

THE ANTI-CROWD PLEASER: FIXING THE CROWDFUND ACT'S HIDDEN RISKS AND INADEQUATE REMEDIES

ABSTRACT

A new form of startup financing is poised to turn the world of early-stage financing on its head. The Crowdfund Act—part of the Jumpstart Our Business Startups Act of 2012—will permit middle-class citizens to invest online in startups for the first time. After the SEC finishes its rulemaking, equity crowdfunding—modeled on the success of rewards-based crowdfunding websites, such as Kickstarter and Indiegogo—will allow startups and eligible small businesses to raise up to \$1 million over a twelve-month period by issuing equity shares to mom-and-pop retail investors through online “funding portals.”

A swelling tide of scholarship, media reports, and security industry publications warns about the risk of fraud inherent in the online selling of equity shares in startups to unsophisticated investors. However, this literature largely omits discussion of the problems with the new civil liability provision included in the Crowdfund Act—an express private action provision that will raise the transaction costs of crowdfunding and ensnare unwary issuers in its liability trap. In an attempt to address the fraud concern, Congress drafted this new civil liability provision as well as a detailed and extensive set of disclosure requirements for issuers to navigate. The new liability provision, which broadens the language of Section 12(a)(2) of the Securities Act of 1933, imposes liability on the issuer and its officers and directors for false or misleading statements or omissions in any written or oral communication. A plaintiff need only prove that an untrue statement or misleading omission occurred and that the defendant did not exercise reasonable care, even if loss causation, reliance, and scienter are not shown.

This Comment analyzes the hidden transaction costs in the Crowdfund Act, particularly the severe liability cost this provision imposes on issuers. Crowdfunded offerings present a new environment in which innocent but inexperienced entrepreneurs face increased risk of making a misstatement or misleading omission. Crowdfunded offerings confront a number of issues not faced by mature companies making public offerings, including the high failure rate of startups, the difficulty of working with emerging technology, the

entrepreneurial psychological predisposition to risk, a lack of sophisticated disclosure assistance, and a dearth of due diligence.

This Comment argues that the new liability provision not only will sweep too broadly—indiscriminately catching negligent entrepreneurs and fraudsters in its swath—but will also fail to provide an effective remedy for defrauded investors. Given the relatively small amount of money in play in a crowdfunded offering and the expense and difficulty of bringing a class action securities lawsuit, plaintiffs’ attorneys are unlikely to pursue cases involving fraudulent behavior. This Comment concludes that the best solution to both issues is to impose scienter as an element of the civil liability provision while also awarding attorneys’ fees to plaintiffs’ attorneys successful on the merits at trial. This solution will decrease the up-front and hidden transaction costs for issuers and will incentivize plaintiffs’ attorneys to pursue issuers committing fraud. Finally, this solution continues the SEC’s goal of balancing securities regulations to protect investors and the integrity of the market, while keeping transaction costs low enough to maintain the utility of the market as this revolutionary experiment in startup financing takes root.

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INTRODUCTION

When startup Pebble Technology founder Eric Migicovsky needed additional funding to take his invention, a “smartwatch” that pairs with smartphones and runs apps, from prototype to production, he started off on the traditional road—he pitched his idea to the established venture capital firms in Silicon Valley.¹ But, as is frequently the case, the traditional venture capital firms turned Migicovsky down.² Migicovsky’s startup then took a new, but increasingly common, approach: it turned to “the crowd” for funding. In April 2012, Pebble Technology posted a funding pitch on Kickstarter, a crowdfunding website, estimating delivery of a Pebble Watch by September to each person who contributed \$115 or more to the venture.³ Pebble Technology set its funding goal at \$100,000.⁴ Within about twenty-eight hours, Pebble Technology had raised \$1 million.⁵ Within thirty-seven days, Pebble Technology had raised \$10,266,845—more than 102 times its goal—without ceding any ownership in the company to investors.⁶

The biggest problem for crowdfunded ventures, such as Pebble Technology? Living up to their own promises. Pebble Technology shipped the first of its black smartwatches in late January 2013, missing its estimated delivery date by four months.⁷ Most of Pebble Technology’s color smartwatches shipped during spring 2013, although supporters that ordered white smartwatches were still awaiting delivery in July 2013.⁸ Even with this delay of more than ten months for certain smartwatch backers, Pebble Technology actually came *closer* to meeting its estimated delivery date than many large crowdfunded projects on Kickstarter.⁹ This problem—failing to

¹ See Joanna Stern, *Pebble Watch: Behind the Smartwatch Sensation*, ABC NEWS (July 11, 2012), http://abcnews.go.com/Technology/pebble-watch-smartwatch-iphone-android/story?id=16750944#.UGYH4WBt_80.

² See *id.*

³ See Pebble Tech., *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER, <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android?ref=live> (last visited Aug. 13, 2013).

⁴ See *id.*

⁵ Pebble Tech., *\$1mm in 28 Hours, Update to Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER (Apr. 12, 2012), <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/posts?page=9>.

⁶ See Pebble Tech., *supra* note 3.

⁷ See *ETA (Estimated Time of Arrival)*, GET PEBBLE, <http://help.getpebble.com/customer/portal/articles/1020569-eta-estimated-time-of-arrival> (last updated July 9, 2013).

⁸ *Id.*

⁹ See Matt Krantz, *Crowd Funding’s Dark Side; Sometimes Investments Just Swirl Down the Drain*, USA TODAY, Aug. 15, 2012, at 1B.

achieve production timetables and delivery promises—is endemic among technology startups on Kickstarter and exemplifies the risks and obstacles startups face.¹⁰

Despite these issues, crowdfunding possesses enormous potential for revolutionizing startup financing and jumpstarting the lagging U.S. economy.¹¹ Kickstarter is an example of a reward crowdfunding site where donors receive rewards, such as products or small perks, in exchange for donations as seen in the Pebble Watch story. Now, a new type of crowdfunding is in the works—equity crowdfunding. In the spring of 2012, Congress passed, and President Obama signed, the Jumpstart Our Business Startups Act of 2012 (JOBS Act).¹² A central provision in the JOBS Act, Title III: Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (Crowdfund Act), mandates that the Securities and Exchange Commission promulgate rules creating a registration exemption to the Securities Act of 1933 (Securities Act) for crowdfunding offerings sold to retail investors, meaning individual, small investors, via registered online funding portals or brokers.¹³ In equity crowdfunding, the investor receives equity, meaning a share of the company, instead of simply a reward or product.¹⁴ Until the SEC promulgates these rules—most likely in early 2014—equity crowdfunding will remain illegal.¹⁵

Securities regulations do not apply to reward crowdfunding sites, such as Kickstarter, which allows them to operate sans SEC oversight.¹⁶ But what if a Pebble Watch scenario occurred in the forthcoming SEC-regulated equity crowdfunding? Thanks to the new civil liability provision in the JOBS Act, Eric Migicovsky and Pebble Technology would be on the hook for all the

¹⁰ See *infra* notes 230–34 and accompanying text.

¹¹ See John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 594 (2013) (describing the “revolutionary power of Internet crowdfunding”).

¹² See Press Release, White House, Office of the Press Sec’y, President Obama to Sign Jumpstart Our Business Startups (JOBS) Act (Apr. 5, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act>.

¹³ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315–21 (2012).

¹⁴ See Wroldsen, *supra* note 11, at 588–89. Unless otherwise noted, all further references to “crowdfunding” are to equity crowdfunding, which is the primary concern of this Comment.

¹⁵ See Robb Mandelbaum, *‘Crowdfunding’ Rules Are Unlikely to Meet Deadline*, N.Y. TIMES, Dec. 27, 2012, at B1. All securities, including shares of a company using equity crowdfunding, must be registered with the SEC or satisfy a registration exemption before they can be sold. See *id.* Registering securities under Section 5 of the Securities Act is prohibitively expensive for startups, and none of the other registration exemptions fits equity crowdfunding. See *infra* Part I.B.

¹⁶ See *infra* Part I.A–B for an explanation of rewards crowdfunding and the inapplicability of current securities regulations.

money raised, plus interest, if Migicovsky or any Pebble Technology officer, director, or partner made a material misstatement or omission in a written or oral communication to the SEC or to Pebble Technology's investors.¹⁷ This liability applies even if the misrepresentation was "merely negligent, not intentional,"¹⁸ such as setting the September 2012 shipping date, for example. This Comment will closely examine the new civil liability provision in the JOBS Act.

The JOBS Act is, as its name suggests, intended to jumpstart economic development and job creation by easing restrictions on startups seeking to raise capital.¹⁹ Based on the obvious and inevitable risk of fraud inherent in an online funding system involving unsophisticated investors,²⁰ Congress drafted detailed, extensive, and complicated disclosure requirements for issuers using crowdfunding.²¹ These hurdles will increase the transaction costs associated with raising a relatively small sum of money through crowdfunding.²² Along with the substantive disclosure requirements, Congress also drafted a new liability provision—referred to as Section 4A(c) throughout this Comment—that borrows almost verbatim from the language of Section 12(a)(2) of the Securities Act.²³ Section 12(a)(2), at least in theory, imposes civil liability on issuers for false or misleading statements or omissions in an oral statement or in a prospectus for a public offering.²⁴ This Comment argues that Section 4A(c) sweeps too broadly, raises further the already high transaction costs in

¹⁷ See Jumpstart Our Business Startups Act § 302(b).

¹⁸ See C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L. J. 195, 217 (2012), available at <http://ssrn.com/abstract=2066088>.

¹⁹ See Press Release, White House, Office of the Press Sec'y, *supra* note 12.

²⁰ See Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1767–69 (2012); Lyndon M. Tretter, *Crowdfunding: Small-business Incubator or Securities Fraud Accelerator?* 18 WL J. SEC. LITIG. & REG., no. 8, Aug. 21, 2012 at 1, 1, available at 2012 WL 3580266; Skip Kaltenheuser, *Legislating to Create the Next Enron*, IBA NET, <http://www.ibanet.org/Article/Detail.aspx?ArticleUid=1542A41C-C561-474A-B057-18696C22BDE0> (last visited Aug. 13, 2013).

²¹ See Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1438–40 (2012).

²² See *infra* Part II.

²³ See Bradford, *supra* note 18, at 210–11.

²⁴ Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012). Although crowdfunding does not permit trading on the public markets, a crowdfunded offering shares several characteristics with an initial public offering (IPO). See Antone Johnson, *The Great Crowdfunding Train Wreck of 2013*, GUST BLOG (Mar. 19, 2012), <http://gust.com/angel-investing/startup-blogs/2012/03/19/crowdfunding-train-wreck/>. Crowdfunding, likewise, makes equity shares in a business available in relatively small dollar amounts to a large number of retail investors. See *id.* (explaining that crowdfunding "sounds virtually identical" to an IPO).

crowdfunding, provides an ineffective remedy for investors, and needs a rewrite to properly fit the new crowdfunding model for startup financing.

Although it is easy to point a finger at Congress for poor or rushed drafting,²⁵ the roots of the problems with Section 4A(c) run much deeper. Crowdfunding inverts the traditional finance system for non-registered offerings.²⁶ Instead of raising a large sum of money from a small number of institutional investors or accredited investors²⁷ in a private placement offering,²⁸ crowdfunding raises this sum from a large number of unsophisticated retail investors.²⁹ The Crowdfund Act's rehashing of Section 12(a)(2)'s "express private cause of action"³⁰ into Section 4A(c) simply does not fit the crowdfunding environment, especially given crowdfunding's heightened risk of material misstatements and already steep transaction costs. As the proverb goes, you can't put new wine into an old wineskin.

²⁵ See *infra* Part I.C.

²⁶ See Letter from William Francis Galvin, Sec'y of the Commonwealth, Commonwealth of Mass., to Elizabeth M. Murphy, Sec'y, SEC (Aug. 8, 2012), available at http://www.sec.state.ma.us/sct/sctpdf/Jobs_Act0001.pdf ("Crowdfunding represents a significant departure from long-established rules for public offerings of securities.").

²⁷ An "accredited investor" is, *inter alia*, "a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years." *Accredited Investors*, SEC.GOV, <http://www.sec.gov/answers/accred.htm> (last visited Aug. 13, 2013).

²⁸ Private placements are securities offerings sold outside of the normal public securities markets. See Jennifer J. Johnson, *Fleeing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993, 995 (2012). Although Rules 505 and 506 of Regulation D allow selling securities to thirty-five non-accredited investors in a private placement, most issuers do not do so to avoid triggering extensive disclosure requirements. See *infra* note 107 and accompanying text; see also Johnson, *supra* note 24. Moreover, although Rule 504 of Regulation D does not limit the number of non-accredited investors, it also does not preempt state law registration requirements, which may in turn impose strict limitations on the number of non-accredited investors permitted. See *infra* note 108 and accompanying text; see also Alexander J. Davie, *Can a Friends and Family Round Include Non-Accredited Investors? Should It?* STRICTLY BUS. L. BLOG (Aug. 15, 2011), <http://www.strictlybusinesslawblog.com/2011/08/15/can-a-friends-and-family-round-include-non-accredited-investors-should-it/>.

²⁹ See Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd 2* (Ctr. for Operations Research & Econometrics, Discussion Paper No. 2011/32, 2012), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=1578175. Currently, several platforms, including AngelList, FundersClub, and MicroVentures, are using crowdfunding to raise money from accredited angel investors. See Sarah E. Needleman & Lora Kolodny, *Site Unseen: More 'Angels' Invest via Internet—Risks Abound, but Investors Search for Promising Startups*, WALL ST. J., Jan. 24, 2013, at B1. Although this variation on equity crowdfunding shows great promise for untethering angel investors from traditional finance hotspots, such as New York City, Boston, and San Francisco, these platforms essentially just move traditional angel investor financing into online communities. See *id.*; see also *infra* note 79. This Comment is primarily concerned with equity crowdfunding involving retail investors, not angels.

³⁰ Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463, 472 (2011).

If the Crowdfund Act is to achieve its acronymistic goal of “Capital Raising Online While Deterring Fraud and Unethical Non-disclosure,”³¹ Congress must revisit and rewrite Section 4A(c). As currently written, Section 4A(c) creates liability for the issuer if a plaintiff can prove the issuer made a verbal or written material misstatement or omission of a fact that makes other facts misleading and can show *any* investment loss, so long as that plaintiff did not know of the untruth or omission.³² Section 4A(c) does not require the plaintiff to prove scienter, loss causation, or reliance, and provides only two weak affirmative defenses for the issuer.³³

As this Comment shows, crowdfunding’s circumstances will create a perfect liability trap for “innocent but unsophisticated entrepreneurs”³⁴ and will also drive up the transaction costs for entrepreneurs aware of the severe liability risk associated with what they write and say. To avoid both punishing uninformed entrepreneurs and ratcheting crowdfunding’s transaction costs even higher, Congress should rewrite Section 4A(c) to require the plaintiff to prove scienter—either intentionality or recklessness—before liability will attach. But, in order to better encourage civil fraud policing, Section 4A(c) also should be revised to allow attorney fee-shifting for plaintiffs’ attorneys, which will help justify the costs of pursuing litigation over the relatively small sums of money involved in crowdfunding.³⁵ Since the maximum amount that an issuer can raise under the Crowdfund Act during any twelve-month period is \$1 million,³⁶ the financial incentive to pursue class action litigation on a contingent fee basis is minimal, which puts investors at risk of having a right without a remedy. Of course, Rule 10b-5—the most famous anti-fraud civil liability provision—will apply to crowdfunded offerings.³⁷ However, the barriers to bringing a claim under Rule 10b-5, including clearing the Federal Rules of Civil Procedure’s heightened specificity standards and proving scienter, reliance, and loss causation, will largely negate the effectiveness of this liability provision, especially given the small sum of money in play.³⁸

³¹ See *supra* note 13 and accompanying text.

³² See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 319 (2012).

³³ See *id.*; see also *infra* notes 205–10 and accompanying text.

³⁴ Bradford, *supra* note 18, at 198.

³⁵ The Crowdfund Act places strict investment caps on individual investors. See *infra* note 279 and accompanying text.

³⁶ Jumpstart Our Business Startups Act § 302(a).

³⁷ See Hazen, *supra* note 20, at 1757.

³⁸ See *id.* at 1757–58.

