

**UNDERSTANDING DEBT AND EQUITY
CROWDFUNDING FROM A LEGAL PERSPECTIVE**

What Is Crowdfunding?

- In today's economy the term "crowdfunding" can take on many contexts but it is, by definition, the practice of funding a project or venture by raising small amounts of money from a large number of people, most commonly via the Internet
- When a person/business attempts to raise money through crowdfunding, this process is often called a "crowdfunding campaign" or simply a "campaign"



What Is Crowdfunding?

- With debt and equity based campaigns, like Kickstarter (and other rewards-based campaign sites), an entrepreneur starts a campaign in order to raise money to fund their new business, create a new product, get working capital, etc.
- Unlike Kickstarter however, a contributing person in a debt/equity campaign will be making an investment in the entrepreneur's business
- Put simply, in debt and equity based campaigns, a person will give money to an entrepreneur in return for a piece of the action



What Is Crowdfunding?

- There are four (4) main types of crowdfunding campaigns:
 - Donation-based campaigns;
 - Rewards-based campaigns;
 - Debt-based campaigns; and
 - Equity based campaigns
- Each of these types of crowdfunding campaigns is differentiated by what (if anything) the person contributing the money can expect to receive in return
- The most commonly known type of crowdfunding campaigns today are rewards-based campaigns. These are the projects you see in the news and other media raising money through sites such as Kickstarter, Indiegogo, etc.



KICKSTARTER

 **indiegogo**



Federal Regulations

- **JOB Act:**

- On March 27, 2012, Congress passed the Jumpstart Our Business Startups (JOBS) Act, a bipartisan effort in both the House and the Senate to ease the regulatory burdens on smaller companies and facilitate capital formation. President Obama signed the legislation into law on April 5, 2012

- **Main Provisions:**

- Title I: Creates a transitional "on-ramp" for a new category of issuer, emerging growth companies (*i.e. total annual gross revenues of < \$1 billion*), easing registration requirements in order to encourage them to pursue IPOs
- Title II: Allows for "crowdfunding" by (and public solicitation of) "accredited investors."
- Title III: Allows for "crowdfunding" by (and public solicitation of) all investors (*i.e. accredited and non-accredited*)
- Title IV (Regulation A+): Modifying the existing "Regulation A" to provide for, among other things, an expansion of the exemption to cover offerings of securities up to \$50 million (*versus the previous \$5 million*) in any 12-month period



JOB S Act Crowdfunding Basics

• Title II Crowdfunding

- Currently In Effect;
- Rule 506(c) Offering;
- To “Accredited Investors” Only;
- No maximum offering amount

• Title III Crowdfunding

- Currently NOT In Effect
(awaiting final rules)
- To ANY investor;
- Up to \$1MM in any 12 months

	Title II – Rule 506(c)	Title III
In Effect:	Yes	No - Regulations have been proposed but not yet finalized
Maximum Dollars Raised:	No maximum	\$1 million per 12 months
Permitted Investors:	Only "Accredited Investors"	Anyone
Per-Investor Limits:	None	Yes – Max inv. depends on income and net worth of investor
General Solicitation Permitted:	Yes	Yes
Exempt from State Registration:	Yes	Yes
Sold Through Portals:	Yes	Yes
Portals Required to Register:	No, provided activities are limited (e.g. no "commission")	Yes
Portals Allowed to Pick and Choose Offerings:	Yes	No (unless registered broker)
Pre-Sale Information Required:	None	Substantial



“Accredited Investors”

- **Current Test (Section 501 of the Securities Act of 1933):**

- Earned annual income > \$200 K (*or \$300 K together with a spouse*) in each of the prior (2) years, AND reasonably expects the same for the current year; OR
- net worth > \$1 million, either alone or together with a spouse (*excluding the value of the person’s primary residence*)



- **Time for Re-examination of current test:**

- Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to re-examine the definition of “accredited investor” every four (4) years
- SEC re-examining the current test; Sparking huge debate



