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The Legal Aspects of Crowdfunding and U.S. Law

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CHAPTER 10

The Legal Aspects of Crowdfunding and U.S. Law

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Like all financings (and other forms of business transactions, for that matter), crowdfunding has a legal context that constrains and otherwise shapes behavior. The legal aspects of crowdfunding can be quite complex, especially when crowdfunding is used to offer and sell financial instruments that are considered securities under U.S. federal or state law. All forms of crowdfunding, however, involve interactions with various laws—both statutory (enacted by legislatures) and decisional (adopted by judges). This chapter outlines the key areas of U.S. law that engage with crowdfunding in the for-profit context. (Funding not-for-profit businesses and projects engages a wholly different set of laws and regulations, as mentioned briefly below.) The topics addressed at length in this chapter are among the most important, fundamental issues involving crowdfunding and U.S. law. The chapter concludes, however, with a brief mention of other significant U.S. laws that interrelate or may interrelate with crowdfunding. For purposes of this chapter, state law does not generally include the law of U.S. territories and possessions, even those that have their own bodies of law governed under the U.S. federal system. Those needing guidance on the laws in those jurisdictions should seek separate guidance.

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Crowdfunding, as a method for soliciting financial backing for businesses and projects from a broad base of potential funders through the Internet, typically employs or is attentive to the laws associated with finance: federal and state (blue sky) securities regulation, the state laws governing business associations, and state contract law. These laws together address the types of financing that may be available for a particular venture and the appropriate documentation for that specific type of financing. An entity or individual must be legally authorized to engage in a specific type of crowdfunding. This involves determining whether the entity or individual can make and keep the promises he, she, or it desires to make to funders and whether the specific type of financing is authorized for use under the circumstances. Crowdfunding is merely one type of financing that may be used under these laws.

It is important, then, to understand a bit about each of these three important areas of finance law as they relate to crowdfunding. Accordingly, the three principal parts of this chapter describe securities regulation, business associations law, and contract law and relate each to crowdfunding. Securities regulation is the most important and detailed area covered, given its many, significant interactions with crowdfunding.

Crowdfunding and Securities Regulation

The nature of securities regulation dictates its effects on financing transactions and those who participate in them. Securities regulation promotes a few key policy objectives using three principal regulatory tools. Understanding these policy objectives and tools enables lawyers to assess the actual and prospective application of securities laws and rules to crowdfunded offerings.

The Nature of Securities Regulation

Securities regulation helps ensure that ventures can raise investment capital to support their operations. Laws and rules at the federal and state levels that protect both investors in those ventures and the integrity of the markets in which the financial commitments of those investors are sought and made support this goal of promoting capital formation. At the federal level, the U.S. Congress has used its constitutional power to regulate interstate commerce to charge the Securities and Exchange Commission (SEC), an independent agency consisting of a five-person commission supported by staff members organized into five divisions, with the difficult role of ensuring that investors are protected and securities markets remain honest, open, and healthy.

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State securities administrators, who voluntarily associate across the continent in the North American Securities Administrators Association (NASAA), serve the same role with respect to transactions involving certain investors and markets, including some not regulated by the SEC.

Enforcement of antifraud provisions through litigation makes more headlines, but the principal method that the SEC and state securities commissions use to protect investors in securities markets is mandatory disclosure: the required revelation of specific, designated information and of all additional important facts needed to make that specific, designated information not misleading. Mandatory disclosure is consistent with the semistrong version of the efficient capital markets hypothesis, an economic theory holding that publicly available information is embedded in the market value of actively traded securities. Mandatory disclosures are triggered by various kinds of transactions and events, including (for public companies) the registration of a class of securities, the solicitation of proxies, the making of a tender or exchange offer, the engagement in a going-private transaction, and the completion of regular financial reporting periods. Statements (including registration statements and proxy statements) and reports (including annual and quarterly reports) that are filed with the SEC (and, in some cases, state securities administrators) include the required information. The documents filed with the SEC, publicly available through the SEC's web site, are designed to give investors the information they need to make ownership (buy, sell, loan, exchange, gift, pledge, etc.) and, if and when applicable, voting decisions. In addition, they standardize the informational foundation of securities markets.

Securities regulation at the federal and state levels also protects investors in and markets for securities through the enforcement of antifraud and other related liability provisions. These provisions prohibit misstatements and misleading omissions of material fact in public communications, especially when they manipulate the market price of securities or deceive investors. Liability may be enforced in proceedings (civil or criminal) brought by public officials or through litigation brought by private parties (typically disgruntled investors). The SEC and state securities commissions have authority to bring public civil enforcement proceedings, and the U.S. attorney's office and state prosecutors are authorized to bring criminal proceedings.

Sometimes—and this part of securities regulation is a growth industry—securities regulation provides specific substantive rules that govern, for example, the terms of transactions involving securities, the way in which various financing activities are conducted, and the entities and individuals who (1) issue, hold, or transact in securities or (2) are intermediaries in connection with securities transactions. This regulatory tool is a more central one; it

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essentially defines the conduct of people and entities, telling them what to do, how to do it, and who can or cannot participate in doing it. In other words, substantive regulation may have the effect of proscribing or limiting certain types of transactions; guiding or determining the process through which a desired transaction may be accomplished; or encouraging, allowing, or prohibiting the participation of various individuals or entities in the transaction.

Each of these regulatory tools is used in a different way to keep investors and markets safe and, in doing so, contribute to the integrity of markets for capital. Currently, securities regulation is national, not international. Given that market transactions now cross borders on a regular basis (including in crowdfunding), the need for international coordination of processes and enforcement efforts has become more and more important. This topic is addressed in another chapter of this book.

Crowdfunding and Crowdfund Investing

The entities and individuals using crowdfunding to finance their businesses or projects may receive funding under various terms and conditions. Some ventures may solicit donations, some may solicit no-interest loans, some may promise rewards in the form of products or services or other nonpecuniary premiums, some may promise a share in the venture's profits or revenues as interest on a loan or as a form of current return on an investment interest of another kind. Crowdfunding can be used to do all of these things, but securities regulation applies only to certain financing models. Because the rules of securities regulation are complex and because a violation of them can have serious consequences for the ventures seeking funding, their principals, and those who assist them in their crowdfunding efforts, it is important to understand which types of crowdfunding constitute "investment crowdfunding" or "crowdfund investing" (also sometimes called "securities crowdfunding")—crowdfunded offerings of securities.

Types of Crowdfunding

As detailed in other chapters of this book, crowdfunding models have been labeled and characterized in various ways. However, one commonly accepted taxonomy separates crowdfunding into donation, reward, and investment crowdfunding. Crowdfunded financings in which a venture solicits contributions in the form of donations (gifts) are often referred to as donation crowdfunding. Reward crowdfunding typically describes crowdfunded financings in which funders are offered a product or service or nonpecuniary

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premium of some kind in return for providing funding. Crowdfunded offerings in which funders are offered pecuniary gain in the form of interest on debt, profit sharing (including in the form of dividends), or revenue sharing typically are described as investment crowdfunding, crowdfund investing, or securities crowdfunding. The debt, equity, and other instruments that embody these financial rights generally are known as securities. Crowdfund investing involves a crowdfunded offering of securities.