This Comment's prescriptive solution borrows the scienter element of Rule 10b-5 and integrates it into Section 4A(c), creating a hybrid provision that protects issuers from liability for beginner's mistakes but holds fraudulent issuers accountable via Section 4A(c)'s express cause of action, coupled with attorney fee-shifting. This recommendation establishes a better balance between issuer liability risk and investor protection from fraud—a perennial seesaw that is currently off-balance for both issuers and investors in crowd-funded offerings. Since fraud will almost inevitably occur,³⁹ a strong liability provision is needed. However, the right balance must take into account the steep transaction costs and heightened liability risk for inadvertent mistakes by issuers while still protecting investors from fraud. This Comment's solution attempts to strike that balance.

Although a few scholars have written about drafting errors and other shortcomings of the Crowdfund Act,⁴⁰ no one has written in more than passing detail about the problems with Section 4A(c), especially in regards to the provision's effects on transaction costs, heavy-handedness toward inadvertent mistakes by entrepreneurs, and potential ineffectiveness as a remedy. This Comment seeks to fill that void and provide a prescriptive solution to these problems.

Part I of this Comment provides an overview of crowdfunding's development. Section A focuses on the evolution of crowdfunding, including the different crowdfunding models, the success and proliferation of rewards-based crowdfunding websites, and crowdfunding's avoidance of securities regulations under the *Howey* test. Section B explores the significant funding gap startups face due to banks' reluctance to extend credit and the selectivity of angel investors and venture capital firms. Section B also discusses the inapplicability of other SEC registration exemptions to crowdfunding. Section C tracks the legislative history of the Crowdfund Act and highlights how additional disclosure requirements and Section 4A(c) were layered onto the Crowdfund Act in the name of protecting investors from fraud.

³⁹ For example, the North American Securities Administrators Association has already identified about 200 crowdfunding website names that appear suspicious and state regulators are taking or considering taking enforcement action against "a handful of companies for allegedly exploiting online fundraising to commit fraud." See Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WALL ST. J., Jan. 18, 2013, at C1. This concern emphasizes the need for a strong liability provision, such as the one proposed, but not a provision that unduly exposes honest but inexperienced issuers to stark liability.

⁴⁰ See generally Bradford, *supra* note 18 (analyzing the requirements of the Crowdfund Act and discussing its flaws); Cohn, *supra* note 21 (comparing the new crowdfunding exemption to other exemptions and criticizing its complexity).

Next, Part II outlines the requirements imposed on issuers trying to raise funds through the Crowdfund Act. It also explains how the up-front transaction costs of crowdfunding, including accountant, attorney, and funding portal fees, coupled with crowdfunding's hidden costs, may outweigh its benefits as a form of financing for early-stage companies.

In Part III, this Comment contrasts liability provision Section 12(a)(2) of the Securities Act with Section 4A(c) of the Crowdfund Act in detail. Section A examines the past application of Section 12(a)(2) in securities litigation and looks at the causes of its diminishing role. Section B explores how Congress tweaked the language of Section 12(a)(2) to drastically expand Section 4A(c)'s reach in the Crowdfund Act. In addition, section B.1 discusses the myriad reasons startups confront significantly higher liability risk in the crowdfunding environment under Section 4A(c) than more mature corporations confront when selling securities on the capital markets under Sections 11 and 12(a)(2). Section B.2 then addresses the concern that plaintiffs' attorneys will be deterred from litigating crowdfunding suits because of the relatively minor sums of money at stake and the expense and difficulty of litigating securities class action lawsuits unless brought in anticipation of a quick settlement.

Finally, Part IV presents recommendations for rewriting Section 4A(c). Part IV first explains the need to add scienter as an element to avoid catching innocent but unsophisticated entrepreneurs in a liability trap and to prevent further escalation of the transaction costs in crowdfunding. Part IV then discusses the benefits of adding a fee-shifting provision to Section 4A(c), which would incentivize plaintiffs' attorneys to pursue litigation on behalf of defrauded investors, thereby ensuring that the most culpable issuers can be held accountable and, hopefully, deterred from initially committing fraud. This crowdfunding-specific liability provision will balance investor protection against the equally urgent need to reduce the hidden transaction costs associated with this groundbreaking form of startup financing.

I. THE BACKGROUND OF CROWDFUNDING

To understand the problems with Crowdfund Act Section 4A(c), it is first necessary to briefly consider the background of crowdfunding, including the evolution of crowdfunding, its ability to plug the startup capital funding gap, and the legislative history of the Crowdfund Act.

A. *The Evolution of Crowdfunding*

Crowdfunding occurs when someone raises small amounts of money from a large group of people, facilitated via the Internet and, particularly, through social media platforms.⁴¹ Internet-based crowdfunding is still in its infancy;⁴² the term “crowdfunding” does not even appear in the print version of the Oxford English Dictionary.⁴³ Crowdfunding has its roots in “crowdsourcing,” which refers more broadly to the efforts of the general public, i.e., “the crowd,” to solve a problem or address an issue,⁴⁴ such as designing T-shirts, fixing bugs in software, or developing a new algorithm for Netflix recommendations.⁴⁵

The primary problem solved by the crowd in crowdfunding is a lack of capital, a frequent and serious concern for startups.⁴⁶ Crowdfunding models usually take three forms: (1) donation or rewards crowdfunding,⁴⁷ (2) crowdfunding loans,⁴⁸ and (3) equity or revenue sharing crowdfunding.⁴⁹ Early adopters of crowdfunding, including musicians, filmmakers, citizen journalists, and political candidates, relied on their popularity to directly solicit funds from

⁴¹ See Bradford, *supra* note 18, at 196.

⁴² See Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 71 (2011).

⁴³ Julia Groves, *A \$2.8bn Global Concept That's Not yet in the Dictionary*, PIONEERS POST (Sept. 4, 2013), <http://www.pioneerspost.com/news/20130409/28bn-global-concept-thats-not-yet-the-dictionary>. To be fair, “crowdfunding” is in the online version of the Oxford English Dictionary. *Crowdfunding*, OXFORD DICTIONARIES, <http://oxforddictionaries.com/definition/english/crowdfunding> (last visited Aug. 13, 2013).

⁴⁴ See Hazen, *supra* note 20, at 1736.

⁴⁵ See Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 976–77 (2011).

⁴⁶ See *infra* Part I.B.

⁴⁷ This category can be broken down into three related subcategories, depending on what the funder receives in return for his or her contribution: (1) a strictly donation-based model where, for example, the funder of a band making an album does not receive anything; (2) a nominal rewards model where, for example, the funder receives a thank-you in the album's liner notes or a poster of the band's album cover; and (3) a pre-purchase model where, for example, the funder receives a copy of the album once it is released. See D. Scott Freed, *Crowdfunding as a Platform for Raising Small Business Capital*, MD. B.J. July/August 2012, at 13.

⁴⁸ Although a great deal could be written about crowdfunding loans or the related topic of microlending, that subject lies outside the scope of this Comment. For more information, see generally Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 445 (2011), offering a proposal of a regulatory scheme aimed to preserve the “innovative mix of social finance, microlending, and disintermediation” involved in person-to-person lending.

⁴⁹ See *Crowdfunding*, CROWDSOURCING.ORG, <http://www.crowdsourcing.org/community/crowdfunding/> 7 (last visited Aug. 13, 2013).

followers via their own websites or through social media platforms, such as Facebook and Twitter, without using dedicated intermediary websites.⁵⁰

The appearance of intermediary websites, such as Indiegogo in early 2008 and Kickstarter in 2009, catalyzed the popularity of rewards crowdfunding by helping people without a built-in following access the crowd.⁵¹ These intermediary websites essentially act as matchmakers between people seeking funding and people interested in donating funds.⁵² Within the last six years, more than 350 new rewards crowdfunding platforms have appeared,⁵³ including niche platforms for teenagers,⁵⁴ gamers,⁵⁵ and even those in the “funeral profession.”⁵⁶

Why all the interest in crowdfunding? Enormous sums of money are in play. As of August 2013, Kickstarter alone had successfully raised more than \$744 million for companies and individuals.⁵⁷ In 2012, crowdfunding platforms in the aggregate reportedly raised approximately \$2.8 billion worldwide.⁵⁸ The sum is likely to grow once the SEC issues its regulations and equity crowdfunding legally commences. Senator Jeff Merkley, the sponsor of an influential crowdfunding bill,⁵⁹ speculated that if Americans move just 1% of their retirement savings to crowdfunding, “[t]he result would be \$170 billion of investment in our startups and small businesses,” which would be “extraordinarily powerful.”⁶⁰

⁵⁰ See Burkett, *supra* note 42, at 71; see also Yoichiro Taku, *Crowdfunding: Its Practical Effect May Be Unclear Until SEC Rulemaking Is Complete*, BUS. L. TODAY (May 2012), <http://apps.americanbar.org/buslaw/blt/content/2012/05/article-03-taku.pdf>.

⁵¹ See Malika Zouhali-Worrall, *Buddy, Can You Spare a C-Note? A Field Guide to Crowdfunding*, INC., Nov. 2011, at 114.

⁵² See Burkett, *supra* note 42, at 68, 71.

⁵³ See *The New Thundering Herd*, ECONOMIST, June 16, 2012, at 71.

⁵⁴ See *CrowdfundingKids.com Launches Crowdfunding Site for U.S. Teens*, SF GATE (Sept. 26, 2012, 7:01 AM), <http://www.sfgate.com/business/prweb/article/CrowdfundingKids-com-Launches-Crowdfunding-Site-3895135.php>.

⁵⁵ See Dean Takahashi, *Gambitious Launches Crowdfunding Platform for Video Games Only*, VENTURE BEAT (Sept. 24, 2012, 11:00 PM), <http://venturebeat.com/2012/09/24/gambitious-launches-crowdfunding-platform-for-video-games-only/>.

⁵⁶ See *SoFund.U.S.: The World's First Crowdfunding Platform Dedicated to the Funeral Profession*, YOUTUBE (Sept. 16, 2012), <http://www.youtube.com/watch?v=U9BYrhQOcb0>.

⁵⁷ See *Kickstarter Stats*, KICKSTARTER, <http://www.kickstarter.com/help/stats> (last visited Aug. 13, 2013).

⁵⁸ See Kurt Wagner, *Waiting to Sow the Seed Funding*, CNN MONEY (Dec. 28, 2012, 5:00 AM), http://tech.fortune.cnn.com/2012/12/28/crowdfunding-jobs-act/?iid=SF_F_River.

⁵⁹ See *infra* notes 122–24 and accompanying text.

⁶⁰ 158 CONG. REC. S1829 (daily ed. Mar. 20, 2012) (statement of Sen. Jeff Merkley). Similarly, the CEO of EarlyShares.com, Maurice Lopes, relies on Amy Cortese, the author of *Locavesting: The Revolution in*

Current crowdfunding websites, including Indiegogo and Kickstarter, maintain a strictly rewards-based model—donation, nominal reward, or pre-purchase—to avoid running afoul of the Securities Act.⁶¹ Section 5 of the Securities Act requires either the registration of securities or an applicable exemption from registration before any securities are sold to investors.⁶² Rather than defining “security” outright, the Securities Act lists a variety of financial instruments that qualify as a security, including an “investment contract,”⁶³ which is the historically broad “catch-all category.”⁶⁴ Thus, whether a crowdfunding venture is subject to securities regulation hinges on whether the financial instrument in question is an investment contract.⁶⁵

Because the Securities Act fails to define “investment contract,” courts have long looked to the Supreme Court’s seminal *Howey* test for guidance.⁶⁶ The *Howey* test defines an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁶⁷ Under the *Howey* test, reward crowdfunding, including the pre-purchase model, does not create an investment contract because the person donating does not “expect profits.”⁶⁸ Because reward crowdfunding involves no anticipation of a return on investment, U.S. securities laws are not implicated and neither registration nor exemption requirements must be satisfied.⁶⁹

Current crowdfunding platforms in the United States are rewards-based, and there is no doubt that sponsors of the equity crowdfunding legislation modeled several provisions of the Crowdfund Act off Kickstarter and

Local Investing and How to Profit from It, who, according to Lopes, explains that “if Americans shift just 1 percent of their \$30 trillion in long-term investments to small businesses, it would equal more than 10 times the venture capital invested in all of 2011.” See Lou Carlozo, *With Crowdfunding, Experts Urge Caution Before Businesses Raise Funds*, REUTERS (Aug. 1, 2012), <http://www.reuters.com/article/2012/08/01/us-jobs-crowdfunding-idUSBRE87014U20120801>.

⁶¹ See Pope, *supra* note 45, at 978. See *supra* note 47 for a description of the three rewards-based model subcategories.

⁶² See Bradford, *supra* note 18, at 196; see also Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2012).

⁶³ 15 U.S.C. § 77b(a)(1).

⁶⁴ C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 30 (2012).

⁶⁵ See Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 886 (2011).

⁶⁶ See *id.*

⁶⁷ SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

⁶⁸ See Burkett, *supra* note 42, at 80.

⁶⁹ See *id.*

Indiegogo, the leading reward crowdfunding platforms.⁷⁰ For example, Kickstarter releases collected funds to the campaign creator only if a preset funding target is reached.⁷¹ If the target is not reached, the money is refunded.⁷² The Crowdfund Act specifically requires the use of either registered brokers or website intermediaries—referred to as “funding portals”—and, likewise, permits the release of funds only “when the aggregate capital raised from all investors is equal to or greater than a target offering amount.”⁷³ However, the Crowdfund Act caps the aggregate amount that any issuer can raise at \$1 million per twelve-month period, whereas Kickstarter and Indiegogo do not impose a cap.⁷⁴

B. *The Startup Capital Funding Gap*

Crowdfunding presents at least four potential advantages for startups over traditional early-stage financing methods. For starters, crowdfunding helps the young company create a prelaunch community around its product.⁷⁵ People who provide financing, especially as an investment, are more likely to promote and support the company and its product because they stand to benefit from the company’s success.⁷⁶ Second, crowdfunding is a way to test the market’s appetite for a product at an early stage in the commercialization process.⁷⁷ Third, crowdfunding facilitates raising capital from any location in the country, rather than tying entrepreneurs to traditional “angel investor”⁷⁸ and venture

⁷⁰ See 158 CONG. REC. S1828 (daily ed. Mar. 20, 2012) (statement of Sen. Jeff Merkley); see also *The New Thundering Herd*, *supra* note 53. The SEC also requested data from Kickstarter, Indiegogo, and RocketHub to help the SEC with drafting regulations. See Mandelbaum, *supra* note 15.

⁷¹ *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, <http://www.kickstarter.com/help/faq/kickstarter%20basics> (last visited Aug. 13, 2013).

⁷² *Id.*

⁷³ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315–16 (2012). Indiegogo, on the other hand, allows users to pay a higher fee but collect raised funds even if the target goal is not reached. See *How Pricing Works on Indiegogo*, INDIEGOGO, <http://www.indiegogo.com/how-pricing-works-on-indiegogo> (last visited Aug. 13, 2013).

⁷⁴ Jumpstart Our Business Startups Act § 302(a); see *Learn How to Raise Money for an Idea*, INDIEGOGO, <http://www.indiegogo.com/learn-how-to-raise-money-for-a-campaign> (last visited Aug. 13, 2013). As of this writing, 42 projects have raised more than \$1 million on Kickstarter. See *Kickstarter Stats*, *supra* note 57.

⁷⁵ See Belleflamme et al., *supra* note 29, at 5.

⁷⁶ See *id.* at 28.

⁷⁷ See Pope, *supra* note 45, at 1002.

⁷⁸ Angel investors are wealthy individuals, typically with an entrepreneurial background. See Johnson, *supra* note 28, at 998.

capital hotspots, such as Northern California, New York City, and Boston.⁷⁹ Fourth and most critically, as this section discusses, crowdfunding provides an alternative source of financing that could help plug the capital gap facing startups.