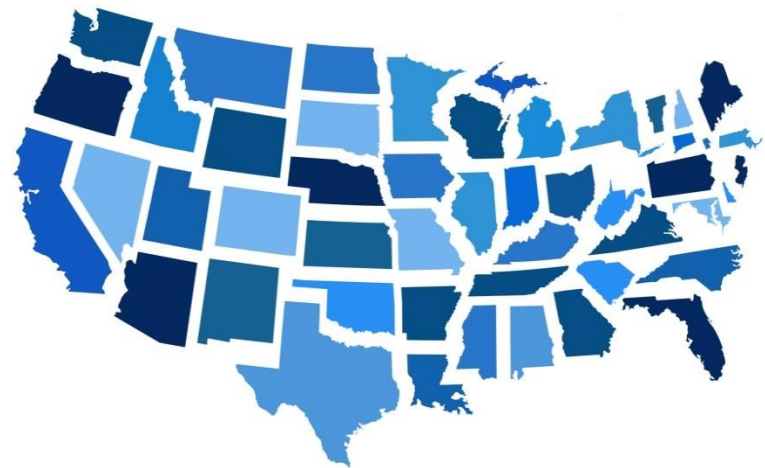
State Regulations (“Intrastate Offerings”)

- **Intrastate offerings:**

- Out of frustration with the SEC’s delay in releasing final Title III rules, many states have enacted (or are in the process of enacting) exemptions for “intrastate” crowdfunding offerings
- “Intrastate” simply means that the Issuer and the investors all reside in the same state
- Intrastate exemptions are enacted under Rule 147 and Section 3(a)(11) of the Securities Act as transactions which are not “public”
- Often state statutes have higher cap amounts than the \$1 MM Title III cap and significantly less administrative hurdles

- **State of enacted and proposed Intrastate Exemptions:**

- Currently 12 states have enacted an Intrastate exemption and 15 states in various stages of enacting/considering legislation regarding an intrastate crowdfunding exemption
- Proposed Illinois Intrastate exemption available at www.illinoiscrowdfundingnow.com



How Does Crowdfunding Actually Work?

- **All Starts with the “Crowdfunding Portal”:**

- “Crowdfunding Portal” just means the website through which the offering is being made
- Portal is the go between the investors and the Issuer
- Portal is responsible for documentation of the deal as well as the pass through of all informational materials to investor



- **Differentiation:**

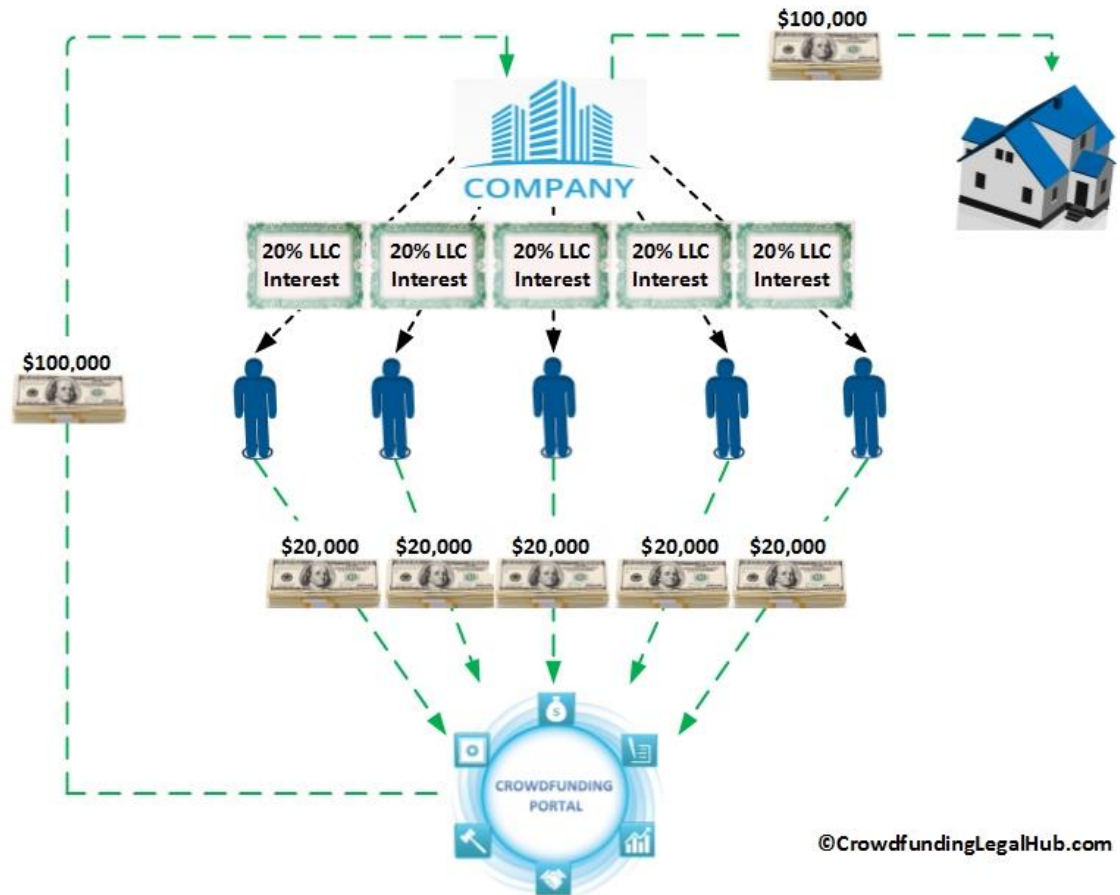
- Portals differentiate themselves by type of crowdfunding (e.g. *debt, equity, reward, etc.*) as well as niche focus
- Most popular niche focuses today center around debt crowdfunding (e.g. “P2P Lending such as LendingClub or Prosper) and Real Estate (*debt and/or equity campaigns, e.g RealtyMogul and Fundrise*)



