

# CRAIN'S DETROIT BUSINESS

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## Crowdfunding young and complex: Here's a 4-step program to decide if it's right for your business

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CRAIN'S DETROIT BUSINESS

### Crowdfunding 101

**M**uch has been made of crowdfunding in the wake of the credit crunch created in the recession years. There have been million-dollar campaigns on **Kickstarter** and actual sale of equity through crowdfunding platforms.

Last year, for example, Rachel and Tarek Kanaan used equity crowdfunding to raise \$136,000 to expand their Ypsilanti-based business, **Unity Vibration Living Kombucha Tea LLC**. Read their story here.

Second-stage businesses hungry for capital have to wonder whether they should try their hand at this new form of fundraising, too.

But second-stage companies, those high-growth firms with revenue between \$1 million and \$50 million, shouldn't burn their bank agreements just yet. Crowdfunding is a young industry with several paths, and the legal sands it rests on are still shifting. Crain's helps you find your way through the labyrinth of information and decide when, or if, crowdfunding is right for your business.

### Step 1: Decide on rewards or equity

Crowdfunding can be split into two broad categories: rewards crowdfunding and securities crowdfunding.

Rewards crowdfunding is what most people think of when they hear about crowdfunding. These are **Kickstarter** campaigns, for example, that allow people to raise money for a business or project in exchange for "rewards." Sometimes these rewards are a T-shirt, sometimes it's an advanced copy of the product being built.

Locally, cousins Lucy Carnaghi and Molly Mitchell used **Kickstarter** last year to raise the final \$19,000 they needed to open **Rose's Fine Food** on East Jefferson Avenue. And **Avegant Corp.**, an Ann Arbor-based startup, raised \$1.5 million to produce a video headset called **Glyph**.

But donors don't own any part of the business, and there is little to no recourse for them if a company fails to send the promised rewards. **Kickstarter** is littered with failures.

What most second-stage companies should be paying attention to is securities crowdfunding, otherwise known as crowd investing.

This funding model actually allows backers to become investors in the business, not just gift givers.

The deals are far more complex and typically involve selling equity in the company or revenue-sharing deals.

The industry is so new that numbers are hard to come by, but Michael Melfi, a Birmingham-based attorney and consultant, estimates that between 15 and 50 securities crowdfunding deals have been done in Michigan. "It's definitely not 10, and it's definitely not 100," he said.

Melfi also is general counsel for Southfield-based platform **Funderbuilt**, which has gotten three companies funded under securities crowdfunding rules since its launch in July. Other crowd investing platforms active in Michigan include Indianapolis-based **Localstake LLC**; Washington, D.C.-based **Fundrise LLC**; and San Francisco-based **CircleUp**.

**Unity Vibration** used **Localstake** to wage a successful crowd investing campaign last year to build out its brewing operations and add a tasting room.

Investors who fund projects through **Localstake** agree to revenue-sharing, which is a type of loan. But instead of being paid back at set interest rates over definite time periods, investors receive a percentage of monthly revenue until they earn back their investment plus an amount beyond that, usually 1.5 times the investment.

But business owners can't just go to **Localstake.com** and plant a campaign, as they do on **Kickstarter**. Because of state and federal laws, **Localstake** must first see a business plan, financials, background checks and references before it can approve a campaign.

### Step 2: Understand the legal limitations

There are almost no legal limitations to rewards-based crowdfunding, but there are significant complexities to crowd investing.

The Securities Act of 1933 and decades of regulation behind it seek to protect investors from fraud or getting in over their heads. This is done by limiting how a security may be solicited and delineating between accredited and unaccredited buyers. (An accredited investor is defined by the **U.S. Securities and Exchange Commission** as having annual income exceeding \$200,000 or net worth greater than \$1 million.)

To offer securities, a company must register with the SEC, which requires extensive public disclosure and reporting. This is expensive and time-consuming — and far too complex for the needs of most small businesses.

But some owners saw the need for a less complex way to raise investment funds through their communities. So in 2012 the federal government attempted to make crowd investing less onerous through exemptions in the **Jumpstart Our Business Startups (JOBS) Act**.