It is no secret that small businesses often face a difficult time raising money through traditional financing sources, such as bank loans, angel investors, and venture capital firms.⁸⁰ Estimates suggest that the financial markets fall \$60 billion short of the demand for early-stage private equity financing each year.⁸¹ This capital funding gap is particularly pronounced for startup companies.⁸² Startups rarely have sufficient cash flow or collateral to qualify for bank loans,⁸³ especially given the tightened underwriting standards imposed by banks following the 2007 financial crisis.⁸⁴ Venture capital firms are highly selective and provide only limited assistance to startups, investing on average less than a quarter of their total investments in early-stage companies, for two main reasons.⁸⁵ First, venture capital firms primarily look to invest larger sums—on average between \$2 million and \$10 million—than startup companies are seeking.⁸⁶ Second, venture capital firms prefer investing in slightly less risky companies—those that have survived the initial startup phase and have proven track records and clearer exit opportunities.⁸⁷

Data also show that angel investors, the traditional source of capital for startup companies, are investing in companies closer to commercialization than in the past.⁸⁸ In 2008, 2009, and 2010, angels reduced their investment in the “seed stage” of companies.⁸⁹ Brian Batchelor, an attorney in Atlanta, Georgia,

⁷⁹ See Ryan Tate, *Feds to Break Up Tech's Investor Party*, WIRED (Aug. 21, 2012, 2:16 PM), <http://www.wired.com/business/2012/08/SEC-tech-investors/>.

⁸⁰ See Bradford, *supra* note 64, at 100–01; see also Burkett, *supra* note 42, at 63.

⁸¹ Bradford, *supra* note 64, at 100 (quoting William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 3 (2004)).

⁸² See *id.*

⁸³ See *id.* at 102.

⁸⁴ See OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, 2012 SURVEY OF CREDIT UNDERWRITING PRACTICES 7–8 (2012). As of May 2012, only 10.2% of small businesses that applied for bank loans received them. See Carlozo, *supra* note 60.

⁸⁵ See Bradford, *supra* note 64, at 102. Venture capitalists turn down 99% of applicants. See *id.* at 103.

⁸⁶ *Id.* at 102.

⁸⁷ See Pope, *supra* note 45, at 973–74.

⁸⁸ See *id.* at 994 (noting that “angel investment in startups has declined steadily since 2007”).

⁸⁹ See *id.* at 994–95. Jeffrey Sohl, Director of the University of New Hampshire Center for Venture Research, stated, “This decrease in seed/start-up stage and first sequence investing is of concern.” Press Release, The Univ. of N.H., Angel Investor Market Rebounds in 2010, UNH Center for Venture Research Finds Total Investment Increases 14 Percent from 2000 (Apr. 12, 2011), available at <http://www.unh.edu/>

who formerly worked with the Atlanta Technology Angels, says, “Since 2008, what a venture capitalist or angel is looking at is going further down the road in terms of ideas and development.”⁹⁰ The Center for Venture Research’s 2012 angel investor market report concluded, “This decrease in [investments in the] seed/start-up stage is of concern since that is the stage of need for our nation’s entrepreneurs.”⁹¹ In addition, scholars and attorneys in the field estimate that only 1%–3% of funding applicants actually receive funds from angel investors.⁹²

Even before progressing to the angel pitching stage, many entrepreneurs are forced to personally finance or bootstrap their startups by using their own fund reserves, taking out additional mortgages, or maxing out their credit cards.⁹³ Most entrepreneurs also turn to family and friends for financing in the early stages,⁹⁴ which can create problems down the road when securities are prepared for registration.⁹⁵

U.S. capital markets also fail to provide any relief for startups seeking to raise capital. The burdens of registering securities are “legendary.”⁹⁶ The registration statement filed with the SEC requires the assistance of attorneys, accountants, and underwriters, and the registration price tag can exceed a few

news/cj_nr/2011/apr/1w12funds.cfm. Seed and startup capital investment improved slightly in 2011, although it decreased again to about 2010 levels in 2012. See Jeffrey Sohl, *The Angel Investor Market in 2012: A Moderating Recovery Continues*, CTR. FOR VENTURE RESEARCH, Apr. 25, 2013, available at http://paulcollege.unh.edu/sites/default/files/2012_analysis_report.pdf.

⁹⁰ Telephone Interview with Brian Batchelor, Associate Attorney, formerly with Atlanta Technology Angels (Sept. 28, 2012).

⁹¹ Sohl, *supra* note 89.

⁹² See Pope, *supra* note 45, at 995 (“Less than three percent of the thousands of entrepreneurs seeking funding from angel investors actually get funding . . .”); Telephone Interview with Brian Batchelor, *supra* note 90 (explaining that around 1–3% of applicants to Atlanta Technology Angels receive funding); *Probability of Success in Raising Angel Capital*, BILL PAYNE (June 7, 2011), <http://billpayne.com/2011/06/07/probability-of-success-in-raising-angel-capital.html> (concluding that “probably about 2% of entrepreneurs seeking funding from angels are successful”).

⁹³ See Bradford, *supra* note 64, at 101.

⁹⁴ See *id.* Reliance on personal funds or family and friends effectively precludes a significant portion of the U.S. population without such resources from pursuing a startup idea. See Deborah L. Cohen, *Fund for All: ‘Crowdfunding’ Supporters Look to Congress to Lighten Regulatory Load*, 98 A.B.A. J. 11 (2012). Similarly, SEC regulatory requirements also “favor those with connections to high-net-worth individuals, wealthy friends and family members.” *Id.*

⁹⁵ Friends and family financing frequently violates Section 5’s registration requirements and is often discovered only when a company is preparing for its initial public offering. See Sara Hanks, *JOBS Act Crowdfunding Provisions Await Clarification by SEC*, in 44 SEC. REG. & L. REP. (BNA) 1710, 1710 (Sept. 17, 2012).

⁹⁶ Burkett, *supra* note 42, at 82.

hundred thousand dollars.⁹⁷ These costs make registration impractical for startups seeking relatively small amounts of capital, especially since startups would have to bear these costs before any capital is raised.⁹⁸

Additionally, none of the traditional securities registration exemptions fit the equity crowdfunding model. For example, while Regulation A exempts offerings of less than \$5 million in a twelve-month period,⁹⁹ it requires filing an offering statement with the SEC and delivering a final offering circular to purchasers.¹⁰⁰ For most startups, these filing costs alone are prohibitive.¹⁰¹ But Regulation A also fails to preempt state registration requirements—meaning issuers have to comply with varying state registration or exemption requirements in each state where a security is sold.¹⁰² In a crowdfunding model, securities would likely be sold in dozens of states and to hundreds of people, which effectively precludes the use of Regulation A.¹⁰³

Additional exemptions under Regulation D—Rules 504 and 505—extend to offerings of no more than \$1 million and \$5 million, respectively, in a twelve-month period.¹⁰⁴ Regulation D Rule 506—a “safe harbor” for the private offering exemption of Section 4(2)—does not limit the aggregate offering size.¹⁰⁵ Prior to the passage of the JOBS Act, Regulation D prohibited general solicitation and advertising under Rules 505 and 506, and Regulation D still only permits solicitation and advertising that complies with applicable state laws for Rule 504.¹⁰⁶ Additionally, Rules 505 and 506 do not permit selling to more than thirty-five non-accredited investors,¹⁰⁷ and Rule 504 does not preempt state registration requirements, thus posing the same problem as

⁹⁷ See Bradford, *supra* note 64, at 42; Burkett, *supra* note 42, at 82.

⁹⁸ See Bradford, *supra* note 64, at 42.

⁹⁹ 17 C.F.R. § 230.251(b) (2012).

¹⁰⁰ *Id.* § 230.251(d).

¹⁰¹ See Bradford, *supra* note 64, at 48. Regulation A offerings typically cost upwards of \$40,000. See *id.*

¹⁰² See Burkett, *supra* note 42, at 88.

¹⁰³ See *id.*

¹⁰⁴ 17 C.F.R. §§ 230.504(b)(2), 505(b)(2)(i) (2012).

¹⁰⁵ See Heminway & Hoffman, *supra* note 65, at 917–18.

¹⁰⁶ 17 C.F.R. §§ 230.502(c), 505(b)(1), 506(b)(1), 504(b)(1) (2012). Following passage of the JOBS Act, the SEC promulgated Rule 506(c), which permits an issuer the option to engage in general solicitation and advertising under Rule 506 as long as all purchasers of the securities are accredited investors and the issuer “take[s] reasonable steps” to verify that purchasers of the securities are accredited investors. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313 (2012); 17 C.F.R. § 230.506(c) (2013).

¹⁰⁷ 17 C.F.R. §§ 230.505(b)(2)(ii), 506(b)(2)(i).

Regulation A.¹⁰⁸ These limitations effectively nullify the value of these exemptions for typical crowdfunded ventures.¹⁰⁹

Given the surge in popularity of crowdfunding, its potential to address the funding gap, and the inapplicability of current registration exemptions, it became apparent that a new crowdfunding-specific registration exemption was needed.

C. *The Legislative History of the Crowdfund Act*

If both sides of the congressional aisle agree upon anything, it is that small businesses are the backbone of the American economy.¹¹⁰ From the late Steve Jobs to Mark Zuckerberg, the entrepreneur behind the high-growth startup is America's darling.¹¹¹ During the recession of 2007–2009, when larger corporations shed jobs and froze hiring, politicians and the public looked to small businesses and startups as job creators and engines of economic growth.¹¹² However, without capital to grow, entrepreneurs cannot keep themselves employed, much less create jobs for others.¹¹³ Perhaps it should not have been a surprise, then, that crowdfunding sailed through the legislative process, even in the most polarized Congress since Reconstruction.¹¹⁴

¹⁰⁸ See *id.* § 230.504(b)(1).

¹⁰⁹ See Heminway & Hoffman, *supra* note 65, at 920. *But see generally* Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. (forthcoming 2014) (arguing that “accredited crowdfunding” under the new Rule 506(c) will likely dominate retail equity crowdfunding).

¹¹⁰ See President Barack Obama, Remarks by the President After Roundtable with Local Business Leaders in Seattle, Washington (Aug. 17, 2010) (transcript available at <http://www.whitehouse.gov/the-press-office/2010/08/17/remarks-president-after-roundtable-with-local-business-leaders-seattle-w>) (“America’s small businesses are the backbone of our economy . . .”); *Restoring the American Dream: Economy & Jobs*, GOP.COM, http://www.gop.com/2012-republican-platform_restoring/ (last visited Aug. 13, 2013) (“America’s small businesses are the backbone of the U.S. economy . . .”).

¹¹¹ President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012) (transcript available at <http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing>) (stating “maybe . . . one of the folks in the audience here today will be the next Bill Gates or Steve Jobs or Mark Zuckerberg”).

¹¹² See Gene B. Sperling & Karen G. Mills, *Introduction to NAT’L ECON. COUNCIL, THE SMALL BUSINESS AGENDA: GROWING AMERICA’S SMALL BUSINESSES TO WIN THE FUTURE* (2011) (“With regards to job creation, however, we know that America’s small businesses pack the biggest punch, creating two out of every three new jobs in the U.S. each year.”).

¹¹³ See Obama, *supra* note 111. For example, angel investments in early-stage companies generated 370,000 new jobs in 2010. Jeffrey Sohl, *The Angel Investor Market in 2010: A Market on the Rebound*, CTR. FOR VENTURE RESEARCH, Apr. 12, 2011, available at http://paulcollege.unh.edu/sites/default/files/2010_analysis_report.pdf.

¹¹⁴ See Frank James, *Political Scientist: Republicans Most Conservative They’ve Been in 100 Years*, NPR (Apr. 13, 2012, 2:24 PM), <http://www.npr.org/blogs/itsallpolitics/2012/04/10/150349438/gops-rightward-shift-higher-polarization-fills-political-scientist-with-dread>.

As early as July 2010, the SEC received and largely ignored one of the first of a number of petitions to create a crowdfunding exemption.¹¹⁵ Then, in September 2011, President Obama endorsed crowdfunding in his proposed American Jobs Act as a way to stimulate the sluggish economy.¹¹⁶ Within two months, on November 3, 2011, crowdfunding House Bill 2930, sponsored by Representative Patrick McHenry, passed the House 407–17.¹¹⁷ The McHenry bill, which was very simple and “broadly consistent with the President’s proposal,”¹¹⁸ called for a crowdfunding exemption allowing firms to raise up to \$1 million with individual investments capped at the lesser of \$10,000 or 10% of an investor’s annual income.¹¹⁹

While McHenry’s bill swept through the House, Senator Scott Brown proposed a different crowdfunding bill, Senate Bill 1791, the Democratizing Access to Capital Act of 2011.¹²⁰ Brown’s bill limited investments to \$1,000 per investor and required more substantial disclosures by the issuer.¹²¹

One month later, on December 8, 2011, Senator Jeff Merkley sponsored yet another crowdfunding bill, Senate Bill 1970.¹²² Merkley’s bill included several new provisions and restrictions, a number of which survived in the final Crowdfund Act. First, Merkley proposed capping annual investment at 1% of the investor’s annual income for investors earning greater than \$50,000 and less than \$100,000 annually and 2% of the investor’s annual income for investors earning greater than \$100,000 annually.¹²³ Merkley’s bill also introduced the “funding portal” intermediary requirement, imposed the target

¹¹⁵ See Burkett, *supra* note 42, at 93, 102–03, 105 (discussing the petition and the unlikelihood of SEC action).

¹¹⁶ See Press Release, White House, Office of the Press Sec’y, Fact Sheet: The American Jobs Act (Sept. 8, 2011), available at <http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-american-jobs-act>; Press Release, White House, Office of the Press Sec’y, *supra* note 12.

¹¹⁷ See Press Release, Congressman Patrick McHenry, House Passes McHenry Crowdfunding Bill (Nov. 3, 2011), available at <http://mchenry.house.gov/news/documentsingle.aspx?DocumentID=267628>.

¹¹⁸ See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATION POLICY: H.R. 2930—ENTREPRENEUR ACCESS TO CAPITAL ACT, (Nov. 2, 2011), available at http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr2930r_20111102.pdf.

¹¹⁹ H.R. 2930, 112th Cong. § 2 (2011). Firms could raise up to \$2 million if they provided audited financial statements to potential investors. *Id.*

¹²⁰ S. 1791, 112th Cong. § 1 (2011).

¹²¹ See *id.* § 2.

¹²² S. 1970, 112th Cong. (2011). It is interesting to note that two of Merkley’s top three contributors by industry were “lawyers/law firms” and “securities and investment.” *Top Industries: Senator Jeff Merkley 2007–2012*, OPENSECRETS.ORG, <http://www.opensecrets.org/politicians/industries.php?type=C&cid=N00029303&newMem=N&cycle=2012> (last visited Aug. 13, 2013).

¹²³ S. 1970, 112th Cong. § 2 (2011). The amount was capped at \$500 if the investor earned \$50,000 or less. See *id.*

offering provision, and required even more substantial issuer disclosures to investors and the SEC than either McHenry or Brown's bill.¹²⁴ Most importantly, at least for the purposes of this Comment, Merkley included a new civil liability provision.¹²⁵ This provision created a direct, private right of action against the

issuer and any person who is a director or officer (or any person occupying a similar status or performing a similar function) or partner in the issuer . . . for any untrue statement of a material fact or omission to state a material fact required to be stated in connection with any offering.¹²⁶

The Senate did not act on either bill until after the House passed the JOBS Act, which essentially incorporated wholesale McHenry's crowdfunding bill, on March 8, 2012.¹²⁷ Five days later Senators Merkley and Brown introduced a hastily written and poorly drafted¹²⁸ compromise crowdfunding bill, Senate Bill 2190.¹²⁹ The compromise bill retained most of Merkley's requirements, although it raised the investor cap to be more in line with the McHenry bill.¹³⁰ Moreover, it retained the direct liability provision from Merkley's bill, although it added an affirmative due diligence defense for issuers—also known as a reasonable care defense—that resembles the due diligence defense in

¹²⁴ See *id.* § 2(b); *supra* notes 116, 118 and accompanying text. Shortly after the introduction of Senate Bill 1970, attorney and blogger William Carleton wrote that the bill “takes paternalism to new (and wholly impractical) magnifications of micro-management.” William Carleton, *Third #Crowdfunding Bill Is No Charm*, COUNSELOR@LAW (Dec. 14, 2011), <http://www.wac6.com/wac6/2011/12/senator-merkley-introduces-alternative-crowdfunding-bill.html>.

¹²⁵ S. 1970 § 2(b).