Equity-Based Crowdfunding

• What is happening in a Typical Equity-Based Crowdfunding Campaign?

- For this example we will assume the subject “campaign” is for an investment in a real estate project (*a build and sell project*) by a company (*here an LLC*) set up by a real estate developer specifically for the subject project (*the “Company”*)
- “Crowd” investors decide to invest in the campaign and deposit funds to the Crowdfunding Portal
- When the offering is complete, the Crowdfunding Portal transfers these funds to the Company
- The Company will use these funds to invest in the subject real estate project
- In return for their investment each crowd investor will receive a percentage ownership interest in the Company (and its assets). **NOTE:** *interests are pro-rata here simply for illustration purposes; NOT required*



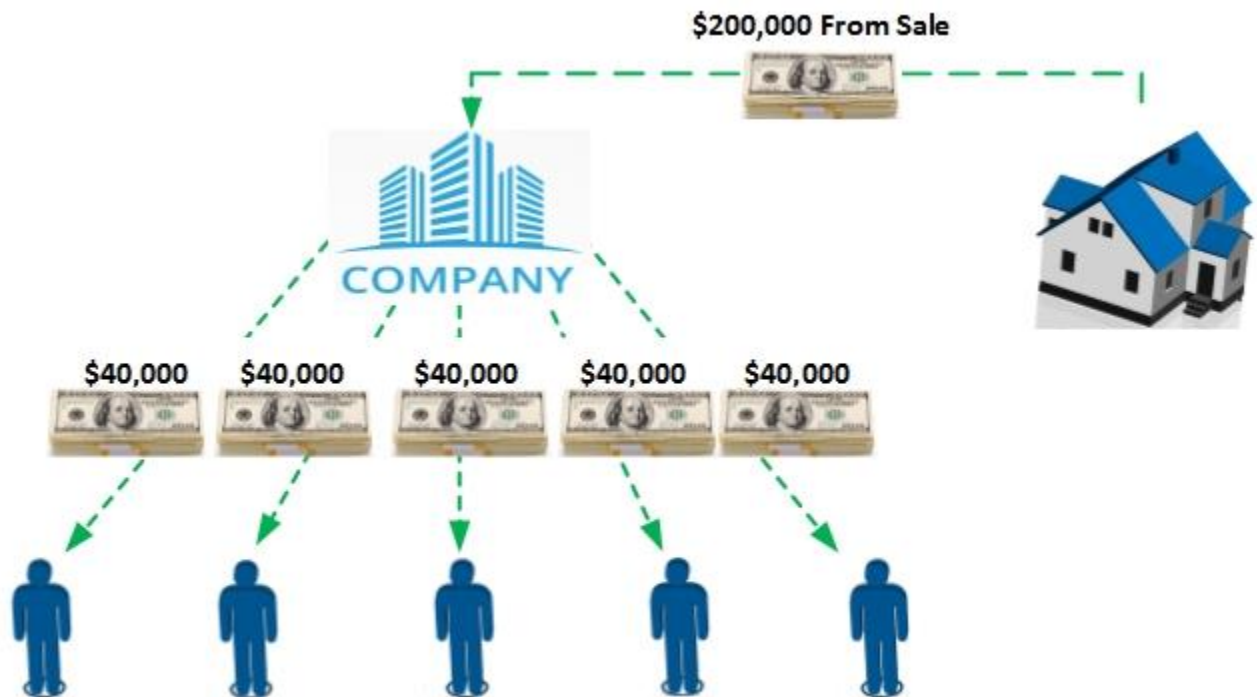
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Equity-Based Crowdfunding

