Equity Crowdfunding

Your next acquisition target could be a crowdfunded company

By David M. Freedman and Jonathan Friedland

Originally published in the April 2016 issue of *The Corporate Counselor*
© 2016 ALM Media Properties, LLC. Reprinted with permission from ALM Media Properties

There has been a great deal of media attention the past several years about the JOBS Act (full name: Jumpstart Our Business Startups Act of 2012). It has various components that do various things. The aspect of the JOBS Act that has the potential to touch the largest number of Americans is Title III ("the crowdfunding exemption").

Do you need to know about equity crowdfunding? If you are a typical reader of *The Corporate Counselor*, the answer is yes, but only in connection with the potential future acquisition of, or investment in, a company that raised money by equity crowdfunding.

WHAT EQUITY CROWDFUNDING IS AND IS NOT

As a threshold matter, let's make sure we are on the same page about what equity crowdfunding is and what it is not: Over the past several years, there has been a proliferation of Internet-based investment platforms through which accredited investors may invest in start-ups, real estate projects, and really any other security that is subject to an exemption under Rule 506(b) or 506(c). This may look like equity crowd-funding to the casual observer, but it is not.

Equity crowdfunding is a defined term under the JOBS Act and, as of the time this article is being published, is not legal and simply does not exist in the United States. That will change in May, when all investors, regardless of income or net worth, will be able to invest in the securities of those companies that comply with the requirements of Title III.

In anticipation of this change, hundreds of Internet-based Title III "funding portals" and broker–dealer-operated "offering platforms" are getting ready to launch, to help companies raise capital and to enable the ordinary person to invest in start-ups. From the perspective of ordinary investors, proponents argue, it is not fair to limit the upside of such investments only to accredited investors.

YOUR COMPANY WILL NOT RAISE MONEY THROUGH TITLE III EQUITY CROWDFUNDING

This is interesting and breaks with more than 70 years of U.S. securities law. But should you care? We say not so much, at least not in the short term in your capacity as counsel to a large

corporation. How can we be so certain? Because an issuer may raise only up to $1 million in any 12-month period through equity crowdfunding portals. It is really that simple.

There are other issues that make using Title III cumbersome as well. For example, an issuer may not engage in general solicitation as defined in Title II offerings, and is strictly limited as to how it may advertise its offerings outside of the crowdfunding portals.

YOUR COMPANY WOULD BE MISTAKEN TO IGNORE TITLE III EQUITY CROWDFUNDING

That said, we could see a large company using equity crowdfunding as a marketing or public relations tool, perhaps in connection with a small subsidiary. Imagine, for example, a large consumer brand business, say Coca Cola, launching a new drink through a new subsidiary and selling small shares in it to 25 million people so that those shareholders have a fiscal reason to buy the product.

Let's segue back for a moment to the distinction between Internet-based investment platforms through which accredited investors may invest under Rule 506(b) or 506(c), on the one hand, and Title III crowdfunding portals and broker-dealer operated offering platforms on the other hand. Why the re-hash? Because you should understand that some major corporations' venture capital (VC) arms have been investing in start-ups though accredited investor-only platforms for a while already. CircleUp, for example, announced this past fall that General Mills' VC arm was about to launch an earmarked fund to invest exclusively in deals on CircleUp.

This sort of deal mining is not new off-line and we think it will continue to explode online. However, it begs the question of whether companies will want to play in the Title III space given the fundamental issues discussed above. We speculate that corporate VC arms (and deal finders of all kinds, for that matter) will search these platforms for promising opportunities but, when they find them, will seek to make deals off-line as quickly as possible to avoid the issues we discuss above. (To be clear, by the way, a Title III raise cannot be done off-line but an issuer can raise money via Title III in parallel with raising money under Title II or Title IV. What we mean by our prior sentence is that a deep-pocketed (strategic or otherwise) investor might discover an investment opportunity on a Title III portal or funding platform but choose to invest by other means.)

The other thing about this area is that it is evolving very rapidly. Before the proverbial ink even dried on the JOBS Act, there were calls for amendments to increase the $1 million limit and to moderate some of its other cumbersome aspects. We suspect the law will be changed in time and, as it does, equity crowd-funding may become much more relevant to a much larger number of companies.

WHEN ELSE MIGHT YOUR COMPANY HAVE TO DEAL WITH TITLE III?

The other context in which you are likely come face to face with Title III in your role as counsel to a large company is if and when your company finds itself looking at an acquisition target that raised money using equity crowdfunding. In this circumstance, there will be some pros and some cons to consider.

On the positive side, such a target will be easier to conduct due diligence on because in order to issue securities under Title III a company has to provide investors and the SEC with a good amount of information, including:

- Description of the business, number of employees, and business plan;
- Capital structure;
- Financial statements (certified, reviewed, or audited depending on several factors);
- Amount of capital the issuer is seeking to raise by the Title III offering, and the intended use of proceeds;
- Valuation methodology;
- Names of officers, directors, and shareholders owning 20 percent or more of total equity;
- Length of time each officer and director has served in that position and the business experience of each over the past three years.

After a successful funding round is complete, an issuer will have to file annual reports with the SEC. And, issuers (including company officers, directors, sellers, and promoters of the offering) will be held liable for any fraudulent or intentionally misleading statements or material omissions made in connection with their offerings. All of this is likely to make due diligence not just easier, but also more reliable.

The potential downside? Think of the added complications that can inure when a target is held by two shareholders instead of one, or four instead of two, or eight instead of four. Now multiply any of those numbers by 100, 1,000 or 10,000. Our point? Even though an issuer can raise only $1 million in a year using Title III equity crowdfunding, it can do so by selling shares to an unlimited number of investors. Sure, the target's governing documents may be very clear regarding drag-along rights and the like but, still, it will be interesting to see how this feature of equity crowdfunding impacts future deals.

A WORD OF CAUTION WEARING YOUR OTHER HAT

If you are an accredited investor, should you consider making Title III equity crowdfunding investments? Sure, maybe. But given the limitations and administrative burdens that must be borne by issuers, it is fair to speculate that one's chance of earning a good return on an investment made via Title III may be significantly less than when investing via Title II (or, for that matter, though an angel investment group or through a private placement memorandum, or PPM). And, we think Title III may come to be, to startup investing under the JOBS Act what the pink sheets are to the NASDAQ.

#

About the authors

David M. Freedman (www.freedman-chicago.com) is co-author of *Equity Crowfunding for Investors* (Wiley, 2015) and a regular columnist for Financial Poise (www.financialpoise.com).

Jonathan Friedland (http://www.sugarfgh.com/jfriedland) is a corporate partner with Sugar Felsenthal Grais & Hammer in Chicago.