Crowdfunded Securities

Both federal and state securities laws define the concept of a security. Under these definitions, notes and other evidence of indebtedness issued to fund the operations of business associations typically are securities. Similarly, stock in a typical for-profit corporation, membership interests in a limited liability company, and limited partnership interests usually are securities. Finally, under federal law principles, "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 a promoter or a third party,"[1] known as an investment contract, commonly is classified as a security. Some state securities laws also use this definition of an investment contract (known as the *Howey* test); but others use other, similar definitions. In many cases, state law definitions of an investment contract, as construed by state courts, are easier to satisfy than the federal *Howey* test. Accordingly, it may be easier for certain funding interests to be classified as securities under state laws than under federal law.

When interests in businesses or projects are securities and are offered and sold through crowdfunding, securities laws and rules apply to the offering unless those laws or rules provide for pertinent exemptions. Exemptions ordinarily exist only where the application of securities regulation is not necessary to serve securities regulation's core underlying investor and market protection policy objectives. Before the president signed the Jumpstart Our Business Startups (JOBS) Act[2] into law in the spring of 2012, few (if any) exemptions were available for the activities conducted in an archetypal crowdfunded offering of securities. Even after that time, the delay in issuing and finalizing required enabling regulations to effectuate investment crowdfunding under Title III of the JOBS Act—known as the Capital Raising Online While

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

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 315 (2012) (codified in scattered sections of 15 U.S.C.).

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Deterring Fraud and Unethical Non-Disclosure Act (or the CROWDFUND Act, for short)—prevented most businesses and projects from engaging in investment crowdfunding. As a result, few crowdfunded securities offerings had been legally conducted when work on this chapter was completed.

Securities Regulation Implications

Securities regulation applies to crowdfunding in a number of ways. For example, the offer and sale of securities in a crowdfunded offering is a regulated activity. In addition, in promoting crowdfund investing, crowdfunding web sites may be subject to regulation in a number of ways. Finally, investment crowdfunding's capacity to generate significant numbers of equity security holders creates the possibility that a crowdfunded offering may require an entity to register a class of securities and become a "public company." Public companies have significant transactional and periodic reporting requirements that effectuate the SEC's mandatory disclosure regime. In each of these contexts, misstatements of, and omissions to state, material fact may generate claims of securities fraud.

Registration of the Offer and Sale of Securities

Under the Securities Act of 1933, as amended (1933 Act),[3] an offer or sale of securities must be registered absent an available exemption. The registration process involves drafting and filing a registration statement—the key mandatory disclosure document in connection with the securities offering—with the SEC. The process is complex and rigorous and therefore expensive. Detailed information about the issuer's operations, management, financial condition, results of operations, and the terms of the offering must be disclosed in the registration statement. Issuers of securities filing registration statements must obtain audited financial statements, which require a thorough review of management's bookkeeping and accounting.

Attention to detail is required in preparing the registration statement because the issuer is strictly liable for any misstatements of material fact and for any misleading omissions to state material fact in the registration statement at the time the registration statement becomes effective. Other offering participants also may be liable for these misstatements and omissions if they cannot satisfy due diligence defenses available under applicable law. Moreover, those who recklessly or willfully manipulate the market for

3. 15 U.S.C. §77a et seq. (2006). Available at www.sec.gov/about/laws/sa33.pdf.

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securities or deceive investors in connection with the offer or sale of a security, including by misstating a material fact or by omitting to state a material fact also subject themselves to potential liability.

The onerous and costly nature of the mandatory disclosure requirements in the registration statement and the threat of liability for misstatements and omissions have the potential to discourage legitimate issuers from engaging in desired public offerings of securities. Unless an available exemption can be found, those issuers of securities either use other financing methods or forego financing their businesses or projects altogether. The standard, pre-JOBS Act exemptions did not fit investment crowdfunding well. They either require an essentially private offering (made to investors who had information or access to information and the perceived ability to understand that information) or prohibited general solicitations and advertising (restricting offers to those who had preexisting connections with the issuer). Ventures desiring to raise funds through investment crowdfunding before full implementation of the CROWDFUND Act typically found compliance with the registration requirements too expensive and time consuming and were unable to avail themselves of any applicable exemptions from registration. Accordingly, the strictures of federal securities regulation forced these ventures to raise capital through other forms of financing, including donation and reward crowdfunding, traditional private placements of securities, and bank loans.

State securities laws have a parallel system of registration in connection with securities offerings. Despite significant progress made by the NASAA and others in standardizing approaches to state registrations of securities offerings, the registration requirements and reviews are not uniform from state to state. In certain cases, federal law preempts state securities regulation, obviating the need for a state law analysis. But in other cases, transaction planners must separately engage an assessment of applicable state securities laws. Specialized (and sometimes local) legal counsel is needed for this analysis, since the securities laws and rules in each state are different.

Depending on the type of offering, some states require that offerings undergo "merit review," which is a type of substantive regulation that involves assessing the quality and fairness of an offering. Merit reviews can be conducted at many different levels of intensity. (Although the SEC does review registration statements, it does not provide a merit review of those filings.) A coordinated review of equity registrations, in which multiple states agree to use the same, expedited review process, is available for some offerings in certain states. State securities laws also include exemptions from registration for certain offerings, some but not all of which are coordinated with federal exemptions. Very few of these state-based exemptions are friendly to

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crowdfund investing (although recent exemptions adopted in Georgia and Kansas attempt to be friendlier to Internet investment solicitations by in-state businesses of in-state residents). The overall effects of state securities regulation on investment crowdfunding prior to full implementation of the CROWDFUND Act have been similar to those created by federal securities regulation—forcing law-abiding promoters of businesses and projects to seek funds through other financing methods or not at all.

Legal Status of Crowdfunding Intermediaries

Federal and state securities laws also regulate those other than issuers and investors who participate in the offer or sale of securities. Again, the key policy objectives underlying this part of securities regulation are the encouragement of capital formation through investor protection and the maintenance of honest, fair capital markets. These policy underpinnings are supported by various different kinds of regulatory provisions, depending on the activities conducted by the intermediary. The emphasis in this area of securities regulation is less on mandatory disclosure and fraud prevention (although those rules still exist and are important) and more on substantive regulation. Intermediaries handling financial assets may have to comply with certain capital requirements, for example. Similarly, securities intermediaries may be required to keep certain types of records. And intermediaries that have a financial interest in the outcome of a transaction may be endowed with fiduciary duties of loyalty designed to curtail self-interest. The SEC may directly control and monitor the activities of intermediaries such as stock exchanges and brokers that have systemic roles integrated into the very fabric of securities regulation.