- **How Do Investors Make Money in a Typical Equity-Based Crowdfunding Campaign?**

- Continuing with the previous example, as “equity” holders investors are betting that they will make a profit upon the eventual sale of the subject real estate project
- Upon completion of the underlying real estate project the Company will sell it and the proceeds will go to the Company who will then distribute the proceeds (*in this case 100% of the proceeds*) to the owners
- Each of the investors is an “owner” of a certain percentage of the Company
- As a result each investor will receive a pro-rata share of the proceeds from the sale



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Equity-Based Crowdfunding - Documentation

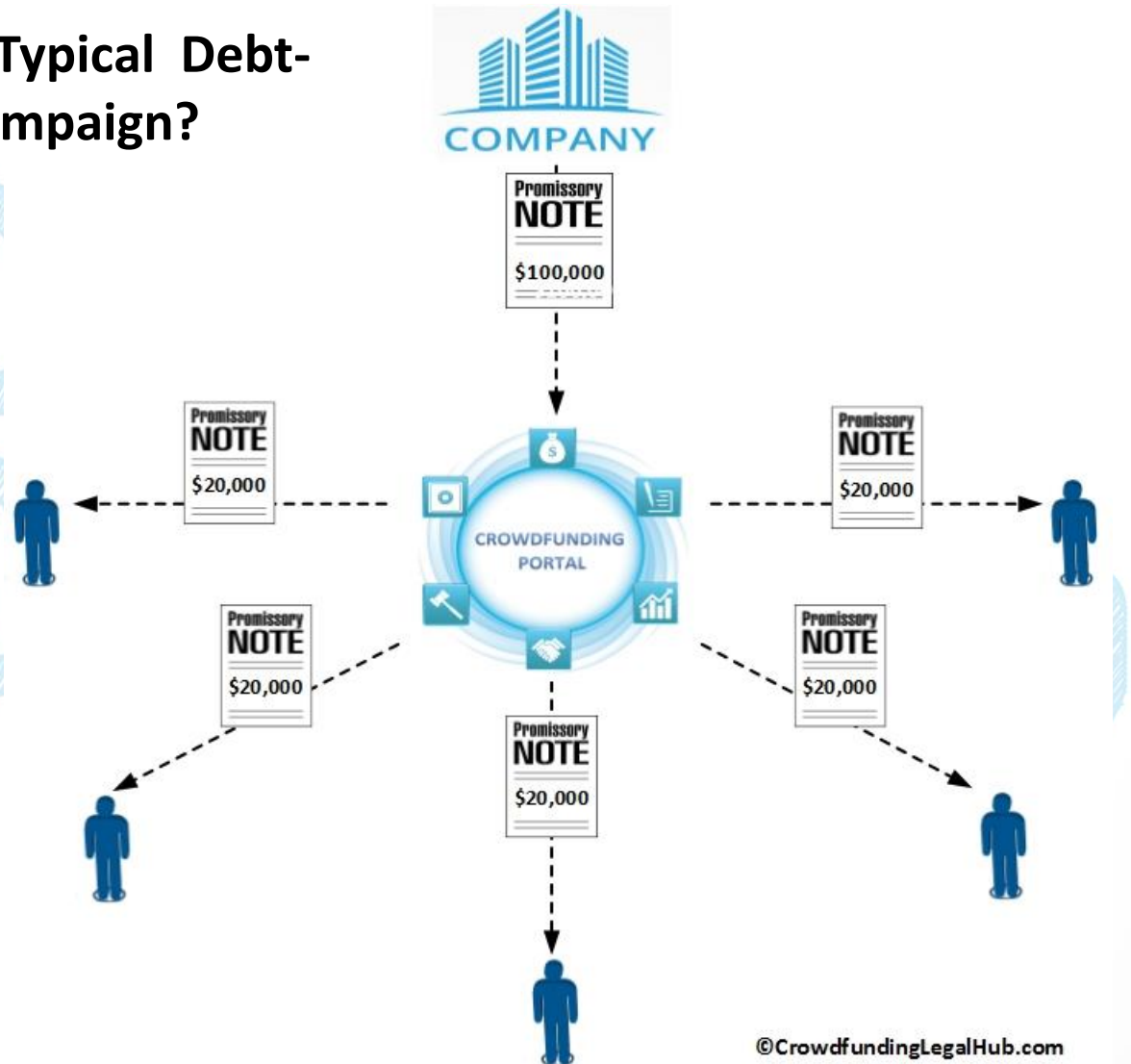
- **1 Transaction** – Investor Investment/Subscription in Company
- **Basic Transaction Documentation:**
 - Private Placement Memorandum (PPM)
 - *See CFIRA Recommendations*
 - Subscription Agreement;
 - Operating Agreement (*2 classes of interests*);
 - Escrow Agreement (*for transaction proceeds*)
- **Securities Documentation:**
 - Investor Questionnaire Materials;
 - SEC/Blue Sky filings
- **General Due Diligence:**
 - Company Organization Documents;
 - Company Specific Risks (*for inclusion in PPM*);
 - Company Financials (*audited, reviewed, internally prepared*);
 - “Bad Actor” searches on officers and directors