¹²⁶ *Id.*

¹²⁷ See Jonathan Weisman, *With November in Mind, House Passes a Jobs Bill*, N.Y. TIMES, Mar. 9, 2012, at A16. The JOBS Act as a whole loosened a number of securities regulations, including lifting the ban on general solicitation and advertising for offers made pursuant to Rule 506 of Regulation D, lessening accounting requirements on “emerging growth companies,” creating a new offering exemption for amounts up to \$50 million per twelve-month period modeled off Regulation A, and upping the shareholder and asset amount cap for mandatory registration. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§102, 201, 401, 501, 601, 126 Stat. 306, 309–10, 313, 323–27 (2012). For more information on the JOBS Act, see generally Elizabeth M. Dunshee & David M. Lynn, *The JOBS Act: Easing Exempt Offering Restrictions*, BUS. L. TODAY (May 2012), <http://dialogueonfreedom.org/buslaw/blt/content/2012/05/article-02-dunshee.pdf>.

¹²⁸ See Bradford, *supra* note 18, at 198 (describing the poorly drafted crowdfunding exemption, which incorporates Senate Bill 2190). Professor Bradford notes that there are a number of inconsistencies and several ambiguities in the Crowdfund Act and even one glaring drafting error that cross-references the wrong section. See *id.* at 215–16.

¹²⁹ S. 2190, 112th Cong. (2012).

¹³⁰ See *id.* § 2(a); *supra* notes 117–19, 122–26 and accompanying text.

Section 12(a)(2) of the Securities Act.¹³¹ In the name of protecting investors from fraud, Senators Merkley, Brown, and Bennet offered this compromise crowdfunding bill as an amendment to the JOBS Act, replacing McHenry's less-burdensome crowdfunding proposal.¹³²

In a rush of bipartisan momentum, exacerbated by the need to pass substantive legislation during an election year, the Senate voted in favor of the amendment and the JOBS Act on March 22, and the House followed suit on March 27, 2012.¹³³ With great fanfare, President Obama signed the JOBS Act into law on April 5, 2012.¹³⁴ The Crowdfund Act instructed the SEC to promulgate securities regulations to govern equity crowdfunding within 270 days after the legislation's signing.¹³⁵ As of this writing, the SEC has missed its 270-day deadline, and industry observers speculate that rules may not be finalized until early 2014.¹³⁶ Given the expected delay in legalizing equity crowdfunding and the Crowdfund Act's high transaction costs, as discussed in Part II, the political self-congratulations for passing the Crowdfund Act were premature.

II. THE HIGH TRANSACTION COSTS OF CROWDFUNDING

Securities regulation involves a requisite balancing act between mandating sufficient disclosures to protect investors from fraud yet refraining from creating regulations so burdensome on companies that businesses cannot effectively raise capital in the markets.¹³⁷ Securities regulation in the United States is grounded in a disclosure-based system—the idea that, as Justice Brandeis stated, “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.”¹³⁸ Thus, the SEC does not examine the merits of public offerings; rather, it attempts to enforce accurate, sufficient disclosures to

¹³¹ See S. 2190 § 2(c)(2) (“An issuer shall be liable . . . if the issuer . . . does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of [a requisite] untruth or omission.”); *supra* note 24.

¹³² See Seung Min Kim, *Senate Passes JOBS Act, with Tweak*, POLITICO (Mar. 22, 2012, 1:29 PM), <http://www.politico.com/news/stories/0312/74363.html>. Senator Merkley stated that the crowdfunding portion of the JOBS Act in the House bill was “simply a pathway to predatory scams.” *Id.*

¹³³ See Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. TIMES, Mar. 28, 2012, at A12.

¹³⁴ See Press Release, White House, Office of the Press Sec’y, *supra* note 12.

¹³⁵ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(c), 126 Stat. 306, 320 (2012).

¹³⁶ See Amy Cortese, *The Crowd Is Anxious*, N.Y. TIMES, Jan. 6, 2013, at BU1.

¹³⁷ Cf. Hazen, *supra* note 20, at 1765.

¹³⁸ LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 62 (1933).

allow investors to determine the merits of an investment for themselves.¹³⁹ There is almost no question that—given the volatility of startups, the difficulty of determining the pre-money valuation of a startup, crowdfunding’s targeting of retail investors, and the risk of fraud—the Crowdfund Act needed robust disclosure requirements.¹⁴⁰ The difficulty lies in mandating sufficient disclosure to remedy information asymmetry between issuer and investor, while not creating an exemption that is too burdensome for issuers to use in practice. At first glance, the Crowdfund Act appears to perform an acceptable job of balancing investor protection and manageable disclosure requirements.¹⁴¹ However, as this Comment shows, the Crowdfund Act’s hidden costs will drive up transaction costs for all issuers and may entirely deter sophisticated issuers from relying on crowdfunding.

Although the mechanics of the Crowdfund Act are complicated, an entire industry is springing up to guide issuers through the process.¹⁴² First, an issuer must file certain basic information with the SEC and make the same information available to potential investors through the funding portal¹⁴³: the issuer’s name, legal status, physical address, and website; the names of the issuer’s directors, officers, and shareholders owning more than 20% of the company; and the issuer’s business plan and the intended use of the proceeds.¹⁴⁴ The issuer must also provide information that will require the assistance of attorneys, including the terms of the securities being offered; a description of how the securities offered are valued; and the specific risks involved with ownership, additional issuance of shares, and a sale of the issuer or of the issuer’s assets.¹⁴⁵ Appropriately disclosing the specific risks involved

¹³⁹ See Hazen, *supra* note 20, at 1741.

¹⁴⁰ See *id.* at 1769; Johnson, *supra* note 24.

¹⁴¹ See Karina Sigar, Comment, *Fret No More: Inapplicability of Crowdfunding Concerns in the Internet Age and the Jobs Act’s Safeguards*, 64 ADMIN. L. REV. 473, 489–502 (2012) (arguing that the wisdom of the tech-savvy market and the JOBS Act’s safeguards render worries over investor protection unfounded).

¹⁴² See *Crowdfunding 101*, STARTUP EXEMPTION, <http://www.startupexemption.com/crowdfunding-101#axzz2FRojAL7A> (last visited Aug. 13, 2013); see *infra* note 272 and accompanying text.

¹⁴³ The JOBS Act also imposes a number of requirements on funding portals, including registering with the SEC and with a self-regulatory organization; providing investors with education materials; ensuring that investors review the education materials and affirm that they understand the risk of investment; obtaining background checks on directors, officers, and shareholders owning more than 20% of the issuer’s outstanding equity; releasing funds only when the target amount is met; and preventing investors from exceeding investment limits. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 316 (2012).

¹⁴⁴ See *id.* at 317.

¹⁴⁵ See *id.* at 317–18. The SEC also has the broad power to require additional information by rule “for the protection of investors and in the public interest,” which may generate additional transaction costs once the SEC promulgates its rules. See *id.*

in ownership to avoid liability will likely be a substantial task that requires an attorney, especially if the SEC adopts a disclosure format resembling the Form I-A offering statement used in Regulation A offerings.¹⁴⁶ While Regulation A-style disclosure requirements may be sensible, they will drive up the cost of using crowdfunding.¹⁴⁷ Moreover, attorneys will also need to review and potentially amend existing corporate provisions, such as voting rights, board composition, restrictions on share transfers, and company right of first refusal, that might conflict with a crowdfunded offering, all of which further increases the costs of crowdfunding.¹⁴⁸

An even greater concern of Crowdfund Act critics is the Act's financial disclosure requirements. Issuers seeking to raise \$100,000 or less must provide company income tax returns for the previously completed year and financial statements of the issuer certified accurate by the principal executive officer.¹⁴⁹ Issuers seeking to raise between \$100,000 and \$500,000 must provide financial statements reviewed by a public accountant, and issuers raising between \$500,000 and \$1 million must provide audited financial statements.¹⁵⁰ These financial disclosure requirements impose larger burdens than certain other registration exemptions, such as Regulation D¹⁵¹ or Regulation A.¹⁵² The cost of audited statements is likely to eat up a "significant percentage" of funds raised,¹⁵³ especially for startups, which rarely undertake the auditing process this early in the business's lifecycle.¹⁵⁴

¹⁴⁶ See Taku, *supra* note 50.

¹⁴⁷ See Heminway & Hoffman, *supra* note 65, at 921 & n.216 ("Although mini-registration under Regulation A costs less than a registered offering, the expense of a Regulation A offering will often still be more than the amount of capital that the crowdfunding venture seeks to raise.").

¹⁴⁸ See Vincent Ryan, *The Burdens of Crowdfunding*, CFO (May 9, 2012), <http://www.cfo.com/article.cfm/14638132/1> (writing that the "regulatory hurdles" in the JOBS Act "may be too complex and onerous—and not very cost-effective" for many startups); Taku, *supra* note 50 (noting that "many companies may be unable to prepare disclosure documents in compliance with the crowdfunding provisions of the JOBS Act" based on the transaction costs).

¹⁴⁹ See Jumpstart Our Business Startups Act § 302(b).

¹⁵⁰ See *id.* § 302(a)–(b).

¹⁵¹ See Cohn, *supra* note 21, at 1442. For example, Professor Cohn notes that CEO-certified financial statements are not required for other federal or state registration exemptions and that Rule 504 of Regulation D does not require financial statements for offerings up to \$1 million. See *id.*

¹⁵² Part F/S of Regulation A Form I-A does not require audited financial statements unless the issuer already has them prepared, for up to \$5 million. 3A HAROLD S. BLOOMENTAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 6:43 (2d ed. 2013); see 17 C.F.R. § 230.251(b) (2012).

¹⁵³ Davis Wright Tremaine LLP, *The Troubles with the New Crowdfunding Law?*, JD SUPRA L. NEWS (May 22, 2012), <http://www.jdsupra.com/legalnews/the-troubles-with-the-new-crowdfunding-1-71994>.

¹⁵⁴ See Cohn, *supra* note 21, at 1442 (noting that "[i]t is difficult to understand how these major practical concerns could have been ignored or so readily dismissed"); Mandelbaum, *supra* note 15.

Based on these disclosure requirements, issuers will have to compensate at least three outside parties: the attorneys preparing the offering materials, the accountants creating the financial statements, and the funding portal hosting the offering. The funding portal fee—likely structured as a percentage of the funds raised¹⁵⁵—will probably be considerable based on all the requirements levied on funding portals, including educating and screening investors, conducting background checks, monitoring investor caps, registering with the SEC and a self-regulatory organization, and potentially confronting Section 4A(c) liability.¹⁵⁶ Compensating all of these outside parties is likely to add up to a substantial sum relative to the amount of money being raised.¹⁵⁷ However, the more significant costs for issuers are hidden—the administrative cost of managing shareholders, the deterrent effect on later rounds of investment, and the potential liability costs down the road.

First, there is the administrative cost associated with managing numerous shareholder investments and relationships.¹⁵⁸ This cost may include new shareholders asking questions of the business and seeking to inspect corporate books and records¹⁵⁹ and the cost of bookkeeping investments.¹⁶⁰ Long-term compliance with the Crowdfund Act will require issuers to retain the services

¹⁵⁵ Crowdcube, an equity crowdfunding platform in the United Kingdom, charges a 5% fee on the total funds collected as well as a legal fee. See Adrienne Jeffries, *The U.K. Already Has Equity-Based Crowdfunding, and This Startup Just Set a Record*, BETA BEAT (June 8, 2012, 8:52 AM), <http://betabeat.com/2012/06/the-u-k-already-has-equity-based-crowdfunding-and-this-startup-just-set-a-record/>.

¹⁵⁶ See Davis Wright Tremaine LLP, *supra* note 153 (“These [registered broker dealers or funding portals] are subject to numerous requirements, and their compliance with those requirements will make the process much more difficult and costly for [startups].”); *supra* note 143. For more on the burdens placed on funding portals, see generally Thomas V. Powers, *SEC Regulation of Crowdfunding Intermediaries Under Title III of the JOBS Act*, BANKING & FIN. SERVICES POL’Y REP., October 2012, at 1. Section 4A(c)’s definition of “issuer” appears to extend liability for misrepresentations and omissions made by the issuer to the hosting funding portal as well. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 319 (2012) (“As used in this subsection, the term ‘issuer’ includes . . . any person who offers or sells the security in [a crowdfunded] offering.”). This appears to mean that the funding portal is liable for statements that it makes about the offering as well as statements that the issuer makes about the offering. See Hanks, *supra* note 95. If the issuer ends up judgment-proof from a lack of funds, then disgruntled investors may go after the funding portals, the cost of which will ultimately be passed along to later issuers via higher hosting fees.

¹⁵⁷ See Tretter, *supra* note 20, at 2.

¹⁵⁸ See Louis A. Bevilacqua et al., *JOBS Act Targets Smaller Business Capital Raising*, PILLSBURY L. (Apr. 5, 2012), <http://www.pillsburylaw.com/publications/jobs-act-targets-smaller-business-capital-raising>. John Alexander, founder and chair of the Twin Cities Angels, writes that “[n]on-accredited investors can be a nightmare for a CEO.” John Alexander, *The Obama JOBS Act and Crowdfunding: Bright Promises, Likely Failure*, BRING ME THE NEWS (May 8, 2012), <http://www.bringmethenews.com/2012/05/08/the-obama-jobs-act-and-crowdfunding-bright-promises-likely-failure/>.

¹⁵⁹ See Taku, *supra* note 50, at 4.

¹⁶⁰ See Sigar, *supra* note 141, at 482.

of accountants and attorneys because reports on the results of operations and the issuer's financial statements must be filed "not less than annually" with the SEC and provided to investors.¹⁶¹ A second hidden cost resides in the fact that many, if not most, venture capital firms and angel investor groups will be reluctant to invest in companies that previously utilized crowdfunding¹⁶² since these groups worry about investing in deals with numerous small and unsophisticated shareholders who could create liability issues down the road.¹⁶³ Venture capital firms will also want to avoid the additional hassles that arise from having numerous shareholders, such as needing to seek shareholder approval before a new round of funding or other corporate actions that may trigger voting requirements.¹⁶⁴ The deterrence of venture capital funding will be especially problematic for potentially high-growth issuers in life sciences, technology, and manufacturing, that typically expect successive rounds of funding from angel investors or venture capital firms.¹⁶⁵ However, the third and most significant hidden cost is the unexpected liability risk posed by Section 4A(c)'s broad sweep as discussed in Part III.

¹⁶¹ See Jumpstart Our Business Startups Act § 302(b).

¹⁶² See John Tozzi, *Alone in a Crowd: How Crowdfunding Could Strand Startups*, BLOOMBERG BUSINESSWEEK (Mar. 6, 2012), <http://www.businessweek.com/articles/2012-03-06/alone-in-a-crowd-how-crowdfunding-could-strand-startups>; Telephone Interview with Devon Wijesinghe, Former President, Atlanta Technology Angels (Oct. 2, 2012) (explaining that angel investors prefer a clean capitalization table).

¹⁶³ See Susan Schreter, *Crowdfunding—Boom or Bust for Entrepreneurs?*, FOX BUSINESS (May 16, 2012), <http://smallbusiness.foxbusiness.com/finance-accounting/2012/05/16/crowdfunding-boom-or-bust-for-entrepreneurs/#ixzz2H23sD74t>; Telephone Interview with Bradley M. Burman, Associate Attorney, Nelson Mullins Riley & Scarborough (Sept. 28, 2012) (opining that venture capitalists are unlikely to invest in a company that engages in crowdfunding because the numerous investors who each own small shares in that company also have the right to sue it).

¹⁶⁴ See Tozzi, *supra* note 162; Telephone Interview with Bradley M. Burman, *supra* note 163 (opining that venture capitalists are unlikely to invest in a company that engages in crowdfunding because they will need to obtain the approval of numerous investors "every time they want to get something done").

¹⁶⁵ See Todd Hixon, *Is Crowdfunding a Boon, or a Disaster?*, FORBES (Apr. 4, 2012, 9:44 AM), <http://www.forbes.com/sites/toddhixon/2012/04/04/is-crowdfunding-a-boon-or-a-disaster/>; Tozzi, *supra* note 162. If, on the other hand, venture capitalists are not deterred from investing in crowdfunded ventures, then there is a significant risk that crowdfunding shareholders' stakes may be diluted if they do not have proper upside protection. For more information on this problem and several excellent solutions, see Wroldsen, *supra* note 11, at 611–22.