In a typical crowdfunding transaction, the key intermediary is the operator of the web site through which the crowdfunding is conducted. Initially, operators of these web sites solicit businesses and projects to raise funds through campaigns hosted on their sites. The activities of these crowdfunding web sites were not conducted under the auspices of any specialized legal regime. However, the common law of agency and other laws of general application applied to crowdfunding web site operations. Crowdfunding web sites promoting businesses and projects that engage in investment crowdfunding, however, are potentially subject to federal and state securities regulation, absent an applicable exemption.

Under federal and state securities laws as they existed prior to full implementation of the CROWDFUND Act, the regulatory status of investment crowdfunding web sites was unclear. Different operators of crowdfunding

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web sites performed distinctive functions for those seeking funding, among them vetting potential businesses and projects for inclusion on the site; promoting the selected businesses and projects to potential funders; advising the potential funders and principal promoters of the businesses and projects about soliciting and making financial commitments; providing a forum for facilitating the funding process; and administering and facilitating the ongoing relationship between the funders and the principals behind the business or project. These roles are similar to those played by more established intermediaries in various types of securities transactions: public offering underwriters, debt indenture trustees, brokers, investment advisers, and even stock exchanges. Each of these traditional intermediaries is separately regulated in specific, different ways under time-honored aspects of securities regulation. The activities typically conducted by crowdfunding web sites blur these lines. If crowdfunding web sites participate in investment crowdfunding, which area of regulation would and should apply to them? This became a mystery for the CROWDFUND Act to solve in relaxing restrictions on crowdfund investing.

Registration as a Public Company

The Securities Exchange Act of 1934, as amended (1934 Act),[4] imposes registration obligations and significant, ongoing mandatory disclosure requirements (including annual and quarterly reporting and the dissemination of information in connection with voting, tender and exchange offers, and going-private transactions) on securities issuers that either (1) desire to have a class of their securities listed on and traded over a national securities exchange or (2) meet specified asset and equity holder thresholds. The 1934 Act also imposes reporting obligations on the management and, in some cases, key equity holders of these issuers. Colloquially, we refer to securities issuers required to register a class of securities under the 1934 Act and meet these mandatory disclosure obligations as "public companies." In the years preceding enactment of the JOBS Act, media reports highlighted the risk that a business entity meeting the asset threshold (greater than $10 million in total assets) with a significant equity investor base and commitments to issue shares under, for example, employee benefit plans, could inadvertently trigger public company status by crossing the equity shareholder threshold provided in the 1934 Act (that threshold was 500 persons). The highly publicized

4. 15 U.S.C. §78a et seq. (2006). Available at www.sec.gov/about/laws/sea34.pdf.

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example of this type of venture is Facebook, Inc., which before its initial public offering in 2012 had concerns in this regard.[5]

The equity-holder threshold, like other elements of securities regulation, is intended to encourage capital investment by protecting investors and promoting the integrity of securities markets. The threshold seeks to achieve its aims by requiring that business entities with the potential for a large and active secondary private trading market in their shares comply with the same mandatory disclosure rules with which entities with exchange-traded securities must comply. In other words, the 500-person rule was designed to ensure that investors acquiring securities in large, impersonal trading markets—whether public or private—have access to all or substantially all of the same information in making an investment decision.

In its most classical form, crowdfunding involves seeking and securing financial backing in incremental amounts from a large number of funders. The possibility of a 1933 Act registration exemption for investment crowdfunding raised concerns among a number of legal commentators that a more significant number of securities issuers would be required to register their stock under, and comply with the periodic and transactional reporting requirements of, the 1934 Act. The weight of this ongoing form of regulation, both in terms of the human and financial resources it requires in drafting and filing the required statements and reports, was enough to stop many potential investment crowdfunding proponents in their tracks.

The JOBS Act and Its Consequences

The U.S. Congress determined to step into the void and address roadblocks to crowdfund investing. As described in other chapters of this book, the JOBS Act, through the CROWDFUND Act (embedded as Title III of the JOBS Act—an act within an act), exempts certain investment crowdfunding from the registration requirements of the 1933 Act and calls for the SEC to promulgate rules to effectuate its CROWDFUND Act provisions. Congress also began to clarify the roles and obligations of two types of crowdfunding intermediaries with different operating and regulatory attributes. The SEC is charged with finishing that task. Finally, in a separate part of the JOBS Act that coordinates with the CROWDFUND Act, Congress addressed the potential issues and costs created by crowdfunding under the

5. See, e.g., Steven M. Davidoff, "Facebook and the 500-Person Threshold." *New York Times*, January 3, 2011. Available at http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/?_r=0.

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500-person rule defining public-company status. Essentially, the JOBS Act provides for and facilitates the general solicitation of securities investors from, and the general advertising of securities offerings to, the broad-based public "crowd" on prescribed terms and under specified conditions.

Specifically, the CROWDFUND Act provides an exemption from 1933 Act registration for offers and sales of not more than $1 million of securities in a 12-month period, as long as no more than a specified aggregate amount of securities is sold to any individual investor under the exemption *by all issuers* in a 12-month period (based on the annual income or net worth of the investor, but not to exceed $100,000 in any case). Offerings under the exemption must be made through one of two regulated intermediaries—either a registered broker (as defined in and preexisting under the 1934 Act) or a funding portal (a new form of registered intermediary created under the CROWDFUND Act). The activities of issuers and intermediaries are further described in more detailed provisions of the CROWDFUND Act.

The rules for issuers (which must be organized under U.S. state or federal law and may not be public companies or regulated investment companies) under the CROWDFUND Act are both wide ranging and unfinished. For example, in its efforts to protect investors and maintain market integrity, the CROWDFUND Act requires issuers to make certain mandatory disclosures to the SEC and investors about itself, its capital structure, and the offering (which must include, for issuers offering more than $500,000 in securities under the exemption in a 12-month period, audited financial statements), limit direct and indirect advertising and promotional activities, and provide to the SEC and investors an annual report on results of operations and financial statements. The CROWDFUND Act also creates new misstatements and omissions liability exposure for issuers, their principal executive officers, their principal financial officers, their controllers or principal accounting officers, and members of their managing bodies (e.g., directors, in the corporate context). These individual provisions, as well as the whole of the law, are qualified by reference to enabling SEC rules, however, making the provisions incomplete and potentially, in some cases, illusory.