The first exemption allows businesses to solicit as openly as they want as long as they sell only to accredited investors. The second exemption, written expressly for crowdfunding, allows nonaccredited investors to participate — with restrictions. Issuers can raise up to \$1 million in a 12-month period but have to mind how much is sold to different investor classes. For example, investors whose annual income is less than \$100,000 can only invest up to \$2,000 or 5 percent of their income, whichever is greater.

"It's not as practical because you can only raise so much money," said Richard McDonald, a securities lawyer in the Bloomfield Hills office of **Dykema Gossett PLLC**. "Most small businesses don't have the means to get audited financial statements. Would you rather have



Clark Hill attorney Daniel H. Minkus

two investors that each can put in \$200,000, or 200 that can put in \$2,000?"

Another problem is that no one can use it. The **JOBS Act** legislation instructed the SEC to come up with rules supporting the new exemptions by the end of 2012, but the SEC has not yet done that — and doesn't plan to until October at the earliest.

Because of this, industry experts say crowd investing is still too new and uncertain to be a viable alternative to more serious capital fundraising needs for businesses.

"My question is whether crowdfunding will live up to its expectations," said Douglas **Toering of Toering Law Firm PLLC** in Troy, who chairs a small-business forum for the State Bar of Michigan. "Small businesses are simultaneously excited about it but also wondering how this will play out."

### Step 3: Understand MILE

A small number of states, restless over the SEC's foot-dragging on the crowdfunding exemption, have tried to move crowd investing ahead by enacting their own laws.

At the end of 2013, Michigan enacted the Michigan Invests Locally Exemption, or **MILE**, which allows nonaccredited investors to buy crowdfunded securities.

Under **MILE**, Michigan businesses can raise up to \$1 million every 12 months from nonaccredited investors. If the issuer is willing to supply audited financial statements, it can raise up to \$2 million.

Nonaccredited individuals can invest up to \$10,000 in a given business in a year, and can do that with as many businesses as they like.

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There is no limit on the amount issuers can raise from accredited investors.

The law takes advantage of a Securities Act registration exemption for intrastate offerings. That exemption requires the issuer to be based in the state, derive at least 80 percent of its income from within the state and use at least 80 percent of the proceeds from the securities issue within the state. Buyers of securities also must be residents of the state.

Additionally, there are reporting and disclosure requirements under MILE, including quarterly reports containing financial and management compensation information that must go to purchasers and the **Michigan Department of Licensing and Regulatory Affairs**.

And the federal rules on solicitation still stand. So while MILE allows issuers to solicit to any Michigan resident, to stay in federal compliance an issuer still has to somehow keep those solicitations within state bounds. Tweeting about an upcoming equity offer would be to flirt with danger.

"The SEC has said if small businesses advertise on social media, that could be an issue for using the MILE exemption," said Dana Thompson, a **University of Michigan** law professor.

This takes some of the punch out of MILE. Its main advantage is that it allows nonaccredited investors to participate, but if getting word to them risks federal violations, that advantage is diminished.

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"It's such a gray area that a lot of attorneys just say, 'I don't know' and take a conservative approach," said Kevin Hitchen, co-founder of Localstake. "That's why you don't see a lot of businesses (using MILE). It's restrictive."

Attorney Jeff Aronoff believes the SEC guidance gives companies some wiggle room. The outgoing executive director of **D:hive** in Detroit has set up a consultancy called **Sidewalk Ventures** for businesses that want to raise money on Localstake under MILE rules.

"If you're getting into the details on social media or any internet-based solicitation, it can be problematic," he said, but it's possible to avoid stating specifics of an offering while still announcing one, and also to set up barriers against out-of-state website visitors.

But MILE is definitely better suited for small businesses that intend to stay small, he said. "The best MILE candidates are not companies with business models to grow into a \$50 million company," Aronoff said.

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#### **Step 4: Decide if crowd investing is for you**

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In the year since MILE was enacted, exactly one company has been funded under its rules. That company, Tecumseh-based **Tecumseh Brewing Co. LLC**, raised \$175,000 last spring to launch a microbrewery. Localstake was the platform that funded the deal.