III. LIABILITY PROVISION 4A(C)—DRACONIAN FOR ISSUERS AND AN INEFFECTIVE REMEDY FOR INVESTORS

Because of the SEC's limited resources, a great deal of policing fraud is accomplished through private actions brought by investors,¹⁶⁶ which helps protect both investors and the market's integrity.¹⁶⁷ Given the expected high number of crowdfunding investments and their small size, such investments will likely escape close regulatory oversight.¹⁶⁸ Crowdfunding presents a dynamic unseen in securities regulations and, thus, requires a rethinking of how civil liability provisions can best protect investors and the functioning of the market.

A. *Current Section 12(a)(2) Elements and Application*

Since Section 4A(c) of the Crowdfund Act borrows directly from the language of Securities Act Section 12(a)(2),¹⁶⁹ any prediction regarding the future application of Section 4A(c) must start with an examination of Section 12(a)(2). Section 12(a)(2) provides investors with a right of action against issuers for materially misleading statements or omissions contained in an oral communication or a prospectus.¹⁷⁰ The prima facie elements for a plaintiff's cause of action under Section 12(a)(2) include (1) an offer or sale of a security (2) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails (3) by means of a prospectus or oral communication (4) that includes an untrue statement of material fact or omits to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading.¹⁷¹ While

¹⁶⁶ See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536 (2006); Érica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story About the "Genius of American Corporate Law,"* 63 EMORY L.J. (forthcoming spring 2014) (manuscript at 49), available at <http://ssrn.com/abstract=2239322> ("Regulators in the United States do not have the resources to provide the existing level of verification and enforcement of securities disclosure without the substantial resources dedicated to the process by private parties.").

¹⁶⁷ Thomas A. Martin, *The JOBS Act of 2012: Balancing Fundamental Securities Law Principles with the Demands of the Crowd* 6–7 (Apr. 12, 2012) (unpublished comment), available at <http://ssrn.com/abstract=2040953>.

¹⁶⁸ See Letter from William Francis Galvin to Elizabeth M. Murphy, *supra* note 26, at 2 (writing that crowdfunding "offerings will fly under the radars of many regulators").

¹⁶⁹ Tretter, *supra* note 20.

¹⁷⁰ See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012).

¹⁷¹ *Id.* The seminal Supreme Court case *Pinter v. Dahl* clarified that liability under 12(a)(2) extends only to "statutory sellers," meaning a seller that passed title to the buyer for value or successfully solicited the purchase of a security. See 486 U.S. 622, 642, 647 (1988).

Section 11's elements are similar,¹⁷² three key differences exist that show Section 4A(c) is more closely patterned off Section 12(a)(2);¹⁷³ thus, this Comment primarily confines its discussion to Section 12(a)(2).

Section 12(a)(2)'s prima facie elements are relatively easy to prove, especially compared to the elements of Rule 10b-5¹⁷⁴—the broadest and most important liability provision in securities law¹⁷⁵—for three reasons. First, the level of culpability required by Section 12(a)(2) is mere negligence, not scienter as required in Rule 10b-5.¹⁷⁶ Second, the plaintiff does not have to prove reliance as required under Rule 10b-5—even if the plaintiff never read or heard the untruth, the issuer could still be held liable under 12(a)(2).¹⁷⁷ Finally, the plaintiff does not need to prove loss causation as required under Rule 10b-5—the share price may have dropped for any reason and the issuer may still be liable if a false statement was made.¹⁷⁸ However, the plaintiff does have the burden of proving that he or she did not know of the misstatement or omission at the time the plaintiff purchased the security.¹⁷⁹ Although liability under Section 12(a)(2) is “more readily triggered” than under Rule 10b-5, it is far narrower in scope¹⁸⁰ because the false statement or omission must have

¹⁷² See *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010) (“Claims under sections 11 and 12(a)(2) are . . . Securities Act siblings with roughly parallel elements . . .”). Section 11 provides investors with a right of action against issuers for materially misleading statements or omissions contained in the registration statement. See Securities Act of 1933 § 11.

¹⁷³ First, Section 11 does not apply to oral statements, whereas Sections 12(a)(2) and 4A(c) both encompass oral statements. See 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 7:6 (2013); see also *infra* note 188 and accompanying text. Second, Section 11 only permits recovery based on the difference between the amount paid for the security and the value of the security at the time of suit, whereas Sections 12(a)(2) and 4A(c) both allow for rescission or damages. See Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 440 (2000); see also *infra* note 211 and accompanying text. Third, the issuer is strictly liable under Section 11 whereas Sections 12(a)(2) and 4A(c) both provide the same “reasonable care” affirmative defense to the issuer. See HAZEN, *supra*, § 7:4; see also *infra* note 205 and accompanying text.

¹⁷⁴ To state a claim under Rule 10b-5, a plaintiff must show the following six elements: (1) the defendant made a materially false statement or omission (2) with scienter (3) in connection with the purchase or sale of a security (4) upon which the plaintiff justifiably relied (5) that caused the plaintiff to suffer economic loss, and (6) there exists a causal connection between the material misrepresentation and the loss. See Tad E. Thompson, Recent Development, *Messin' with Texas: How the Fifth Circuit's Decision in Oscar Private Equity Misinterprets the Fraud-on-the-Market Theory*, 86 N.C. L. REV. 1086, 1087–88 (2008).

¹⁷⁵ See Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 4 (1998).

¹⁷⁶ See *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 367–68 (S.D.N.Y. 2011); 1 STUART R. COHN, SECURITIES COUNSELING FOR SMALL AND EMERGING COMPANIES § 19:4 (2012).

¹⁷⁷ See *Currie v. Cayman Res. Corp.*, 835 F.2d 780, 782 (11th Cir. 1988).

¹⁷⁸ See *In re Wachovia*, 753 F. Supp. 2d at 367.

¹⁷⁹ See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012).

¹⁸⁰ See *In re Wachovia*, 753 F. Supp. 2d at 368.

occurred in a written prospectus or oral communication that relates to the prospectus in a public offering.¹⁸¹

In the seminal and highly controversial 5–4 opinion in *Gustafson v. Alloyd Co.*, the Supreme Court essentially redefined the meaning of “prospectus” and limited the application of 12(a)(2) to public offerings of securities.¹⁸² Following *Gustafson*, this limitation meant that investors purchasing shares in a private offering, such as a Rule 144A or Rule 506 of Regulation D offering,¹⁸³ no longer had a private right of action for negligent misrepresentations or omissions.¹⁸⁴ Prior to *Gustafson*, the courts had overwhelmingly held that Section 12(a)(2) applied to all securities offerings, including secondary or private sales,¹⁸⁵ and that the definition of “prospectus” as used in Section 12(a)(2) included any “communication, written or by radio or television.”¹⁸⁶ The majority in *Gustafson* stated that such a broad interpretation of “prospectus” would “create[] vast additional liabilities” since it “gives rise to an action for rescission, without proof of fraud by the seller or reliance by the purchaser.”¹⁸⁷ Yet, in Section 4A(c) of the Crowdfund Act, this

¹⁸¹ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 567–68, 584 (1995).

¹⁸² See *id.* at 569. The Court repeatedly emphasized that for liability to attach under 12(a)(2), the material misstatement or omission must have been made “by means of a prospectus or an oral communication.” See *id.* at 567 (internal quotation marks omitted). Based on the use of “prospectus” in Section 10 of the Securities Act, the Court held that “the term [prospectus] is confined to a document that, absent an overriding exemption, must include the ‘information contained in the registration statement.’” *Id.* at 569.

¹⁸³ However, Section 12(a)(2) specifically applies to the new “small” offering exemption created by the JOBS Act, referred to as Regulation A+, which permits exempt offerings up to \$50 million. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401(a), 126 Stat. 306, 324 (2012); Bevilacqua et al., *supra* note 158.

¹⁸⁴ See Natasha S. Guinan, Note, *Nearly a Decade Later: Revisiting Gustafson and the Status of Section 12(A)(2) Liability in the Courts—Creative Judicial Developments and a Proposal for Reform*, 72 FORDHAM L. REV. 1053, 1075 (2004); Bevilacqua et al., *supra* note 158.

¹⁸⁵ See COHN, *supra* note 176.

¹⁸⁶ Cf. *Gustafson*, 513 U.S. at 585–87 (Thomas, J., dissenting).

¹⁸⁷ See *id.* at 572, 574 (majority opinion). The Court reasoned:

It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that . . . could give rise to an action for rescission, with no evidence of fraud on the part of the seller or reliance on the part of the buyer.

Id. at 578. The dissent shared the majority’s opinion that “extending § 12(2) to secondary and private transactions might result in an unwanted increase in securities litigation,” although the dissent believed the Court “must rely upon other branches of government to limit the 1933 Act.” *Id.* at 594–95 (Thomas, J., dissenting). Academics have criticized *Gustafson* as being policy-based and “blatantly results-driven.” See, e.g., Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1231–32 (1994–1995).

is exactly what Congress did when it replaced “by means of a prospectus” with “by any means of any written or oral communication,” thus broadening the scope of liability for crowdfunding offerings by startups far beyond the scope of Section 12(a)(2) liability for companies issuing public offerings.¹⁸⁸

Before *Gustafson*, a “substantial upswing” in claims brought under Section 12(a)(2) had occurred.¹⁸⁹ After *Gustafson* excluded purchasers in private offerings from making a claim under Section 12(a)(2), the usefulness of Section 12(a)(2)—and the number of cases brought under it—decreased.¹⁹⁰ Adding insult to injury, courts also utilized *Gustafson* to impose even stricter “tracing” requirements on shareholders bringing a 12(a)(2) claim.¹⁹¹ This required shareholders to plead and prove that they bought their shares either “in” or “pursuant to” the public offering in which the prospectus containing the material misstatement was issued.¹⁹² This standing requirement effectively limits the class of people who can bring suit under Section 12(a)(2) to purchasers of shares directly connected to the faulty prospectus.¹⁹³ As a result of this limitation, the vast majority of claims brought under Section 12(a)(2) do not survive motions to dismiss and class certification is denied for want of traceability.¹⁹⁴ Given these tight restrictions, experienced securities fraud class action lawyers generally assert Rule 10b-5 claims instead.¹⁹⁵ Section 12(a)(2) claims are more likely to be secondary or pro forma if included at all.¹⁹⁶

The above-mentioned restrictions have severely limited “the deterrent and remedial purposes” of Section 12(a)(2) in civil litigation.¹⁹⁷ However, none of these restrictions is likely to be present in Section 4A(c) in a crowdfunding

¹⁸⁸ See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315, 319 (2012).

¹⁸⁹ See Bainbridge, *supra* note 187, at 1234.

¹⁹⁰ See Sale, *supra* note 173, at 431–32; Guinan, *supra* note 184, at 1069 (“[T]he *Gustafson* decision was, arguably, a policy-based result, the express aim of which was to decrease securities litigation by facilitating fewer lawsuits.”).

¹⁹¹ See Sale, *supra* note 173, at 432.

¹⁹² See *id.* at 441.

¹⁹³ See *id.* at 441–42. For example, Professor Sale notes that if the shareholders purchased previously issued common stock and not new common stock issued under the faulty prospectus, the shareholders will not have a cause of action. *Id.* at 442.

¹⁹⁴ See *id.* at 482–83.

¹⁹⁵ 1 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC HANDBOOK § 10:38 (2012).

¹⁹⁶ *Id.*

¹⁹⁷ See Sale, *supra* note 173, at 431. Professor Sale elaborates—“Indeed, the effect of the tracing requirement and *Gustafson* on the accessibility of section 11 and 12(a)(2) claims to shareholders is dramatic. The Second Circuit’s mistaken finding that the tracing requirement would both prevent overinclusiveness and fulfill the statute’s purpose has resulted in scores of dismissed cases.” *Id.* at 462.

offering. Because Congress replaced “prospectus” with “any written or oral communication,” the reach of Section 4A(c) will certainly cover all disclosure statements filed with the SEC and provided to investors, and it will likely cover all additional statements related to the offering or selling of the securities.¹⁹⁸ Minimal traceability issues will exist because investors must hold purchased securities for a minimum of one year under the Crowdfund Act.¹⁹⁹ The absence of these hurdles will make class certification far easier under Section 4A(c) than under Section 12(a)(2). Given Section 4A(c)’s broad sweep and minimal elements, plaintiffs’ attorneys will now likely prefer to bring a claim under Section 4A(c) rather than under Rule 10b-5.²⁰⁰ Temporarily leaving aside the financial incentive to bring the class action, Section 4A(c) is far more likely to provide an express cause of action for plaintiffs than Section 12(a)(2) ever supplied. However, Section 4A(c)’s cause of action is likely *too* express to fit the new crowdfunding environment. Startups issuing a crowdfunding offering will confront substantial liability exposure based on a number of factors unique to startups and crowdfunding that will increase the likelihood of an inadvertent material misstatement or omission occurring in a crowdfunded offering as discussed in the following section.

B. Crowdfunding’s New Liability Dynamic

Section 4A(c) of the Crowdfund Act imposes liability on any issuer, including personal liability on all officers and directors, for any materially²⁰¹ false or misleading statements or omissions made by “any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of Section 4(6).”²⁰² Section 4A(c), like Section 12(a)(2), presents three bases for liability: (1) a misrepresentation of factual information, (2) an omission of factual information in the face of an affirmative duty to disclose, or (3) an omission of factual information that is

¹⁹⁸ See *supra* note 188 and accompanying text.

¹⁹⁹ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315, 319 (2012). However, purchasers may transfer these securities (1) to the issuer, (2) to an accredited investor, (3) as part of a registered offering, or (4) to a family member prior to the one-year mark. *Id.*

²⁰⁰ See Sale, *supra* note 173, at 469 (noting that “Securities Act claims [Sections 11 and 12] should be easier to prove than their Securities Exchange Act counterpart [Section 10b]”). Given the discarding of the restrictions in Section 4A(c) detailed above, it follows that attorneys will now *actually* find a Section 4A(c) claim easier to prove than a Rule 10b-5 claim.

²⁰¹ Presumably, “materiality” will continue to mean a substantial likelihood that a reasonable investor would consider the misstatement or omission significant in deciding whether to invest. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

²⁰² Jumpstart Our Business Startups Act § 302(b).

necessary to prevent previous disclosures from being misleading.²⁰³ The liability provision limits plaintiffs to purchasers in a crowdfunding transaction who do not know of the “untruth or omission.”²⁰⁴ Section 4A(c), like Section 12(a)(2), also provides two affirmative defenses for issuers. First, the issuer can attempt to prove that it “did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.”²⁰⁵ This defense—known as the “reasonable care” or “due diligence” defense—places a heavy burden on the issuer, because it is charged with constructive knowledge until it can prove that it could not have learned of the material misstatement or omission through the exercise of reasonable care.²⁰⁶ If the issuer or any of its employees is negligent, then this defense will likely not preclude recovery.²⁰⁷ In addition, the issuer can avoid liability for part or all of the damages if it can prove that the loss of value occurred because of something other than the untrue statement.²⁰⁸ This is the opposite of the burden imposed in Rule 10b-5, under which the plaintiff must prove loss causation,²⁰⁹ but is in line with the negative loss causation defense under Section 12(a)(2).²¹⁰

Section 4A(c)’s remedies also parallel those of Section 12(a)(2). If the plaintiff tenders the security back to the issuer, the plaintiff may recover “the consideration paid for such security,” plus interest on it.²¹¹ If the plaintiff “no longer owns the security,” the plaintiff can sue for damages,²¹² although the statute does not state how to calculate such damages.²¹³ Plaintiffs often prefer rescissory damages, such as those available under Sections 12(a)(2) or 4A(c), rather than the actual damages available under Rule 10b-5, because

²⁰³ See *id.*; 17A J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT § 6:133 (2013).

²⁰⁴ Jumpstart Our Business Startups Act § 302(b).

²⁰⁵ See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012); Jumpstart Our Business Startups Act § 302(b).

²⁰⁶ See HICKS, *supra* note 203, § 6:165.