Crowdfunding intermediaries, both brokers and funding portals, also are regulated under the CROWDFUND Act. All crowdfunding intermediaries must be registered with the SEC and the Financial Industry Regulatory Authority (FINRA). They also are responsible for making certain disclosures, engaging in investor protection (educational and fraud reduction) activities, providing a watchdog function with respect to the issuers' use of offering proceeds and the investors' compliance with the investment limitations, and ensuring the privacy of investor information. In addition, crowdfunding

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intermediaries are prohibited from compensating "promoters, finders, or lead generators for providing . . . the personal identifying information of any potential investor," and their management may not have any financial interest in any issuer using their services. Funding portals are subject to further restrictions. Specifically, a funding portal cannot "offer investment advice or recommendations; . . . solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; . . . compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; . . . [or] hold, manage, possess, or otherwise handle investor funds or securities." Again, the SEC is responsible for further tailoring and adding to these rules applicable to crowdfunding intermediaries.

The JOBS Act also facilitates investment crowdfunding by making it a lot harder for securities issuers to trigger the registration and related reporting requirements under the 1934 Act. While the $10 million total asset threshold remains the same, the 500-person rule was amended in Title V of the JOBS Act. Now, an issuer having total assets exceeding $10 million is required to register under the 1934 Act if it has a class of equity securities held of record by 2,000 persons, as long as no more than 500 persons are not accredited investors (a term that includes perceived high-net-worth individuals, financial institutions, and entities as well as the issuer's directors, executive officers, or partners, as applicable). Securities offered and sold in crowdfunded offerings exempt under the CROWDFUND Act are not counted at all for purposes of this threshold. The protections provided by the former 500-person rule were deemed nonessential in the context of CROWDFUND Act offerings because of the other statutory safeguards (i.e., mandatory disclosure, liability, and substantive regulatory provisions—including the mandatory involvement of registered brokers or funding portals) provided for these offerings.

What role does state securities regulation end up playing in crowdfund investing after the JOBS Act? The CROWDFUND Act expressly provides that certain state administrative and enforcement powers (such as notice filings) are preserved, but it also expressly prohibits states from separately requiring registration or qualification of offerings qualifying for the CROWDFUND Act exemption and from regulating funding portals in a manner inconsistent with the federal regulatory scheme. Accordingly, for most purposes, the CROWDFUND Act preempts state regulation of crowdfund investing.

States have, however, begun to address crowdfunding on their own. A few states have either passed legislation or regulations enabling crowd-based intrastate offerings of securities or are entertaining legislative or regulatory exemptions designed to permit these kinds of offerings within

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their borders.[6] Ultimately, these initiatives do not fulfill the broader mission of crowdfunding proponents: to reach out to a relatively large and fluid crowd—one that surely crosses state borders. However, financing local small businesses and projects may well be the most realistic, near-term, practical application of crowdfunding in any case.

Crowdfunding Interests in Business Associations

A business may be conducted and a project may be developed and completed by an individual acting alone or through contractual relationships with third parties that supply goods and services to the individual for that purpose. The law labels this way of doing business a sole proprietorship. The laws governing sole proprietorships are the laws governing the activities of individuals and businesses more generally. There is no specialized statute governing the rights and responsibilities of a sole proprietor.

In the alternative, business ventures may conduct their operations through a statutory business entity—a legally recognized business form created by legislative action. In most cases, state law ordains these forms of business association. The most common forms of business entity include partnerships, limited liability partnerships, limited partnerships, limited liability companies, and corporations. In general, the state law rules governing these forms of entity determine the rights and responsibilities of the participants in the venture. They also define the types and nature of investment interests that may be offered or sold.

All business owners face important decisions about whether to conduct their operations through a form of business entity or as a sole proprietor. The principals behind a venture that desires to raise funds through crowdfunding optimally should factor that desired method of financing into their decision making on whether to form a business entity through which they can operate their business. This part of the chapter focuses on these ventures. Although all

6. See, e.g., Ga. Comp. R. & Regs. R. 590-4-2-.08 (2012); Kan. Admin. Regs. § 81-5-21 (2013). See also Patrick Clark, "Kansas and Georgia Beat the SEC on Crowdfunding Rules. Now Others Are Trying." *Bloomberg Businessweek*, June 20, 2013. Available at www.businessweek.com/articles/2013-06-20/kansas-and-georgia-beat-the-sec-on-crowdfunding-rules-dot-now-others-are-trying; David Drake, "One State Is Leading in Investment Crowdfunding: Guess Which One." *Forbes*, May 2, 2013. Available at www.forbes.com/sites/groupthink/2013/05/02/one-state-is-leading-in-investment-crowdfunding-guess-which-one/; Kevin Lawton, "State Crowdfunding & State Banks Will Moot the JOBS Act." *VentureBeat*, June 21, 2013. Available at http://venturebeat.com/2013/06/21/state-crowdfunding-state-banks-will-moot-the-jobs-act/.

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business entities can borrow funds and issue short-term and long-term profit-sharing interests, each form of business entity offers different options for these and other securities that may be issued for capital-raising. This part of the chapter briefly describes the nature of business associations law, compares and contrasts the basic forms of business entity, and highlights a few ways in which choice of entity may be significant in the crowdfunding context.

The Nature of Business Associations Law

Business associations law provides venturers with a standardized set of rules designed to effectuate their reasonable expectations in forming and operating a business. Different venturers may have different anticipated roles. Some may desire to be owners—equity holders—venturers with both financial and governance (voting, consent, or other management) rights. Others may desire to be managers, and among those managers, some may want to manage the day-to-day business operations, and others may only want a say in more fundamental, higher-order business matters.

Business associations law exists to facilitate the formation of business entities. Since the law provides the standardized rules that govern the roles and relationships of the venturers, the venturers do not have to incur costs to formulate and negotiate these rules on their own. In many cases, the rules represent what venturers typically would devise and adopt in the absence of entity law statutes. Where the off-the-rack entity law rules do not work well for specific venturers, venturers can, in most cases, modify those default rules to better suit their needs. These modifications, however, require affirmative action on the part of the venturers and generate transaction costs.

Principal Forms of Business Entity

Business lawyers routinely advise business founders and promoters about the appropriate legal business forms for their ventures. To do this, they often rely on one or more of five key attributes of business entities that help distinguish among them: the costs of forming and maintaining business associations (which, while not significant in absolute dollar terms, can make a difference for new businesses); owner and manager liability to those outside the firm for the firm's obligations; overall governance structure (the roles, rights, and responsibilities of participant venturers); the type of permitted equity and other investment interests; and federal income tax status (firm and owners). State law governs all of these attributes except the last, which is governed by federal tax law. Table 10.1 summarizes these five attributes for each

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TABLE 10.1 Comparative Attributes of Business Entities

	Partnership	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	Corporation
Costs of Organization & Maintenance	Drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating operating agreement	Filing expenses and fees (initial and annual); drafting and negotiating bylaws and shareholder agreement(s)
Governance Structure	Partners are both owners and managers	Partners are both owners and managers	General partners are both owners and managers; limited partners are owners with limited management rights and responsibilities	In member-managed LLCs, members are both owners and managers; in manager-managed LLCs, members are owners and managers manage	Shareholders are owners; officers are day-to-day managers; at the highest level, the corporation is managed by or under the direction of a board of directors
Owner/Manager Liability to Third Parties	Partners are jointly and severally personally liable for the obligations of the partnership	Partners generally have no liability for partnership obligations	General partners are jointly and severally personally liable for the obligations of the LP limited partners generally have no liability for LP obligations	Absent veil-piercing, members and, as applicable, nonmember managers generally have no liability for LLC obligations	Absent veil-piercing, shareholders, officers, and directors generally have no liability for corporate obligations