The **Michigan Municipal League** has been giving presentations on crowdfunding and MILE to local groups and chambers of commerce, promoting Localstake and Fundrise in particular as economic development tools.

Summer Minnick, MML's director of policy initiatives and federal affairs, said securities crowdfunding is well-suited to established businesses because their proven revenue encourages people to invest. Restaurants are a good example, she said, because the business is familiar to the community.

Other businesses, such as larger B2B businesses — a tool and die shop, a payroll outsourcing firm, an engineering software company — can benefit, too, but have to work harder, she said.

"It's a question of how creative they can be to reach out to people in the community and people they do business with," Minnick said. "It's too early to rule things out. ... Right now (crowdfunding) might be more utilized by certain sectors, but the more common it gets and the more people understand it, the more it will open up."

"I don't want to come across as a naysayer, but I don't think it's going to reform the way businesses invest," said Daniel Minkus, a transactions attorney at **Clark Hill PLC's** Birmingham office. "A lot of people are sitting on the sidelines watching."

Small community businesses stand the best chance of benefitting from securities crowdfunding, McDonald

said. Larger businesses with bigger capital needs are going to want sophisticated investors with deeper pockets to make it worth their while.

"For smaller companies raising a couple hundred thousand dollars or opening a doughnut store, and maybe some smaller kinds of manufacturing, it has potential but it's still not the first choice," he said.

"It's gotten a lot of press and it's popular politically, but the reality is that it's quite limited in its use."

Heads of crowdfunding companies also say the time has yet to come for larger, established businesses. These firms typically are looking for amounts between \$1 million and \$20 million, and the largest amount raised on Funderbuilt thus far is \$480,000.

"Companies seeking over \$1 million should seek more traditional funding outlets," Melfi said.

Crowdfunding also is not an ideal setup for high-tech startups of the sort spawned by university research and end up backed by venture capital firms, Thompson said. She represents UM student startups and has worked with mom-and-pop businesses in the past. Crowdfunding is more attractive for the latter than the former — traditional businesses that can't get a traditional loan, not companies hoping for rapid growth, she said.

"If a company is interested in venture funding, then crowdfunding can be problematic because they'll have so many investors in the company they'll have to track

## **CROWDFUNDING DEFINED**

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**Rewards crowdfunding:** Online fundraising campaigns such as Kickstarter that allow supporters to give monetary "gifts" in exchange for a "reward." Supporters of an independent movie production might get listed as producers in the film credits, for example, in exchange for donating to the campaign.

**Investment crowdfunding:** Online fundraising campaigns in which investors purchase securities, such as shares of ownership and debt. This allows individuals to be investors or owners in the company, not just donors. There is strict legal oversight on these campaigns in terms of who can and cannot invest. Related terms include equity crowdfunding, securities crowdfunding, crowd lending and crowd investing.

down," Thompson said.

The legal burden to informing all those investors scares off VC money. "I've talked to some venture capital firms that have expressed concern with crowdfunding," she said.

These types of companies also would have a hard time generating interest from the general public. "If it's a complex, life sciences company working on a cancer drug, most people won't be able to understand what they're doing," Hitchen said.

As it stands, securities crowdfunding right now means tapping into the same "crowd" that's always been available for raising private capital — accredited investors — not the general public.

"It's a misnomer. It's completely incorrect," Dan Miller, president of Fundrise, said of the term "crowdfunding," in that it implies anyone can buy private securities online.

That, however, may be the reason capital-seeking businesses should at least keep an eye on securities crowdfunding. As the industry develops, its usefulness could prove to be in creating an efficient way of reaching accredited investors, instead of relying on lawyers and bankers.

Securities crowdfunding still has three to five years to go before it develops the track record needed to bring institutional investors to the table, Miller said.

But as it does, it will serve to "tighten the supply chain of capital" and begin serving up the \$3 million-\$10 million transactions that mid-market businesses need — "transactions that are too big for local banks but too small for Wall Street," he said.

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