²⁰⁷ See COHN, *supra* note 176, § 19:4. Under Section 12(a)(2), the courts look at several factors in evaluating the due diligence defense, “including level of participation in the transaction, access to source material, skill in finding the truth, financial interest in completing the transaction, and level of trust in the relationship between purchaser and seller.” Sale, *supra* note 173, at 439.

²⁰⁸ Bradford, *supra* note 18, at 210–11.

²⁰⁹ See Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes of Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163, 163–64 (2007).

²¹⁰ Bradford, *supra* note 18, at 210–11.

²¹¹ Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012); Jumpstart Our Business Startups Act § 302(b).

²¹² Securities Act of 1933 § 12(a)(2); Jumpstart Our Business Startups Act § 302(b).

²¹³ Bradford, *supra* note 18, at 210.

rescissionary damages often provide fuller compensation.²¹⁴ As discussed below, crowdfunding's dynamic creates a greater risk of startup issuers making material misstatements or omissions than issuers face in a typical public offering. Thus, the Crowdfund Act's adoption and broadening of Section 12(a)(2)—a liability provision that applies only to statements in a public offering prospectus and is inapplicable to private offerings—simply does not fit the crowdfunding context. At the same time, the relatively small amounts invested by individuals and the high obstacles to class action certification suggest that crowdfunding investors who suffer losses due to actual fraud may have no access to a remedy.²¹⁵

1. The Increased Risk of Material Misstatements or Omissions for Startups in a Crowdfunding Offering

Several unique characteristics of startups and crowdfunding will dramatically increase the likelihood of a material misstatement or omission in a crowdfunded offering, resulting in greater liability exposure for crowdfunding issuers. As discussed in Part III.A, Section 12(a)(2) applies only to companies making a public offering, which means the company has reached a certain stage of maturity in its lifecycle. Crowdfunding, on the other hand, is designed for startups—businesses still in their infancy.²¹⁶ Startups face multiple disadvantages compared to more mature companies due to startups' limited human, informational, and financial resources; personal financial pressures; and greater risk and complexity in decision-making.²¹⁷ Crowdfunded startups simply will not have the same resources to hire compliance experts and may not even realize the necessity of doing so.²¹⁸ In addition, crowdfunded startups will confront six different issues—explored in detail in the rest of this

²¹⁴ See Bainbridge, *supra* note 187, at 1233–34.

²¹⁵ See *infra* Part III.B.2.

²¹⁶ Technically, any company that satisfies the Crowdfund Act's requirements can use crowdfunding. However, Section 4A(f) disqualifies reporting companies, meaning any company that is required to “file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934,” which effectively limits the size of crowdfunding companies. See Jumpstart Our Business Startups Act § 302(b).

²¹⁷ See Jill Perry-Smith & Leslie H. Vincent, *The Benefits and Liabilities of Multidisciplinary Commercialization Teams: How Professional Composition and Social Networks Influence Team Processes*, in 18 TECHNOLOGICAL INNOVATION: GENERATING ECONOMIC RESULTS 35, 36 (Gary D. Libecap & Marie C. Thursby eds., 2008).

²¹⁸ See Bryan Sullivan & Stephen Ma, *Crowdfunding: Potential Legal Disaster Waiting to Happen*, FORBES (Oct. 22, 2012, 7:00 AM), <http://www.forbes.com/sites/eric savitz/2012/10/22/crowdfunding-potential-legal-disaster-waiting-to-happen/> (noting that many of the businesses using crowdfunding “won’t have the business experience or savvy to make even the minimum appropriate disclosures or hire an attorney to guide them through disclosure drafting and execution”).

section—that will raise the likelihood of liability attaching under Section 4A(c): (1) dramatically higher likelihood of business failure, (2) emerging technology product development problems, (3) entrepreneurs’ psychological predispositions to risk, (4) the broadening of Section 4A(c)’s applicability to “any written or oral communication,”²¹⁹ (5) crowdfunding’s unique pitching strategy, and (6) a lack of thorough due diligence conducted by investors. These six characteristics converge to create a dramatically heightened likelihood that startups using crowdfunding will make material misstatements or omissions.

First, startups are far more likely than reporting companies to fail and result in investor losses, which raises the risk of investors bringing Section 4A(c) lawsuits.²²⁰ When investors earn money, there are rarely lawsuits; it is when investors lose money that “opportunistic plaintiff attorneys will look aggressively for errors in company disclosures,”²²¹ which raises the liability exposure for crowdfunding startups.²²² The maxim in venture investing is that out of ten startups, three or four fail completely, three or four break even, and one or two provide significant returns.²²³ A 2011 study by Professor Shikhar Ghosh of Harvard Business School shows that the failure rate is actually even higher: approximately three-quarters of venture-backed startups do not return investors’ capital.²²⁴ Even more alarming when considering the likelihood of material misstatements in financial statements and projections, Professor Ghosh found that more than 95% of venture-backed startups fell short of either their declared cash flow break-even date or specific revenue growth rate projection.²²⁵ These figures do not bode well for crowdfunding startups

²¹⁹ Jumpstart Our Business Startups Act § 302(b) (emphasis added).

²²⁰ See Keith Paul Bishop, *Crowdfunding—There Will Be Investor Losses*, CAL. CORP. & SEC. L. (Apr. 4, 2012), <http://calcorporatelaw.com/2012/04/crowdfunding-there-will-be-investor-losses/> (writing that he “expect[s] that many of the issuers that use [crowdfunding] will be start-ups just trying to get off the ground” and that “[m]any, if not most, of these companies will fail and there will be investor losses”).

²²¹ Schreter, *supra* note 163.

²²² Of course, this is not a new phenomenon or one unique to startups. However, the combination of earlier stage companies and the volatility of the high-tech industry are likely to exacerbate the problem. For example, Professor Alexander documented a large number of computer-related companies that went public in 1983 at an earlier stage in development than was normal at the time. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 507 (1991). When these newly public firms failed to hit product deadlines and meet sales goals, their stock prices declined and “[i]n due course class action suits were filed alleging securities violations in the offerings.” *Id.* at 508–09.

²²³ Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-ups Fail*, WALL ST. J., Sept. 20, 2012, at B1.

²²⁴ *Id.*

²²⁵ See *id.*

because the startups Professor Ghosh tracked received funding from established venture capital firms, which are highly selective, invest at a later stage in the game,²²⁶ and generally conduct thorough due diligence before investing.²²⁷ Yet even these closely vetted startups fail at an incredibly high rate. These statistics should raise alarm bells for startups considering crowdfunding and for investors as well because the issuers using crowdfunding may at times be the same companies turned down by the more cautious angel investors and venture capital firms.

Second, startups, especially high-tech startups, face serious issues with developing emerging technology products on schedule.²²⁸ This challenge makes crowdfunding issuers more vulnerable to liability actions brought by unhappy investors when products fail to materialize as promised. Although the press described the Pebble Watch as “a poster child for what can go wrong with crowdfunded projects,”²²⁹ the Pebble Watch project’s failure to deliver its product on schedule is not an anomaly. Professor Ethan Mollick of the University of Pennsylvania’s Wharton School of Business tracked the results of 381 successfully funded projects with “clearly identifiable outcomes” from Kickstarter’s Design and Technology categories.²³⁰ Professor Mollick found that “the majority of products were delayed, some substantially, and may, ultimately, never be delivered.”²³¹ Despite making “efforts to fulfill their obligations to funders,” over 75% of Kickstarter-funded ventures “deliver products later than expected” and 33% of projects had yet to deliver the promised product at all.²³² Another study by CNN Money shows that 84% of the 50 most-funded projects on Kickstarter missed their target delivery dates²³³ because of manufacturing obstacles, logistics issues, and regulatory certification roadblocks.²³⁴ The Pebble Watch and several other high-profile,

²²⁶ See *supra* notes 85–87 and accompanying text.

²²⁷ See *infra* notes 273–75 and accompanying text.

²²⁸ See Perry-Smith & Vincent, *supra* note 217, at 36 (noting that high-tech startups routinely confront “technology challenges that stem from the novelty and uncertainty associated with the technology itself”).

²²⁹ See, e.g., John Koetsier, *Pebble’s Lead Designer ‘Stuck in Asia’ to Get the 21st Century E-paper Watch Built*, VENTURE BEAT (Oct. 11, 2012, 2:51 PM), <http://venturebeat.com/2012/10/11/pebbles-lead-designer-stuck-in-asia-to-get-the-21st-century-e-paper-watch-built/>.

²³⁰ Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, J. BUS. VENTURING (forthcoming 2013) (manuscript at 11), available at <http://dx.doi.org/10.1016/j.jbusvent.2013.06.005>.

²³¹ *Id.* (manuscript at 12).

²³² *Id.* (manuscript at 1–2, 12).

²³³ Julianne Pepitone, *Why 84% of Kickstarter’s Top Projects Shipped Late*, CNN MONEY (Dec. 18, 2012, 8:04 AM), <http://money.cnn.com/2012/12/18/technology/innovation/kickstarter-ship-delay/index.html>.

²³⁴ See Stacy Cowley et al., *9 Reasons Kickstarter Projects Ship Late*, CNN MONEY (Dec. 19, 2012, 1:27 PM), <http://money.cnn.com/gallery/technology/2012/12/18/kickstarter-ship-late/index.html?iid=EL>.

multimillion-dollar projects have been described in the press as “vaporware,” a tech industry term that refers to a product announced to the public but never actually released, or officially cancelled.²³⁵ One frequent Kickstarter funder, Dustin Wood, complains that he has spent approximately \$800 on a number of different crowdfunding projects yet has “no products to account for it.”²³⁶ Professor Mollick believes that such delays and failures will continue in equity crowdfunding and comments, “You will have many disappointed people. You’ll have people backing things, most of which will go bad.”²³⁷ Of course, the high development failure rate is not always solely the fault of the entrepreneurs behind these startups, who are often capable and well-intentioned.²³⁸ Instead, a number of factors, including the difficulty of design, testing, and manufacturing, problems with scaling up, and the capriciousness of the market, hamper the commercialization process.²³⁹

Third, crowdfunded startups face greater liability exposure because entrepreneurs’ unique psychology makes them more likely than established company managers to make risky, overly optimistic assertions. In academia and the public consciousness, entrepreneurs are intrinsically associated with risk.²⁴⁰ John Stuart Mill, who brought the term “entrepreneur” into common usage, even distinguished “entrepreneurs” from company “managers” based on the additional “risk bearing” role of entrepreneurs.²⁴¹ It is well known that entrepreneurs risk their financial, psychic, and emotional well-being; career

²³⁵ See, e.g., Farhad Manjoo, *Kickstarter Warnings as Dreamy Projects Flounder*, SYDNEY MORNING HERALD (Oct. 14, 2012, 9:15 AM), <http://www.smh.com.au/digital-life/digital-life-news/kickstarter-warnings-as-dreamy-projects-flounder-20121005-2736b.html#ixzz29IFr6SES>. Since the Pebble Watch started shipping in late January 2013, it is no longer a “vaporware” product. See *supra* note 7 and accompanying text.

²³⁶ Tim Bradshaw, *Project Delays Anger Kickstarter Backers*, FIN. TIMES (Nov. 14, 2012, 1:17 PM), <http://www.ft.com/cms/s/0/d34bada8-2ad1-11e2-802d-00144feabdc0.html#axzz2SBNTGFDO>.

²³⁷ See Krantz, *supra* note 9.

²³⁸ Professor Mollick’s study found that the “direct failure rate”—those who had refunded money or stopped responding to backers—was “well below 5%,” despite the fact that Kickstarter does not have an “enforcement mechanism to prevent con artists from using the system to raise funds for fake projects.” See Mollick, *supra* note 230 (manuscript at 12). In September 2012, Kickstarter refined its policies, including banning photorealistic product simulations and forcing project founders to disclose and highlight risks, in response to these product delays. Bradshaw, *supra* note 236.

²³⁹ See Robert Prentice, *Vaporware: Imaginary High-Tech Products and Real Antitrust Liability in a Post-Chicago World*, 57 OHIO ST. L.J. 1163, 1175 (1996). Such development issues plague even the world’s largest corporations, and vaporware claims have resulted in securities fraud lawsuits—primarily grounded in Rule 10b-5 claims—against Apple, Microsoft, and several other corporations. See *id.* at 1253.

²⁴⁰ See Brian Wu & Anne Marie Knott, *Entrepreneurial Risk and Market Entry*, 52 MGMT. SCI. 1315, 1315–16 (2006).

²⁴¹ Robert H. Brockhaus, Sr., *Risk Taking Propensity of Entrepreneurs*, 23 ACAD. MGMT. J. 509, 509 (1980).

opportunities; and even family relations when they engage in a new business venture, which historically has led scholars to describe entrepreneurs as excessive risk-takers.²⁴² Recent scholarship, such as writing by Professor Anne Marie Knott and Brian Wu, presents a more nuanced view of entrepreneurial risk-taking. Professor Knott and Wu posit that, while entrepreneurs display classic risk aversion with respect to market demand uncertainty, entrepreneurs exhibit overconfidence regarding their “own entrepreneurial ability.”²⁴³ That is to say, entrepreneurs do not believe they are taking significant economic risks because they are “overestimating their capability” in their risk calculations.²⁴⁴ This helps explain why entrepreneurs “all have rosy glasses through which they view their business and their market.”²⁴⁵ According to Professor Knott and Wu, entrepreneurs believe their superior abilities can translate a long-shot idea—at least as viewed from an outside perspective—into the next Facebook.²⁴⁶

Of course, overestimating one’s own ability can be positive, encouraging entrepreneurs to risk their life savings (and often the savings of their families and friends) on the next big venture, at least a few of which will succeed wildly. Before signing the JOBS Act, President Obama praised risk-taking among American entrepreneurs:

We think big. We take risks. And we believe that anyone with a solid plan and a willingness to work hard can turn even the most improbable idea into a successful business. So ours is a legacy of Edisons and Graham Bells, Fords and Boeings, of Googles and of Twitters. This is a country that’s always been on the cutting edge. And the reason is that America has always had the most daring entrepreneurs in the world.²⁴⁷

²⁴² See *id.* at 510–11.

²⁴³ Wu & Knott, *supra* note 240, at 1315.

²⁴⁴ See *id.* at 1317. For example, when engineers in “entrepreneurial firms” were asked to fill out a self-assessment comparing their abilities to those of their peers, 42% of the engineers surveyed believed they were in the top 5% of peer performance and 73.3% believed they were in the top 10% of peer performance. *Id.* (“Thus, while all engineers are prone to overconfidence, those drawn to start-ups are particularly overconfident.”).

²⁴⁵ Telephone Interview with Brian Batchelor, *supra* note 90; accord Carmen Nobel, *Why Companies Fail—and How Their Founders Can Bounce Back*, HARV. BUS. SCH. WORKING KNOWLEDGE (Mar. 7, 2011), <http://hbswk.hbs.edu/item/6591.html> (“[S]tubborn entrepreneurs continue to found companies, in spite of the failure rates Sometimes this is due to naïveté and hubris—the notion that their idea simply cannot fail.”).

²⁴⁶ See *supra* notes 243–44 and accompanying text.

²⁴⁷ Obama, *supra* note 111.

Such entrepreneurial ventures are critical to the country's economic growth.²⁴⁸ However, risk-taking based on an inflation of one's own likelihood of success is exactly the type of risk-taking that is likely to lead to overconfident projections that fall outside of the Securities Act's safe harbor for forward-looking statements.²⁴⁹ Thus, crowdfunded startups run by entrepreneurs with this mindset will confront substantially greater liability risk than companies run by comparatively conservative managers.

Fourth, crowdfunded startups face greater liability exposure because Section 4A(c) significantly broadens the scope of communications that may trigger civil liability for issuers.²⁵⁰ Post-*Gustafson* judicial discussions of Sections 11 and 12(a)(2) frequently refer to the "*interrorem* [sic] nature of the liability" of these sections.²⁵¹ These cases justify the "stringent standard of liability"²⁵² imposed on issuers because public offering materials are formal documents intended for public reliance; thus, issuers bear a "moral responsibility to the public [that] is particularly heavy."²⁵³ Liability for material misstatements and omissions under Section 4A(c)'s "any written or oral communication" standard will clearly attach to the formal disclosures distributed to the public and the SEC.²⁵⁴ However, Section 4A(c), at least on its face, appears to cover other informal statements and communications to the public—to the extent such communication is permitted under the SEC's final rules—since the phrase "any written or oral communication, in the offering or sale of a security" is not limited to formal statements filed with the SEC.²⁵⁵ Formal disclosures to the SEC and the public are already substantial and provide ample room for misstatement and omissions even without the extension of liability for promotional statements under 4A(c).²⁵⁶

²⁴⁸ See *supra* notes 110–13 and accompanying text.