(*Continued*)

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TABLE 10.1 (*Continued*)

	Partnership	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	Corporation
Equity Interest	Partnership interest, share, or unit	Partnership interest, share, or unit	General partnership interest, share, or unit; limited partnership interest, share, or unit	Membership interest, share, or unit; multiple classes (voting, nonvoting; common, preferred) typically permitted	Stock; multiple classes (voting, nonvoting; common, preferred) typically permitted
Federal Income Taxation	Partnership is not taxed (pass-through entity); partners pay taxes on partnership income, whether or not distributed to them; can be modified by "checking the box"	LLP is not taxed (pass-through entity); partners pay taxes on LLP income, whether or not distributed to them; can be modified by "checking the box"	LP is not taxed (pass-through entity); partners pay taxes on LP income, whether or not distributed to them; can be modified by "checking the box"	LLC is not taxed (pass-through entity); members pay taxes on LLC income, whether or not distributed to them; can be modified by "checking the box"	*For C corporations*: corporation pays taxes on its income; shareholders pay taxes on income distributed to them *For S corporations*: corporation is not taxed (pass-through entity); shareholders pay taxes on corporate income, whether or not distributed to them; can be modified by notice to the Internal Revenue Service after shareholder vote

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of the principal forms of for-profit business association. These summaries are general and nonspecific, created without reference to any single or selected laws. Rather, they are intended to illustrate basic similarities and differences among the different entity forms.

These entity characteristics are the most central, but not the only, factors useful in distinguishing among possible legal structures for a business.

A more detailed summary of key information about each principal form of for-profit business entity follows. The summaries provided, like those in Table 10.1, are generic in nature, highlighting common elements of the various forms among the different state statutes. Accordingly, these summaries and those in the chart should not be relied upon in making choice-of-entity decisions for a particular business. In advising clients about their choice of entity, lawyers would, of course, rely on the actual applicable statutes in the state in which the entity is to be formed.

Remember also that the summaries provided in this part of the chapter are summaries of the default rules in state entity law statutes (i.e., rules that apply in the absence of a contrary agreement of the parties). As noted earlier, most of these rules can be—and in many cases are—varied by agreements between the venturers in the individual businesses. In key cases, these abilities to vary the rules are noted in the summaries provided.

Partnerships

A partnership (often referred to in common parlance as a general partnership) exists when two or more individuals or entities associate to conduct a business for profit. No filings or filing fees (what lawyers call "formalities") are required to form a partnership. Accordingly, venturers may not know that they have created a partnership.

A written partnership agreement typically is not required. The association of partners in a partnership may be governed by an oral agreement. The drafting and negotiation of a written partnership agreement adds cost to the formation of the partnership. Because the terms and provision of the partnership agreement have both entity and tax law consequences, legal counsel typically is sought in the purposeful formation of a partnership. This also adds to formation expenses.

In most states, an agreement between or among venturers to share profits creates a presumption that the venturers are partners. As a result, if a sole proprietor offers an investor a share of profits from a product or service, the law may view that investor as a partner. Although the presumption of partnership is rebuttable by evidence to the contrary, the sole proprietor or investor may

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be required to incur significant expenses to successfully rebut the presumption in court as needed or desired.

The co-owners of a partnership are partners. Each partner owns and manages the business of the partnership and is an agent of the partnership for the purpose of conducting its business. Issues in the ordinary course of business of the partnership typically may be determined by a majority of the partners; extraordinary matters generally require unanimous consent. Partners are obligated to act in good faith and in a manner consistent with fair dealing. They owe fiduciary duties of care and loyalty to the partnership and their fellow partners.

Under partnership law, partners in a partnership are together (jointly) and individually (severally) personally liable for the debts and other obligations of the partnership. This is perhaps what partnerships are most well known for among those who think about choice-of-entity issues. It is also what they are most often avoided for, since business owners and operators rarely desire to take on obligations they did not create for themselves. What this means is that each partner in a partnership is obligated to pay or otherwise satisfy, himself, herself, or itself, individually, up to and including all of the obligations of the business, whether generated through contracts or resulting from harms caused by the business to individuals, other businesses, or property (known in the law generally as torts, unless the activity is criminal). For example, these obligations may include damages awarded by a court in a legal action for the partnership's breach of a contract or the commission of a tort by another partner in the ordinary course of the partnership's business.

Partnership law provides that partners must contribute their *pro rata* share of any partnership obligation covered by a fellow partner, and partnership agreements may reallocate liabilities among the partners. But these legal and contractual provisions merely adjust obligations among the partners themselves. Unless otherwise agreed in a valid, binding, and enforceable contract, a third party still has the right to satisfy his, her, or its entire claim against any one partner. That partner then must seek contribution from another partner or partners under law or the partnership agreement.

The bundle of financial and management rights in a partnership typically is referred to as a partnership interest, share, or unit. By default, each partner is entitled to an equal share of partnership profits and is charged with a share of the partnerships losses equal to the partner's share of profits, and each partner has coequal management rights in the partnership. This equality exists regardless of the input of each partner to the partnership. In other words, under these default rules, partners who contribute more money or more time and effort do not get more of the profits or a larger say in management. That

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is why these default rights often are altered in a partnership agreement signed by all partners.

Partnership interests, units, or shares typically are viewed under securities law as investment contracts. Under the *Howey* test, for example, they generally are presumed not to be securities because the profit-sharing interest is not generated from the efforts of others (since partners are managers of the partnership). Remember that the *Howey* test determines whether financial instruments other than, for example, debt and stock—labeled under the law as investment contracts—are securities. An investment contract, under this judge-made test, is "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 a promoter or a third party." However, the presumption that partnership interests are not securities may be rebutted by evidence of the actual rights and responsibilities of partners as dictated by the partnership agreement and actual partnership activities.

Partnerships are not taxed on their income under federal income tax laws; they are referred to as "pass-through entities." Instead, their owners—the partners—are taxed on the partnership's income. Partners incur this tax obligation regardless of whether any of the partnership's profits have been distributed to them, and partners are not entitled to receive salaries or other distributions from the partnership. As a result, partnership agreements often provide for distributions to cover federal income tax and other routine partner liabilities. Federal tax law requires the partnership to report its income and the partners to report their individual allocable shares of that income so that the taxation requirements can be enforced. Partnerships may change their default status under federal income tax rules by filing a form with the U.S. Internal Revenue Service in which the partnership elects to be taxed as a corporation.