Debt-Based Crowdfunding

- **What is happening in a Typical Debt-Based Crowdfunding Campaign?**

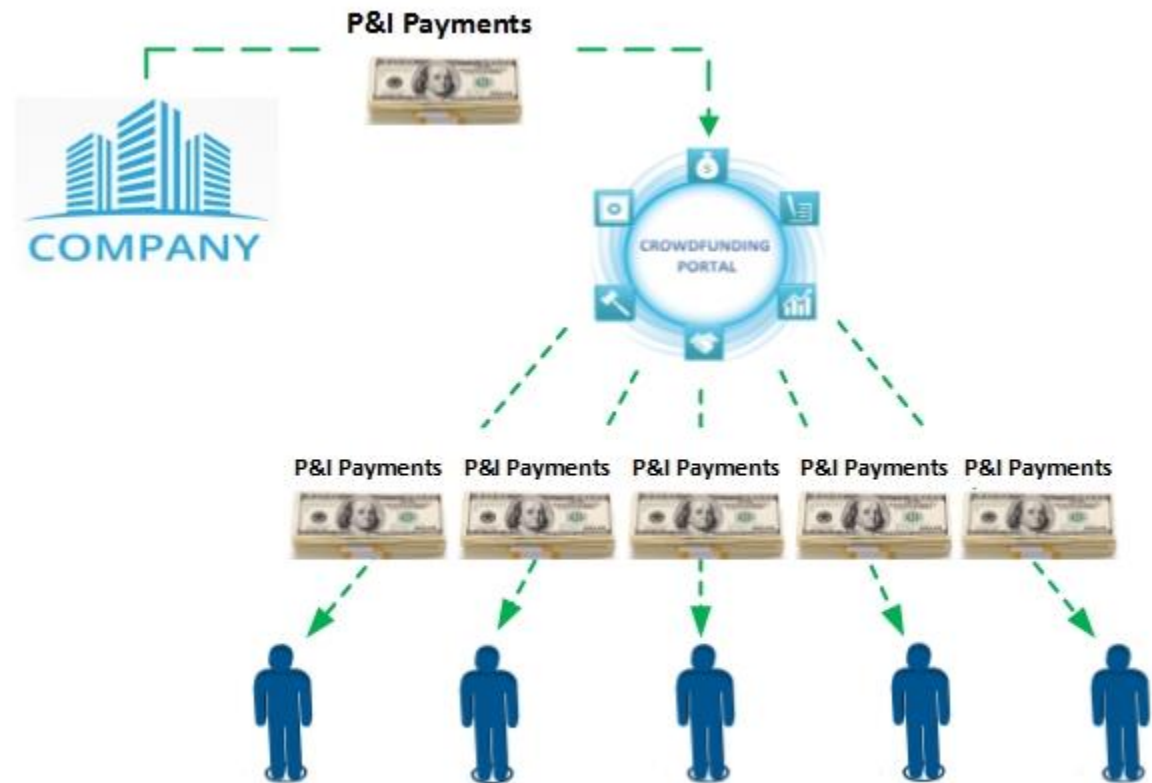
- For this example we will again assume the subject “campaign” is for an investment in a real estate project (*a build and sell project*) by a company (*here an LLC*) set up by a real estate developer specifically for the subject project (*the “Company”*)
- “Crowd” investors decide to invest in the campaign but here they make a loan to the Crowdfunding Portal
- When the offering is complete, the Crowdfunding Portal takes all of the investor funds and makes a loan to the Company
- In return for the loan made from the Crowdfunding Portal to the Company, the Crowdfunding Portal will receive a Promissory Note payable by the Company
- In return for the loan made from the investors to the Crowdfunding Portal, each investor will receive a Promissory Note payable by the Crowdfunding Portal (e.g. the “borrower dependent notes” discussed later)



