standard, accountants compiling the financials require special certifications for public offerings, and therefore at higher costs.

3. Portal Costs – How do the Portals get paid? Assuming some cost to the Issuer, out of the raise, or in advance?

4. Portal Legal Fee Cost – Legal Negotiations between Issuer and Portal. What liability shifting from Portal to Issuer will occur in the Portal Agreement? Issuer's counsel called on scene to protect Issuer from liability, or alternatively add a liability risk disclosure to the Disclosure Document. Will Portal's counsel start with

an underwriting agreement and edit? (If so, this process will keep Issuer's counsel busy, and on their toes.) Very costly process either way, especially as we collectively "figure this out". Even after "standard" provisions settle in, the Portal Agreement would likely be a negotiated agreement, which adds Portal's law firm costs to the mix. Who pays those? Negotiating process between Issuer's counsel and Portal's counsel will add cost to an already "too large budget, for the size of the deal". Add an interesting phenomenon if the Portal does not have counsel?

5. Legal Fee Cost of Subscription Agreements, with many permutations. With complexity comes cost. Though these costs will settle down eventually.

6. Legal fee Cost, Consultant's Cost, or Issuer's In-House Compliance Cost, of Monitoring Investor Compliance with the Investor Thresholds. Various percentage calculations and income or net worth calculations, and investment limits based on both, will require due diligence on the investor. Issuer must maintain calculations on each investor and its threshold. The "per investor" cost of legal fees goes up.

7. Legal Fee Cost, or Issuer's In-House Compliance Cost, of Reporting Notice to the SEC. Crowdfunding notice will likely be a pre-offer notice, which typically includes substantial detail in reporting, if not inclusion of the disclosure document.

8. Social Media Cost - Legal Fee cost of managing/reviewing/editing communications of Issuer/clients over social media.

In most professions, the service providers rejoice:

> *"Great, more work for us!"*

However, in the small, unfunded start-up scenario, I think most of us lawyers (and maybe accountants?) are cringing:

> *"Oh no! Another situation where start-ups need legal work that they can't afford! Legal work for which we lawyers would incur huge liability if we took the deal!"*

What Crowdfunded startups have the money required to do the proper document compliance and investor threshold compliance? What law firms would be willing to incur the legal and financial risk of working on a Crowdfunded offering, if Crowdfunded Issuer deals are not likely to be able to pay their law firms? Large gap to bridge between the two in order to make Crowdfunding viable.

****

Nancy Fallon-Houle, Business, Corporate & Securities Lawyer
Nancy Fallon-Houle, P.C.
5449 Bending Oaks Place
Downers Grove, IL 60515-4456
nfallon@nfhlaw.com
www.nfhlaw.com
630-963-0439 x 22 phone