Under federal income tax rules, a partnership electing to be taxed as a corporation is taxed on its income, and partners are taxed only on the income actually distributed to them. Accordingly, if the partnership's income is distributed to partners, there are two separate income taxes paid on those same dollars: one at the entity (partnership) level and one at the owner (partner) level. As a result, this form of income taxation commonly is referred to (usually pejoratively) as "double taxation."

Limited Liability Partnerships

The exact same law that governs partnerships governs limited liability partnerships (LLPs). The overall governance structure, equity interests, and federal

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income taxation rules are the same. The big difference? Partners in an LLP, unlike partners in a partnership not organized as an LLP, are not liable for some or all of the obligations of the partnership. Note that partners continue to be liable for the contracts they sign that are not contracts of the partnership and any torts they commit (harms created by them to individuals, entities, or property), although the partnership also may be liable for some of these obligations. In other words, by forming an LLP, partners do not get out of their own personal liability. They merely do not take on liability for some or all of the obligations of the partnership. Lawyers call this form of liability for owners and managers "limited liability," since it limits the liability of a venturer—owner or manager—primarily or exclusively to funds already invested in the firm and liability for the acts the venturer commits.

Organizing as an LLP requires compliance with formalities: a filing (often called a statement of qualification) with, and the payment of an attendant fee to, the secretary of state of the state in which the venturers want to organize their LLP. Annual maintenance filings and fees also are required. Although these filings are relatively simple, the preparation costs and filing fees add cost to the organizational process that is not present in organizing a venture using the partnership form. (The cost of drafting and negotiating a written partnership agreement is common, however, to both partnerships and LLPs.) These formation and maintenance fees may exceed the fees charged for other forms of entity in certain states.

Finally, in some jurisdictions, LLPs are restricted from making distributions to partners unless certain financial tests are met. The purpose of this type of rule is to ensure that a small equity cushion is available for creditors that desire to bring actions against the LLP. This idea comes from corporate law where a similar rule often exists. The rule may operate to prevent the LLP from making distributions to partners to cover, for example, their federal income tax obligations.

Limited Partnerships

Limited partnerships (LPs) are organized under a different statutory framework than partnerships and LLPs. In many states, however, limited partnership law cross-references or incorporates partnership law for key concepts. Formalities—a filing (typically called a certificate of limited partnership) with, and the payment of an associated fee to, the secretary of state in the state of organization—are required to organize an LP. Annual maintenance filings and fees also are required to maintain an LP. This, and the expense of creating the required filings, adds cost to the formation and maintenance

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of an LP as it does for LLPs. Without these formalities, an LP typically is (form a legal point of view) a partnership, since it involves the association of two or more individuals or entities in a for-profit business. This may mean that the purported limited partners in a defectively formed LP are treated as partners in a partnership for liability and tax purposes.

An LP has two different types, or levels, of partnership. There are general partners and limited partners. The same individual or entity may be both a general partner and a limited partner, but there must be at least two individuals or entities that are partners.

General partners in an LP are typically subject to the same management and liability rules as partners in a partnership. They manage the LP coequally, are agents of the LP for the purpose of conducting its business, and have general, joint and several, personal liability for the obligations of the partnership (unless the LP is organized—where permitted—as a limited liability limited partnership, a rarely used form of entity in which the general partners enjoy limited liability like partners in an LLP). They generally have approval rights, obligations of good faith and fair dealing, fiduciary duties of care and loyalty, and rights to contribution substantially similar to those of partners in a partnership not organized as an LP.

Limited partners in an LP have few management rights by default. They are not agents of the LP, and their consent generally is required only to make certain basic changes in the structure and operation of the LP. For example, they may have the right to participate in making decisions about changing the business purpose of the LP, converting it into another form of entity, or dissolving it (that is, providing for its windup and termination). Historically, limited partners have not had fiduciary duties to the partnership or their fellow partners, but modern statutes and case law have varied the rule, allowing for limited partners to have fiduciary duties. All partners in an LP usually are charged with obligations of good faith and fair dealing.

Limited partners also have limited liability for the obligations of the LP. This means that they generally are not liable for obligations of the LP, although they remain liable for obligations created by their own actions taken in the ordinary course of the LP's business. (The LP also may be liable for some of these actions.) Under older versions of limited partnership law still in operation in many states, limited partners are jointly and severally liable for obligations of an LP when they participate in control of the LP.

Partners in an LP own general or limited partnership interests, shares, or units as determined by their role in the LP. The financial and management rights and obligations included in these ownership interests are typically defined in a written partnership agreement; otherwise, they may be

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determined by reference to the equality principles established under partnership law. In most cases, however, the partnership agreement tailors these rights and obligations.

Like interests, shares, or units in a partnership, general partnership interests, shares, or units in an LP are presumed not to be securities under the *Howey* test because of the comprehensive management rights of the general partners in the LP. However, limited partnership interests, shares, or units are presumed to be securities because limited partners have, as a general rule, only limited management rights. Accordingly, their profits are deemed to result solely or primarily from the efforts of others. Both presumptions—against and for security status—are rebuttable by a showing that the presumption is unwarranted based on the actual facts relating to the operation of the LP's business.

LPs and their owners have the same default tax status and reporting responsibilities that partnerships and LLPs have under federal income tax law. LPs themselves are not taxed on their income; general and limited partners are taxed on that income, whether or not it is distributed to them. Like partnerships, LPs can opt out of partnership taxation and choose to be taxed as corporations by filing an election with the U.S. Internal Revenue Service.

Limited Liability Companies

Limited liability companies (LLCs) are formed in a manner much like that in which LPs are formed. Venturers must comply with formalities—the filing of articles of organization (or similarly labeled documents) and the payment of related filing fees—to form an LLC. Maintaining LLC status also requires compliance with annual filing and fee requirements. The formation of an LLC typically involves the drafting and negotiation of an operating agreement that includes the financial, management, and tax-related rules applicable to the different participants. Legal counsel generally is retained for these purposes to ensure that the LLC effectuates the expectations of the venturers. The fees and expenses of these activities can be relatively high.

A key reason why formation and maintenance costs in an LLC can be higher than those in other forms of entity is the flexibility in LLC structure. Under most state statutes, LLCs can be organized in one of two forms: as a member-managed LLC or as a manager-managed LLC. The governance rules for each form are different, but both forms have members as their owners.

A member-managed LLC may consist of only one member. Other than that, the LLC is structured and governed like a partnership. Each member of a member-managed LLC both owns and manages the business of the LLC

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and is an agent of the LLC for the purpose of conducting the LLC's business. Members of an LLC may be either individuals or entities. Management decisions in the ordinary course of business of a member-managed LLC typically may be approved by a majority of the members, and actions outside the ordinary course of business necessitate unanimous consent. Members of a member-managed LLC have obligations of good faith and fair dealing and owe fiduciary duties of care and loyalty to the LLC and their fellow members.