²⁴⁹ For example, a projection or forward-looking statement does not fall within the Securities Act's "safe harbor" if the "statement was made or reaffirmed without a reasonable basis." 17 C.F.R. § 230.175 (2012); Prentice, *supra* note 239, at 1252–53. The "reasonable basis" requirement could be challenged in circumstances of unrealistically overconfident projections.

²⁵⁰ See *supra* notes 181–88 and accompanying text.

²⁵¹ See, e.g., *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010).

²⁵² See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381–82 (1983) ("[Section 11] was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." (footnote omitted)).

²⁵³ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 581 (1995) (quoting H.R. REP. NO. 73–85, at 9 (1933)).

²⁵⁴ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 317–19 (2012).

²⁵⁵ See *id.*

²⁵⁶ See Hanks, *supra* note 95 ("The disclosure requirements will be unfamiliar to small companies that may be entering the capital markets for the first time and they are likely to make inadvertent mistakes.").

Fifth, crowdfunded offerings involve a unique blend of customer marketing and investor pitching, which is likely to open issuers to additional liability if promotional statements fall within Section 4A(c).²⁵⁷ A crowdfunding startup is seeking not just financing from the crowd, but also the establishment of a customer base to promote its product.²⁵⁸ This dual purpose means that entrepreneurs need to show more than just the startup's financial statements and business plan, as required by the Crowdfund Act.²⁵⁹ Instead, entrepreneurs need to convince hundreds of potential investors to also become customers.²⁶⁰ The notable difference between this pitch and a securities marketing road show²⁶¹ is that, in crowdfunding, these pitches will target unsophisticated retail investors instead of the institutional investors, money managers, and brokerage firms typically courted during road shows.²⁶² In rewards-based crowdfunding, this sales pitch often takes the form of a marketing video.²⁶³ Since liability for inaccurate representations under Section 4A(c) on its face attaches to “any written or oral communication” as discussed above, liability may very well attach to all online and video promotions related to selling the security, at least to the extent the SEC rules permit such promotional material. Companies are more likely to make predictions and representations on websites and in videos that they would not make in print and certainly would not make in a prospectus.²⁶⁴ Potentially even more problematic is that entrepreneurs will likely attempt to promote their offerings through social media platforms, which

²⁵⁷ Even if promotional statements do not fall within Section 4A(c), this environment creates a risk of triggering Rule 10b-5 liability for issuers and funding portals. *See id.* (“It is easy to imagine the type of promotional statements that inexperienced funding portals might make that would form the basis for a 10b-5 suit.”).

²⁵⁸ *See* Slava Rubin, *The Wisdom of Crowdfunding*, FORBES, Oct. 22, 2012, at 62.

²⁵⁹ *See supra* notes 144, 150 and accompanying text.

²⁶⁰ In some ways, this is a more difficult sale than pitching to angel investors or venture capital firms where the entrepreneur simply needs to convince the investor that customers exist regardless of whether the investor sees himself or herself as a customer.

²⁶¹ A “road show” may occur before a large securities offering, such as an IPO, to drum up interest among investors. *See* CRAIG F. ARCELLA, THE NUTS AND BOLTS OF ROAD SHOWS 1 (2010), [http://www.cravath.com/files/Uploads/Documents/The%20Nuts%20and%20Bolts%20of%20Road%20Shows%20\(5-502-2419\).pdf](http://www.cravath.com/files/Uploads/Documents/The%20Nuts%20and%20Bolts%20of%20Road%20Shows%20(5-502-2419).pdf). During a road show, the issuer's senior management and its lead underwriters make presentations to potential investors. *Id.*

²⁶² *See id.*

²⁶³ On Kickstarter, for example, projects featuring videos “succeed [at raising funds] at a much higher rate than those without.” *Making Your Video*, KICKSTARTER, http://www.kickstarter.com/help/school#making_your_video (last visited Aug. 13, 2013).

²⁶⁴ *See* Prentice, *supra* note 175, at 33.

currently form the backbone of crowdfunding solicitation efforts.²⁶⁵ Even these casual communications could result in Section 4A(c) liability since they are written communications.²⁶⁶ Of course, the likelihood of counsel reviewing all these communications in a crowdfunding setting is slim, given the cost of such review and the relatively small amount of money being raised in a crowd-funded offering.

Sixth, misleading statements, omissions, and overly optimistic assertions are less likely to be caught and rooted out in crowdfunding than in traditional financing because of the minimal level of due diligence that will likely be undertaken in crowd-funded offerings.²⁶⁷ If, as posited above, entrepreneurs skew expected return calculations and omit certain risks based on overconfidence in their own performance, these skewed returns and omissions will inevitably appear in risk disclosure statements, business plans, and financial projections. When angel investors and venture capital firms receive business plans and financial projections, they take a closer, skeptical look during the due diligence process.²⁶⁸ Sophisticated investors expect overstatements and anticipate finding material mistakes and misstatements during due diligence.²⁶⁹ However, crowdfunding does not present the same opportunity for thorough due diligence on the part of investors. Crowdfunding investors will rely either on the issuer's sales pitch or, at best, on the issuer's disclosed financials and projections, without the ability to conduct their own due diligence.²⁷⁰ Several scholars and legal practitioners question the extent to which these financial disclosures will actually benefit retail investors since

²⁶⁵ Telephone Interview with Jim Cummings, Member, Ormana, LLC (Sept. 27, 2012) (explaining how he used social media platforms, including Facebook and "anything else [he] could" to promote his campaign). Professor Mollick's Kickstarter results study also demonstrates the value of social media connections. See Mollick, *supra* note 230 (manuscript at 8) ("To take an average project in the Film category, a founder with 10 Facebook friends would have a 9% chance of succeeding, one with 100 friends would have a 20% chance of success, and one with 1000 friends would have a 40% chance of success.").

²⁶⁶ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 317, 319 (2012). It is currently unclear to what extent issuers will be able to promote their offerings through promotional materials or social media. The Crowdfund Act currently states that issuers shall "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker." *Id.* at 318.

²⁶⁷ See Daniel Isenberg, *The Road to Crowdfunding Hell*, HBR BLOG NETWORK (Apr. 23, 2012, 10:57 AM), http://blogs.hbr.org/cs/2012/04/the_road_to_crowdfunding_hell.html (arguing that due diligence is too expensive for crowdfunding).

²⁶⁸ "A lot of what entrepreneurs disclose may or may not be 100% accurate. . . . It takes a lot of time and a lot of specific knowledge to drill down to what is realistic." Telephone Interview with Brian Batchelor, *supra* note 90.

²⁶⁹ See *id.* ("Groups like the ATA and sophisticated angels and venture capital firms cut to the chase because they have seen this standard entrepreneur optimism a million times and they know what to do.").

²⁷⁰ See *infra* notes 273-77 and accompanying text.

many, if not most, retail investors will either not understand these documents or not bother reading them.²⁷¹ The concern around the lack of due diligence is so strong that several businesses, including CrowdCheck, Crowdfunding Roadmap, and CrowdQualifier, have sprouted to offer due diligence services for issuers and crowdfunding intermediaries.²⁷² However, these due diligence services are unlikely to be as thorough as those conducted by sophisticated investors because of the time and cost involved in high-quality due diligence.²⁷³ Venture capital firms may spend upwards of \$50,000 on due diligence before committing funds to a startup,²⁷⁴ and angel investor groups perform an average of sixty hours on due diligence before investing.²⁷⁵ Since crowdfunding will involve smaller sums of money, especially in comparison to venture capital investing, and because issuers will ultimately have to foot the bill for due diligence,²⁷⁶ expensive and lengthy due diligence is not practical.²⁷⁷ This financial reality increases the likelihood that material mistakes will not be unearthed—mistakes that may come back to haunt issuers under Section 4A(c) if the startup flounders or fails.

2. *The Likelihood of Plaintiffs' Attorneys Bringing Suit Under 4A(c)*

Despite Section 4A(c)'s minimal elements, the Crowdfund Act's liability provision is at risk of providing investors a right without an effective remedy unless attorney fee-shifting is instituted as this Comment proposes. The small dollar amounts in a crowdfunded offering may well render the liability section ineffective because no single individual is likely to have a sufficient

²⁷¹ See Bradford, *supra* note 64, at 112 (writing that “at least some of the people investing in crowdfunding offerings will not have the basic financial knowledge required to understand the risks” even if disclosed); Wroldsen, *supra* note 11, at 605 (writing that a disclosure’s “effectiveness in helping investors, especially unsophisticated ones, judge the quality of securities offerings is questionable”); Sullivan & Ma, *supra* note 218 (“Typical crowdfunding investors, even with basic disclosure requirements for participation, won’t have the investment savvy to determine whether an investment is real or a fraud.”).

²⁷² See CROWDCHECK, <http://www.crowdcheck.com/about-us> (last visited Aug. 13, 2013); CROWDFUNDING ROADMAP, <http://www.crowdfundingroadmap.com/> (last visited Aug. 13, 2013); CROWDQUALIFIER, <http://www.crowdqualifier.com/home> (last visited Aug. 13, 2013).

²⁷³ See Isenberg, *supra* note 267.

²⁷⁴ See *id.*

²⁷⁵ See ROBERT WILTBANK & WARREN BOEKER, RETURNS TO ANGEL INVESTORS IN GROUPS 5 (2007). Venture capitalists may spend several months conducting due diligence. *Id.*

²⁷⁶ Even if some funding portals cover the up-front cost of due diligence, this cost will ultimately be passed along to the issuer in higher hosting fees.

²⁷⁷ Isenberg, *supra* note 267.

investment to pursue litigation.²⁷⁸ Under the Crowdfund Act, an individual with an annual income or net worth of less than \$100,000 can invest the greater of \$2,000 or 5% of the individual's income or net worth; if the investor's annual income or net worth is equal to or greater than \$100,000, the investment is capped at 10% of the individual's annual income or net worth, not to exceed \$100,000.²⁷⁹ The limited dollar amount essentially necessitates filing a class action suit that pools together investor claims.²⁸⁰ However, even as a class action suit, the sum of money at issue is so small that attorneys will have to anticipate reaching a quick settlement before trial in order to justify even the pretrial costs of the litigation.

The vast majority of security lawsuits are filed as class actions in order to balance the costs of the litigation against the potential awards to the class.²⁸¹ However, crowdfunding presents a much smaller investment pool than other financing rounds, such as IPOs, because the Crowdfund Act caps offerings at \$1 million in any twelve-month period.²⁸² Attorney Lyndon Tretter worries that "even the aggregate amount of investments [in a crowdfunded offering] may not be enough to attract plaintiffs' class-action counsel to take the case on a contingency-fee basis."²⁸³ Plaintiffs' attorneys must incur the up-front expenses of litigation in hopes of securing an award that offsets the cost of litigation, while these attorneys can hope to recover 30% of the award.²⁸⁴ In this calculation, plaintiffs' attorneys must also discount both for the likelihood of losing in court and for the time value of money until the award is secured.²⁸⁵ As a result of this calculation, a substantial sum of money is required to motivate lawyers to bring suit. One study on IPOs asserted that "smaller sized

²⁷⁸ See Hazen, *supra* note 20, at 1759 (writing that there are "questions regarding the economics of bringing such a claim and the adequacy of the economic incentives to plaintiff's law firms to bring suit on a contingent fee basis").

²⁷⁹ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315 (2012). Although it remains to be seen, it seems unlikely that an investor would invest anywhere near \$100,000 because such an investor could invest as an angel and negotiate more favorable terms.

²⁸⁰ See Sullivan & Ma, *supra* note 218.

²⁸¹ See HICKS, *supra* note 203, § 6:48 ("The securities laws are complex; actions under them are expensive. Without a class action, many actionable wrongs would go uncorrected and uncompensated." (quoting *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59, 71 (N.D. Tex. 1984))).

²⁸² Jumpstart Our Business Startups Act § 302(a). By comparison, the median IPO deal size in 2012 measured \$124 million and \$160.2 million in 2011. Tomio Geron, *IPO Market Raises \$43B in 2012, but Median Deal Size Down 23%*, FORBES (Dec. 18, 2012, 12:00 PM), <http://www.forbes.com/sites/tomiogeron/2012/12/18/ipo-market-raises-43m-in-2012-but-median-deal-size-down-23/>.

²⁸³ Tretter, *supra* note 20.

²⁸⁴ 1 ALBA CONTE, ATTORNEY FEE AWARDS § 2:8 ("[C]ommon-fund fees in complex class action and shareholder derivative suits normally constitute 20 to 30% of the class recovery . . .").

²⁸⁵ Coffee, *supra* note 166, at 1543.

offerings hardly ever experience a securities-fraud lawsuit,” noting that less than 1% of offerings below \$5 million resulted in a class action lawsuit.²⁸⁶ Another study asserted that a threshold of \$20 million in damages must be available to “make the class action economically attractive to plaintiffs’ attorneys.”²⁸⁷ Because the maximum recovery under the Crowdfund Act is approximately \$1 million, the economics of bringing a class action are questionable; but the possibility of litigation should not be ruled out entirely because attorneys may bring individual or class action suits in anticipation of a quick settlement.²⁸⁸

The minimal burdens Section 4A(c) imposes on plaintiffs may propel a rash of suits filed in anticipation of a quick settlement—suits that may or may not have any merit. In 1995 Congress passed the Private Securities Litigation Reform Act (PSLRA) to reduce the “routine filing” of frivolous or nonmeritorious suits brought for their settlement value,²⁸⁹ commonly referred to as “strike suits.”²⁹⁰ However, Section 12(a)(2) claims alleging negligence and not fraud are not subject to the PSLRA’s heightened pleading standards.²⁹¹ As a result, plaintiffs need not “state with particularity all facts”²⁹² on which their belief in a securities violation is founded.²⁹³ Presumably, Section 4A(c) cases will likewise be exempt from the heightened pleading standard, which means that plaintiffs can proceed without particularized evidence of misleading statements and force defendants to undergo expensive discovery.²⁹⁴ Additionally, the defenses to Section 4A(c) liability—reasonable care and negative loss causation—are both affirmative defenses, meaning the defendant will bear the burden—and costs—of proving these in court.²⁹⁵ Before crowdfunding has even legally commenced, there are already “strike suit

²⁸⁶ *Id.*

²⁸⁷ *Id.* at 1544 n.28.

²⁸⁸ See Sullivan & Ma, *supra* note 218 (“[C]rowdfunding will lead to, perhaps, one Google and thousands of Friendsters. And plenty of lawsuits.”).

²⁸⁹ See Coffee, *supra* note 166, at 1534 n.1 (quoting H.R. REP NO. 104–369, at 31 (1995)).

²⁹⁰ See William S. Feinstein, *Pleading Securities Fraud with Particularity—Federal Rule of Civil Procedure 9(b) in the Rule 10b-5 Context: Kowal v. MCI Communications Corporation*, 63 GEO. WASH. L. REV. 851, 864 (1995).

²⁹¹ See *Rombach v. Chang*, 355 F.3d 164, 170–71 (2d Cir. 2004).

²⁹² 15 U.S.C. § 78u-4(b)(1) (2012).

²⁹³ See *Rombach*, 355 F.3d at 170–71.

²⁹⁴ See Gorga & Halberstam, *supra* note 166, at 6 (stating that Congress enacted the PSLRA to prevent strike suits that threatened defendant corporations with “costly discovery”).