Debt-Based Crowdfunding

• How Do Investors Make Money in a Typical Debt-Based Crowdfunding Campaign?

- In a typical Debt-Based Crowdfunding Campaign, investors are looking to make money in the way of “interest” payments on the money they are lending
- Continuing with the previous example, the Crowdfunding Portal received a Promissory Note payable by the Company (the “Company Note”)
- The Company Note will often require the Company to make certain regular (e.g. *monthly, quarterly, annually, etc.*) payments of principal and/or interest to the Crowdfunding Portal (“P&I Payments”)
- Continuing again with the previous example, each investor received a Promissory Note payable by the Crowdfunding Portal (each an “Investor Note”)
- Each Investor Note will often require the Crowdfunding Portal to make certain regular (e.g. *monthly, quarterly, annually, etc.*) P&I Payments to each of the investors.



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Debt-Based Crowdfunding - Documentation

- **2 Transactions:**

- Loan from investors to Crowdfunding Portal;
- Loan from Crowdfunding Portal to Company

- **Basic Documentation For Each Transaction:**

- Loan Agreement;
- Promissory Note;
 - Investors receive what is referred to as a “payment dependent” (or “borrower dependent”) promissory note.
 - A payment dependent note simply means that if the portal doesn’t get paid from the developer, the investor won’t get paid from the portal
- Escrow Agreement (*for transaction proceeds*);
- Security Documents*
 - Including: Mortgage, Assignment of L&R, Security Agreement, Guarantees, Pledge Agreements, etc.
 - Enhanced Security Issues when dealing with Construction Loans (*including assignments of management agreements, assignment of plans and specs, etc.*)



Debt-Based Crowdfunding - Documentation

- **Securities Documentation:**
 - Private Placement Memorandum;
 - *See CFIRA Recommendations*
 - Investor Questionnaire Materials;
 - SEC/Blue Sky filings
- **General Due Diligence:**
 - Company Organization Documents;
 - “Bad Actor” searches on officers and directors;
 - UCC Tax, Lien and Judgment Searches on Borrowing Company/Guarantors;
 - Real Estate Due Diligence Materials:
 - Surveys;
 - Title Commitment;
 - Project Documents;