Manager-managed LLCs typically can be structured and governed like a limited partnership or like a corporation. The managers in the manager-managed form may be individuals or entities and, as the name suggests, manage the LLC and are agents of the LLC for the purpose of conducting its business. Members in a manager-managed LLC, like limited partners in an LP, may be either individuals or entities, are not agents of the LLC, and have limited management rights. There may be multiple levels of managers in a manager-managed LLC, with some managers having day-to-day management responsibilities and others (often acting as a board of managers) having an overarching management role. Under some older LLC laws, the articles of organization could provide that the LLC was managed by a board of governors through a chief manager and other officers. Few of these statutes are still in effect.

The managers of the manager-managed LLC typically owe fiduciary duties of care and loyalty to the LLC and its members and must act in a manner consistent with good faith and fair dealing. Members in a manager-managed LLC do not owe fiduciary duties to the LLC or their fellow members or have express obligations of good faith and fair dealing, unless they undertake managerial activities in the LLC. They may, however, be held to implied contractual duties of good faith and fair dealing under the operating agreement.

Members and, as applicable, managers enjoy limited liability. Neither members nor managers are personally liable to third parties for the obligations of an LLC merely by being members or managers in the LLC (although, as always, they remain liable for their own wrongful actions). This is true regardless of the level of management control afforded to and exercised by any member or manager.

However, courts may pierce this veil of limited liability and impose personal liability on LLC members (and even managers) under certain limited circumstances. These circumstances typically involve situations in which a member exercises an extreme level of control, uses that control to direct the LLC to engage in wrongful conduct that harms another individual or entity. There are many variants of this common law veil-piercing rule (known as, for example, alter-ego and instrumentality doctrines), each of which originated

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under corporate law. Accordingly, the application of veil-piercing doctrine in the LLC context is not always clear.

The financial and management rights and obligations represented by membership interests, shares, or units in an LLC are much like those inherent in partnership interests in most jurisdictions. Members share coequally in profits and, as noted above, the management of a member-managed LLC unless the operating agreement otherwise provides. Under LLC law and practice, however, LLCs are given more latitude in providing for different levels of membership interest than partnerships typically are afforded.

Under many LLC statutes, LLCs are expressly permitted to create different classes of membership interests, shares, or units with distinct financial and management rights and responsibilities. The idea of creating different classes of ownership interests, shares, or units is derived from corporate law, which long has authorized the creation of multiple classes of common and preferred stock. Some states expressly allow LLCs to offer and sell financial rights only—uncoupled from any ongoing financial obligations to the LLC or any LLC governance rights or responsibilities. As a result, LLCs offer venturers flexibility in both overall governance structure and capital structure.

Membership interests, shares, or units are treated as investment contracts for securities law purposes. Under the federal law rule in *Howey*, membership interests, shares, or units in a member-managed LLC, like partnership interests, shares, or units in a partnership, are presumed not to be securities. Membership interests, shares, or units in a manager-managed LLC, like limited partnership interests in an LP, are presumed to be securities. In each case, these presumptions are rebuttable.

Like other unincorporated entities, an LLC is taxed as a partnership under federal income tax law unless it elects to be taxed as a corporation by notifying the U.S. Internal Revenue Service. The LLC is not a separate taxpayer for these purposes; it is a pass-through entity. Instead, the LLC's members pay taxes on the LLC's income.

Corporations

Corporations are the oldest form of statutory entity. (Legislatures enacted partnership statutes long after courts started recognizing partnerships.) Corporations are formed when a chartering document (labeled in various ways by different states as articles of incorporation, a certificate of incorporation, and a charter, among other things) is filed with the secretary of state of the state in which venturers desire to organize the corporation and the required filing fee is paid. Annual reports and fees also are required.

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Internal governance and other related rules of the corporation not established in the corporate charter document are set forth in bylaws (sometimes referred to by another name, such as a code of regulations) and in shareholder agreements. Bylaws are authorized and required by statute; every corporation must have them and every corporate statute provides for them. The form and contents of shareholder agreements, contracts between or among the corporation's owners, may be expressly authorized or restricted by statute and must be construed in accordance with these statutes and any related judge-made law.

Corporations are managed by or under the direction of a board of directors, a management body that typically decides matters by a majority vote of the directors (historically individuals, not entities, but many statutes now allow entities to be board members). The board of directors delegates the day-to-day management authority of the corporation to officers, who are the agents of the corporation for the purpose of conducting its business. Some state statutes require that corporations have at least two named officers—a president and a secretary (or the equivalent). More modern statutes omit this requirement. The board of directors also typically elects or appoints the officers of the corporation.

The owners of a corporation are called shareholders—or stockholders, in some statutes. Some legislatures use the terms interchangeably. Shareholders are passive owners in the corporate form. They have few management rights, and those rights all are expressly provided for in the statute. They generally include the right to elect the directors and approve certain basic changes in the corporation: amending the corporate bylaws; voting for the directors of the corporation; and, after board approval, amending the corporate charter, approving a merger or sale of significant corporate assets, or dissolving the corporation. Corporate charters may, in some circumstances, vary the shareholders' management rights (for example, by changing quorum and voting requirements), but typically only within limited ranges.

Both directors and officers owe fiduciary duties of care and loyalty to the corporation. These duties have been construed to include or be supported by an obligation of oversight and good faith. Directors also owe a duty of candor or disclosure to the corporation or its shareholders in certain circumstances that may be part of or supplemental to their fiduciary duties. The law in this area is complex and has been evolving.

Delaware corporate law is a key source of corporate law principles, and the Delaware courts have been leaders in interpreting corporate law as it relates to the fiduciary duties of directors. Many legal commentators assert that, under Delaware corporate law, director fiduciary duties serve—or optimally should

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serve—solely or primarily to maximize the corporation's value to shareholders. Some contend that the purpose of a corporation is to maximize shareholder value. Others argue that shareholder wealth maximization is one (even if often the determinative one) of a number of different objectives of director and corporate action. The recent rise of corporate social enterprise entities (e.g., benefit corporations and flexible purpose corporations) responds to the perceived need for a form of corporate entity that exists to promote social and environmental, as well as shareholder wealth, objectives.

It is clear that shareholders, in the ordinary course, do not owe fiduciary duties to the corporation or their fellow shareholders. In some (limited) circumstances, majority shareholders may owe fiduciary duties of care and loyalty to minority shareholders. Also, courts in many jurisdictions (notably, Massachusetts) have held that shareholders in closely held corporations—corporations with small numbers of shareholders, who typically also serve as directors or officers of the corporation and often are related by family or friendships ties—have fiduciary duties to each other.

Directors, officers, and shareholders of a corporation all have limited liability for corporate obligations. As noted in the context of LLCs, however, courts may "pierce the corporate veil" or find a breach of fiduciary duty and hold shareholders, directors, or officers liable for corporate conduct. Courts often have trouble finding that the requisite extreme level of control or willful or reckless conduct exists in veil piercing cases, however.