²⁹⁵ See *supra* notes 205–10 and accompanying text.

lawyer advertisements on the internet,” which suggests that plaintiffs’ lawyers have not overlooked this opportunity for a quick payout.²⁹⁶

Of course, claims brought under Section 4A(c) may have merit, especially given that its express cause of action presents such a minimal hurdle for plaintiffs. Another parallel to IPOs is helpful. Consider that companies going public may spend several hundred thousand dollars preparing the prospectus and registration statements.²⁹⁷ Despite the cost and careful preparation of these materials, many of these companies, especially high-tech companies, are sued in a class action or derivative suit shortly after their IPO.²⁹⁸ Groupon and Facebook provide illustrative examples. A lawsuit filed against Groupon pointed to its “material weakness in internal controls” that, if true, potentially resulted in false and misleading statements in its registration statement and prospectus.²⁹⁹ After Facebook’s dismal IPO in May 2012, investors filed forty-two securities lawsuits against Facebook, alleging it misrepresented its financial condition prior to its IPO.³⁰⁰ These suits inevitably arise because IPOs are “the most attractive kind of suit for the plaintiff’s bar,” according to Columbia Law Professor John Coffee.³⁰¹ Since crowdfunding offers share many of the same characteristics as IPOs—aside from the monetary value of the offering—they may likewise be very attractive to the plaintiff’s bar.³⁰² Although the past frequency of such suits is not a guarantee of the frequency of crowdfunding litigation, it at least indicates that plaintiffs’ attorneys will be looking closely at the potential benefits of bringing a suit under Section 4A(c), which means issuers must factor this cost into their crowdfunding transaction calculations. As discussed in the next section, providing fee-shifting for plaintiffs’ attorneys successful at trial on the merits will motivate attorneys to pursue cases that might not otherwise make financial sense, thus ensuring investors a more effective remedy under Section 4A(c).

²⁹⁶ See Jeff Koepfel, *Singing in the Rain*, CROWD FUNDING NEWS (Dec. 24, 2012), <http://jeffkoepfel.wordpress.com/2012/12/24/singing-in-the-rain/>.

²⁹⁷ See *supra* note 97 and accompanying text.

²⁹⁸ See Johnson, *supra* note 24 (“[A] rite of passage for any publicly traded tech company is its first securities class action or derivative suit.”).

²⁹⁹ See Sam Gustin, *Groupon Faces SEC Probe, Investor Lawsuit as Stock Hits New Low*, TIME (Apr. 5, 2012), <http://business.time.com/2012/04/05/groupon-faces-SEC-probe-investor-lawsuit-as-stock-hits-new-low/>.

³⁰⁰ Nate Raymond, *Judge Names Lead Plaintiffs in Facebook Litigation*, THOMSON REUTERS NEWS & INSIGHT (Dec. 6, 2012), http://newsandinsight.thomsonreuters.com/SECurities/News/2012/12_-_December/Judge_names_lead_plaintiffs_in_Facebook_litigation/.

³⁰¹ Aaron Lucchetti, *Facebook’s Next Fight: Suits, and More Suits*, WALL ST. J., Sept. 26, 2012, at C1.

³⁰² See *supra* note 24 and accompanying text.

IV. RECOMMENDATIONS FOR CONGRESS AND ISSUERS

Given the overly broad liability sweep of Section 4A(c), its cost implications, and the potentially ineffective remedy it provides to investors, Congress must revise the Crowdfund Act's overbearing liability provision. This possibility is not as far-fetched as one might initially believe, especially when considering Congress's frustration at the SEC over the delay in rulemaking.³⁰³ If Congress picks up the pencil to complete rulemaking, it should take the opportunity to revisit Section 4A(c) as well.³⁰⁴ This Part provides a prescriptive solution for redrafting Section 4A(c) that balances investor protection from fraud and issuer liability exposure.

As discussed in Part III.B, the negligence-like standard of care imposed by Section 4A(c) imposes draconian liability on issuers.³⁰⁵ This level of care is difficult—if not impossible—to achieve even for more mature companies undergoing IPOs with far greater sums of money to expend on attorneys and accountants.³⁰⁶ For many startups and emerging companies with limited financial resources, the disclosure requirements and hidden transaction costs will make crowdfunding unsustainable for the very companies the crowdfunding legislation was intended to benefit.³⁰⁷ This Comment addresses this problem by proposing a redraft of Section 4A(c) to require issuer scienter, while simultaneously providing a fee-shifting provision for plaintiffs' attorneys who are successful on the merits at trial. This simple rebalancing of Section 4A(c) will lower issuer liability exposure and transaction costs but will also maintain investor protection from fraud and the integrity of the market.

³⁰³ See Letter from Senator Jeff Merkley et al., to Mary Schapiro, Chairman, SEC (Dec. 10, 2012), available at <http://www.merkley.senate.gov/newsroom/press/release/?id=911718cf-ad8b-4f66-8455-8cad3960f51d> ("The law directed the SEC to promulgate the necessary rules within 270 days of the enactment of the Act. . . . At this point, it will be difficult to complete the rules by the deadline in the Act, but the SEC should move expeditiously to attempt to do so.").

³⁰⁴ Sara Hanks, a former SEC attorney, notes that congressional legislation already supplanted SEC rulemaking once in the JOBS Act when Congress altered Section 12(g) registration triggers, and that "[i]t is not impossible that the drafting pencil could be seized from the Commission's hands again." Hanks, *supra* note 95. At the same time, Congress is not always known for fixing what it may consider a minor detail. See William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 160 n.109 (2006) (noting the fact that Congress "will not rethink its choices" regarding the Sarbanes-Oxley Act despite criticism from the Act's author).

³⁰⁵ See *supra* Part III.B.

³⁰⁶ See *supra* notes 298–302 and accompanying text.

³⁰⁷ See *supra* Part II.

Although Rule 10b-5 will apply to crowdfunding transactions,³⁰⁸ the heightened risk of fraud in online crowdfunding warrants a new liability provision, albeit not one as oppressive as Section 4A(c). The PSLRA requirement that plaintiffs have certain facts in hand before trial when alleging Rule 10b-5 claims³⁰⁹—coupled with the burden of proving the six elements of Rule 10b-5 and the small sums of money in play—will likely minimize the effectiveness of Rule 10b-5 for defrauded investors. Even in securities fraud cases with much higher monetary stakes than in crowdfunding, many people worry that PSLRA requirements are preventing legitimate lawsuits as well as frivolous ones.³¹⁰ Although this Comment proposes that scienter—carrying its standard meaning of recklessness³¹¹ or deliberateness—should be added as an element of Section 4A(c) to be proved by the plaintiff, the heightened PSLRA pleading standard should not apply to Section 4A(c) claims because this barrier could prevent the plaintiff from advancing to discovery to unearth fraud. This compromise revision of Section 4A(c) provides several benefits: lowering the issuer’s transaction costs, focusing litigation on fraudulent issuers, avoiding PSLRA’s hurdles, and reducing the likelihood of strike suits.

First, this revision helps lower the up-front and hidden transaction costs of crowdfunding. The role of the SEC is to mandate disclosure and to remedy the information asymmetry between issuer and investor without choking off the market’s utility.³¹² However, as noted, the Crowdfund Act currently risks creating burdens disproportionate to the Act’s benefits.³¹³ The likelihood of making a material misstatement or omission in a crowdfunded offering is extremely high.³¹⁴ This risk increases the need for attorneys and further raises the costs of using crowdfunding. Concededly, adding a scienter requirement to Section 4A(c)’s liability standard might let some issuers avoid liability for negligence. However, allowing issuers to avoid some limited liability is a

³⁰⁸ See Hanks, *supra* note 95; *supra* note 37 and accompanying text.

³⁰⁹ See Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 925 (2003); *supra* notes 291–92 and accompanying text.

³¹⁰ See Jane Bryant Quinn, *Madoff Victims Face Grim Prospects in Court*, BLOOMBERG (Feb. 11, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&refer=columnist_quinn&sid=axkhffRnncpl (discussing how the PSLRA acts as a barrier to recovery for victims of Bernard Madoff scam); see also Perino, *supra* note 309, at 926 & nn.73–75.

³¹¹ “Recklessness” is “an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or was so obvious that the defendant must have been aware of it.” *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 348 (S.D.N.Y. 2011) (quoting *S. Cherry St., LLC, v. Hennessee Grp., LLC*, 573 F.3d 98, 109 (2d Cir. 2009)).

³¹² See Johnson, *supra* note 24.

³¹³ See *supra* Part II.

³¹⁴ See *supra* Part III.B.1.

trade-off warranted by the economic benefits of potentially plugging the startup capital funding gap.³¹⁵

Additionally, this proposed revision to Section 4A(c) will help focus recovery efforts on the most culpable issuers—those actually engaging in clear and demonstrable fraud.³¹⁶ Under Section 4A(c), as presently written, a plaintiff's attorney is just as likely to bring a case against an issuer that carelessly mistranscribes a decimal in its financial statements as against an issuer that deliberately cooks its financial statements. The addition of scienter as an element of Section 4A(c) will concentrate litigation against the latter—the issuers that intentionally or recklessly abuse crowdfunding and damage the market's integrity. Next, by eschewing the PSLRA's heightened pleading standard, this revision would allow plaintiffs to more readily survive a motion to dismiss and proceed to discovery, where evidence of fraud could be unearthed. Finally, this change would reduce the potential likelihood of suits filed in anticipation of a quick settlement, because plaintiffs' attorneys would face the hurdle of proving scienter and not mere negligence.

In addition to requiring scienter for material misstatements or omissions, Section 4A(c) should permit attorney fee-shifting for the prevailing party at trial on the merits of the case, such as is done in civil rights cases.³¹⁷ If patterned after attorney fee-shifting in civil rights cases, the revised Section 4A(c) would allow either party to win attorney's fees, although civil rights precedent favors recovery by the plaintiff rather than the defendant.³¹⁸ This revision would provide defrauded plaintiffs with a more robust remedy since the economic incentives of litigating a class action suit under Section 4A(c) are questionable at best.³¹⁹ Permitting fee-shifting would alter the calculations made by plaintiffs' attorneys. Instead of being deterred by the limited size of the award, attorneys could concentrate on the likelihood of success because

³¹⁵ See *supra* notes 57–60 and accompanying text; see also *supra* Part I.B.

³¹⁶ To further this end, plaintiffs' attorneys and the courts should first look to culpable corporate insiders for the payment of any judgment instead of initially seeking recovery from the corporation, which would just impoverish the remaining shareholders. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 719 (1992) (discussing how enterprise liability for securities fraud “simply replaces one group of innocent victims with another” while “a large percentage of the plaintiffs' recovery goes to their lawyers”).

³¹⁷ See, e.g., 42 U.S.C. § 1988(b) (2006).

³¹⁸ See Mark R. Brown, *A Primer on the Law of Attorney's Fees Under § 1988*, 37 URB. LAW. 663, 664 (2005) (“A prevailing defendant can win attorney's fees under § 1988 only if it can prove that a plaintiff's claim is frivolous, groundless, or vexatious.”). Allowing recovery by the defendant in such situations would further discourage strike suits.

³¹⁹ See *supra* Part III.B.2.

they would receive adequate compensation if they won on the merits at trial.³²⁰ The court could base the awarded fee on a lodestar calculation that multiplies hours expended by counsel by a reasonable hourly rate, and then adjust the result based on other pertinent factors, such as the experience of counsel, novelty of the questions, and the “undesirability” of the case.³²¹

This fee-shifting provision would place some issuers on the hook for far more money than under Section 4A(c) in its current form, which provides only for rescission of funds plus interest upon a tendering of the plaintiff’s securities.³²² However, holding fraudulent issuers accountable for plaintiffs’ attorney fees may additionally deter would-be fraudulent issuers, especially those issuers who would be willing to commit fraud when the most likely civil repercussion is simply returning the raised funds.³²³ Of course, instituting fee-shifting may deter legitimate issuers from using crowdfunding as well. However, the deterrent effect should not be as great on legitimate issuers contemplating crowdfunding because the addition of scienter to Section 4A(c) will shield issuers from liability if they simply commit a beginner’s mistake sans scienter.

Until these issues with Section 4A(c) are revisited by Congress or attended to by the SEC or the courts, issuers need to be aware of this hidden liability trap and factor it into their crowdfunding cost calculations. In particular, startups and high-tech companies—those companies facing the highest risk of making a material misstatement or omission³²⁴—should think twice before using crowdfunding. What initially seems a fast and easy form of financing may quickly unravel into costly and time-consuming litigation.

³²⁰ If the defendant settles the case, any fees should come from the common fund and not through attorney fee-shifting to avoid encouraging strike suits.

³²¹ See Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees in Class Action Settlements: An Empirical Study*, 1 J. EMPIRICAL LEGAL STUD. 27, 30–31 (2004) (internal quotation marks omitted). The authors also note several potential problems with this form of calculation, although an in-depth discussion of these issues lies outside the scope of this Comment. *Id.* at 31.

³²² See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315, 318 (2012).

³²³ Of course, the SEC and state enforcement agencies can also levy monetary sanctions and suspensions against fraudulent issuers. However, statistics show that from 2000 to 2002, private action awards amounted to more than twice those imposed by the SEC and more than all those imposed by the SEC, state regulatory authorities, the National Association of Securities Dealers Exchange, and the New York Stock Exchange combined. See Coffee, *supra* note 166, at 1542.

³²⁴ See *supra* Part III.B.1.

CONCLUSION

Crowdfunding poses the potential for the most significant shake-up and democratization of the investment industry in decades. For the first time, nearly every American adult will be able to invest in startups, once a privilege largely reserved to the fewer than four million accredited investors in the United States.³²⁵ Of course the positives should not be overstated. When unsophisticated investors meet unsophisticated issuers, there will be investor losses and there will be fraudulent offerings.³²⁶ But fraudulent offerings and investor losses already occur in the public and private markets.³²⁷

The key to this grand experiment is balancing investor protection from fraud and the burdens of issuing a crowdfunded offering. The up-front transaction costs of attorneys and accountants to prepare disclosure statements that comply with SEC regulations, plus the fees owed to funding portals, will consume a substantial portion of the \$1 million maximum that can be raised.³²⁸ Even more significant are crowdfunding's hidden costs, including the administrative cost of managing shareholders, the deterrent effect of numerous shareholders on later rounds of investment, and, most critically, the potential liability costs under Section 4A(c) down the road.

Section 4A(c) of the Crowdfund Act sweeps too broadly for the crowdfunding environment and will ensnare unsophisticated entrepreneurs in its trap. The liability provision's minimal elements—merely proving a material misrepresentation or omission that makes a stated fact misleading—coupled with the expansion of Section 12(a)(2)'s language to include “any written or oral communication,”³²⁹ will impose draconian liability on unsuspecting issuers. The problems with this liability provision are further exacerbated by the dynamics of startups using crowdfunding: young companies statistically likely to fail, emerging technology issues, entrepreneurial predisposition to risk, broad mediums of communication, a unique form of investor pitching, and a lack of thorough due diligence by the crowd.³³⁰

As a new, unprecedented form of financing, crowdfunding likewise deserves a new liability provision, not a rehashing of a liability provision

³²⁵ Wagner, *supra* note 58.

³²⁶ See *supra* notes 20, 39 and accompanying text.

³²⁷ See Johnson, *supra* note 28, at 995, 1009; Bishop, *supra* note 220.

³²⁸ See *supra* Part II.

³²⁹ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315, 319 (2012).

³³⁰ See *supra* Part III.B.1.

intended for companies undertaking a high-priced public offering with the assistance of a small army of attorneys, accountants, and investment professionals. Moreover, crowdfunding deserves a liability provision that actually addresses the risk of securities *fraud*, not beginners' reporting mistakes. Congress should revise Section 4A(c) to require the plaintiff to prove scienter in the untrue statement or omission rather than only allowing the issuer to prove reasonable care or negative loss causation as affirmative defenses. The redrafted provision should also permit attorney fee-shifting to justify the costs of plaintiffs' attorneys pursuing class action litigation over a relatively small sum of money in order to provide defrauded investors with an effective remedy. These corrections will focus the liability provision on those issuers committing fraud—the ostensible concern of lawmakers and regulators—instead of extending liability to cover the inevitable mistakes inexperienced entrepreneurs will make in crowdfunded offerings. These revisions will also drive down the transaction costs of crowdfunding by reducing the need for attorneys to vet every statement and lessening the risk of civil liability springing up down the road. Ultimately, this Comment's proposal would balance securities regulations to protect investors and the integrity of the market, while keeping transaction costs low enough to allow this revolutionary experiment an opportunity to develop.

DAVID MASHBURN*

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