Debt-Based Crowdfunding Secured v. Unsecured

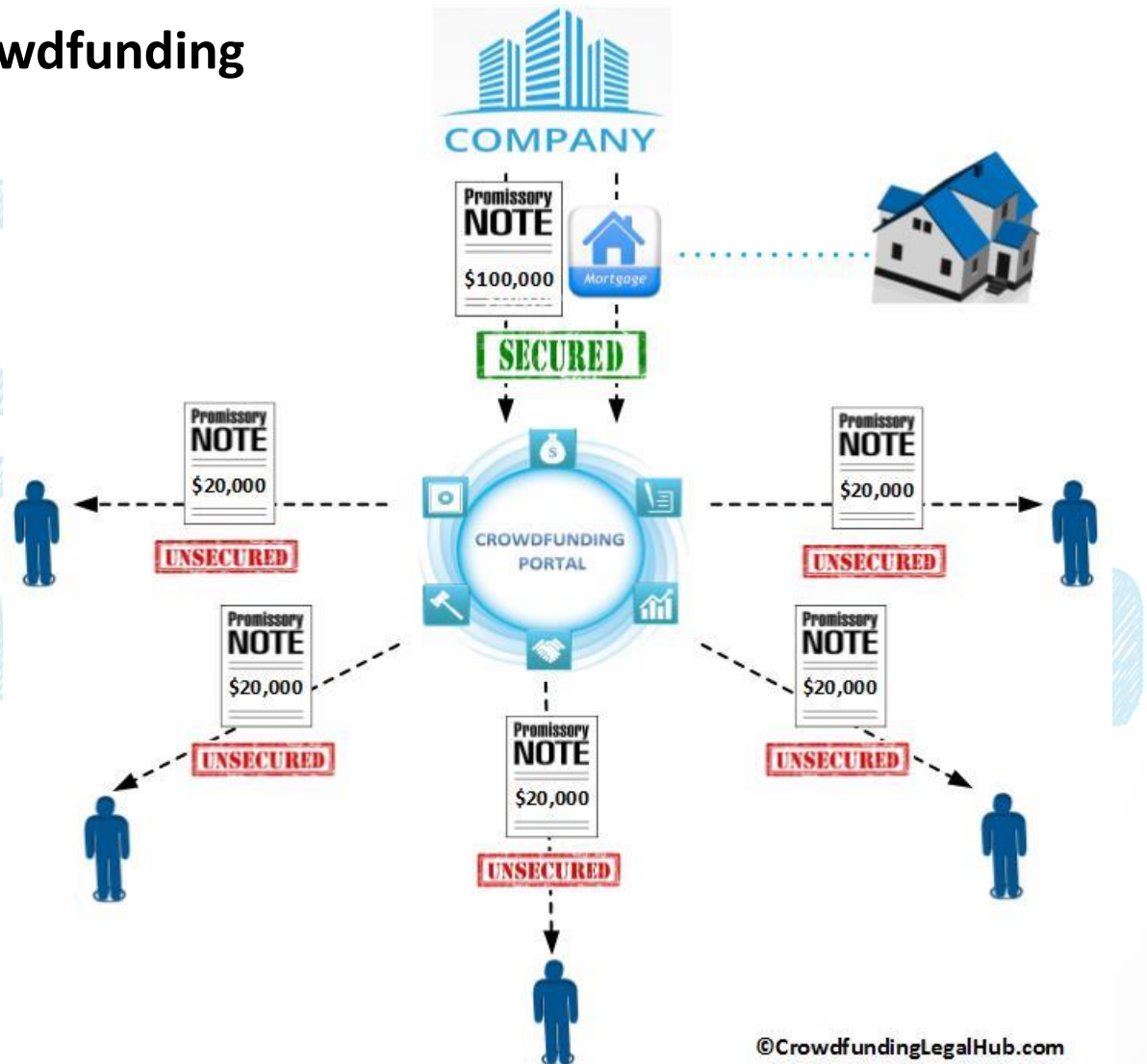
- **Many Debt-Based Transactions Are Unsecured To Investor:**
 - Loan from Crowdfunding Portal to Company is often Secured by some interest
 - e.g. Mortgage, Pledge, Collateral Assignment, Security Agreement, etc.
 - Loan from Investor to Crowdfunding Portal however is often completely unsecured
 - Underlying collateral interest not being passed through to investors
 - Investors Receiving only Payment Dependent Note



Debt-Based Crowdfunding Secured v. Unsecured

• Typical Debt-Based Crowdfunding Transaction Structure:

- For purposes of illustration let's continue with the previous example of a typical Debt-Based Crowdfunding Campaign
- "Crowd" investors make a loan to the Crowdfunding Portal
- The Crowdfunding Portal makes a loan to the Company
- In return for the loan made from the Crowdfunding Portal to the Company, the Crowdfunding Portal will receive a Promissory Note payable by the Company
- They will also typically receive a mortgage encumbering the underlying project
- The mortgage will secure the payment of the Promissory Note payable by the Company to the Crowdfunding Portal
- Again, in return for the loan made from the investors to the Crowdfunding Portal, each investor will receive a Promissory Note payable by the Crowdfunding Portal to the Investor
- These Promissory Notes however are completely **UNSECURED**. The illustrated mortgage only secures the loan made by loan made from the Crowdfunding Portal to the Company



Debt-Based Crowdfunding

Additional Documentation Considerations

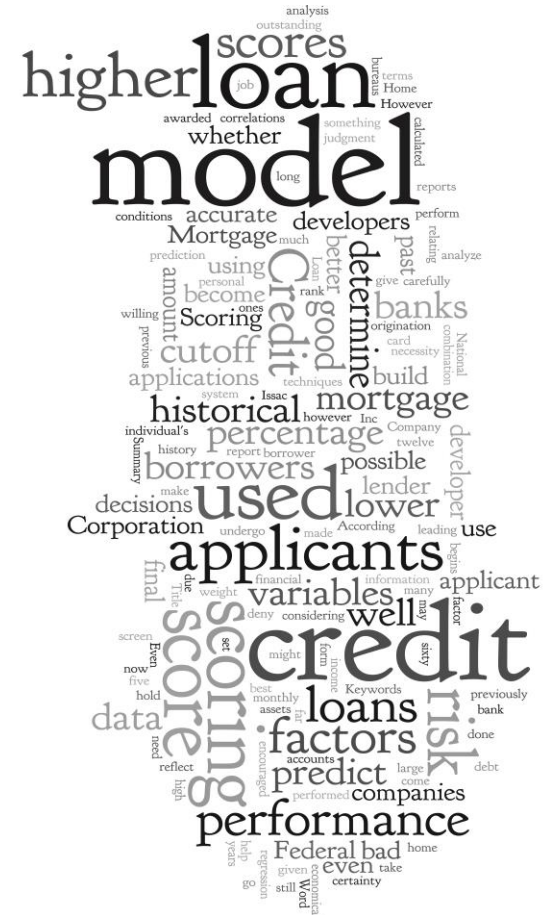
- **Loan Covenants To Consider:**

- **General Covenants:**

- Ordinary course of business;
 - No change of control;
 - Delivery of Financials;
 - Etc.

- **Financial Covenants:**

- Debt Service Coverage Ratio;
 - Loan-To-Value Ratio;
 - Liquidity/Net Worth of Guarantors;
 - Borrowing Base (*if proceeds not being disbursed in lump sum*);
 - Etc.



Debt-Based Crowdfunding

Additional Documentation Considerations

- **Enforcement/Amendment Control Considerations:**

- Should be considered like a “participation loan” or “club loan” where the Crowdfunding Portal is acting as the “administrative agent” for the lending investors;
- Consent of “requisite” number of investors should be required for material actions such as waiver of defaults, loan document amendments, enforcement/non-enforcement of collateral documents, etc.
- Currently this is NOT the case; Crowdfunding portal has unilateral control



- **State Specific Considerations:**

- Documents should be set up to include/waive essential state specific provisions and to be effective on a state level;
 - Particularly with respect to collateral documents (*e.g. use of Mortgage v. Deed of Trust; waiver of community property statutes/consent of spouse; waiver of homestead/farm rights; etc.*);
- State Specific Enforcement Rules;
 - E.g. California “one action” rule;
- Should have forms reviewed by local counsel



TAKE-AWAYS

1. Debt and Equity Crowdfunding are simply “private placements” conducted using general solicitation (*or some limited form thereof*).
2. You need to determine whether the offering will be conducted under a federal or a state exemption as this will determine the notice and filing requirements with respect to securities regulations.
3. Crowdfunding rules and best practices are still in flux. When documenting these transactions seek to maximize due diligence and investor protection.
4. Be wary of specific state laws which may impact collateral perfection.



Thank You

QUESTIONS??

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