The ownership interests of shareholders in a corporation are shares of stock. Stock represents a shareholder's distribution (including as dividends and upon liquidation) and voting rights. Shareholders are not entitled to distributions as a matter of right; the board of directors must approve them. By default, each share of stock affords the holder one vote, and shareholder decisions generally are made by shareholders having a majority of the shares present and voting at a meeting at which the required quorum (a majority of the outstanding shares of common stock) is present.

Stock typically is divided into two principal classes: common stock and preferred stock. The rights and obligations of holders of common stock are almost exclusively a matter of statutory law. The rights of preferred stock are much more contractual. Preferred stock typically provides the holder a preference (in timing or amount or both) in the payment of dividends or on liquidation. Because holders of preferred stock get these distribution preferences, they often do not have voting rights (other than voting rights required by law, typically for decisions that adversely affect the preferred shareholders).

Corporate law also provides that each of the two principal classes of stock (common and preferred) can be subdivided into multiple series. The board of

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directors and, when a charter amendment is required to create the series, the shareholders entitled to vote, must approve the designation of a new series of stock. Each series of stock has its own terms and conditions consistent with the terms and conditions of the overall class of stock under which the series is designated. This high degree of control over the corporation's capital structure allows corporate boards of directors, officers, and shareholders significant flexibility in financing the operations of the corporation.

Unless the context otherwise requires (and it rarely does), stock is a security under federal and state securities laws. Accordingly, the offer and sale of shares of stock requires registration under federal and state law, absent an exemption. Most public companies (issuers of securities trading on a stock exchange or issuers meeting the total asset and shareholder thresholds established under the 1934 Act) are corporations; and most of those are Delaware corporations.

Under U.S. federal income tax law, corporations are taxed on their income. Corporations taxed in this manner are referred to as "C corporations" or "C corps." Federal income tax law also provides that shareholders are taxed on the income, including salary and the dollar amount of any distributions (dividends and liquidation), received by them from the corporation. This creates the possibility of double taxation.

A corporation that qualifies (based on, for instance, its place of incorporation and the nature and number of shareholders it has) can request to be treated like a partnership for federal income tax purposes. Corporations taxed in this manner are referred to as "S corporations" or "S corps." S corporations are not taxed at the federal level on their income; they are pass-through entities for federal income tax purposes. Shareholders are taxed on the S corporation's income, whether or not that income is distributed to them. Unlike unincorporated business associations, a corporation's election to become an S corporation cannot be accomplished merely by checking a box on a form. The U.S. Internal Revenue Service reviews the election, filed on Form 2553, and notifies the corporation whether its election is accepted or not accepted.

Crowdfunding and Business Associations

The possibility of crowdfunding and other financing options should be taken into account in determining a choice of entity for a venture. Familiarity with the basics of the law of business associations helps promoters of businesses and projects that may want to use crowdfunding as a financing tool to assess how to organize their firms, from a legal point of view, to best accomplish their business objectives and their short-term and long-term financing goals.

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Principals that desire to use crowdfunding may or may not have taken formal action to organize their venture as a statutory form of entity at the time they seek funding from the crowd. If no filing has been made with the office of the secretary of state in any state to form an LLP, LP, LLC, corporation, or other statutory entity, the venture through which a business is conducted or a project is developed generally is legally recognized as either a sole proprietorship or a partnership.

Both sole proprietorships and partnerships are easy and inexpensive to form, making them attractive to small business owners (including those desiring to use crowdfunding) at first blush. However, these forms of entity may not be desirable for the principals as they begin business operations and make promises to funders buying crowdfunded interests in their business or project. Among other things, the owner-operator structure of sole proprietorships and partnerships, where all owners also are managers, and the fact that sole proprietors and partners have unlimited personal liability for the firm's obligations, often make them undesirable. In this regard, it is significant to note that, by offering an investor a share of the profits generated by a business or project (as is done in investment crowdfunding), that investor may acquire the legal status of a partner and, as a result, be vested with the financial and management rights and personal liability of a partner—a status that the promoter(s) of a business or project or investors may find undesirable. Said another way, most crowdfunders, like small business owners more generally, are concerned about offering management rights to third-party funders not known by them; investors may be similarly concerned with this and with the prospect of personal liability for the obligations generated by the business or project. Also, although the income of a partnership is taxed at the federal level only once for both sole proprietorships and partnerships, that tax is paid by each partner individually, based on that partner's allocable share of the partnership's income, regardless of whether the partnership has distributed any of its profits to that partner. Businesses or projects that are in the start-up phase often need to reinvest profits and may not have sufficient cash to distribute to partners to cover income tax payments.

For these reasons, venturers are well advised to consider affirmatively organizing a statutory form of business association to conduct business or develop a project that may be funded by the crowd. Most new businesses are formed either as LLCs or as corporations, both of which are more expensive to form and maintain than a sole proprietorship or partnership and offer limited liability to venturers. Although LLPs and LPs also offer limited liability, venturers generally prefer the governance structures of LLCs and corporations. LLCs are the newest and most popular form of unincorporated

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business association, although both LLCs and corporations offer significant benefits. LLCs offer structural flexibility, but LLC law is less well developed than corporate law and LLCs historically have been less accepted, as a general rule, in venture capital and "going public" circles. They also offer default pass-through taxation for federal income tax purposes, which may or may not be desirable to the principals. Corporations, however, offer less structural flexibility, although corporate law is well developed, and the corporate form is widely accepted by investors. Shareholders are taxed only on corporate income distributed to them; the corporation pays taxes on its own income.

Crowdfunders can offer profit-sharing interests in LLCs and corporations without involving investors in the management of the firm. This can be done in a variety of ways, including by offering investors nonequity interests—profit-sharing interests not recognized as ownership interests. This flexibility, taken alone, is a large benefit to using LLCs and corporations as legal entities for crowdfunding.

Contracts in Crowdfunding

Business transactions involve contracts—express and implied, written and unwritten—and crowdfunding comprises a variety of different business transactions. Of course, in all buy-sell arrangements, there may be contracts between the buyer(s) and seller(s), as principals, memorializing the transactional terms and conditions under which one party is offering value for something possessed by the other. Financing, as a specialized form of buy-sell arrangement, involves the transfer of value by a funder in return for an interest in a business or project.

In financing transactions involving intermediaries (including crowdfunding), there typically are contracts involving each intermediary. Crowdfunding intermediaries, construed broadly, may include not only crowdfunding web sites, but also any other promoters of the crowdfunded offering. Separate contracts may exist for each of these arrangements. For example, principals of a business or promoters of a project may contract with a crowdfunding web site to host a crowdfunded offering or contract with one or more marketing agents (videographers, writers, etc.) to help promote the business or product in the offering. Prospective funders may contract with the crowdfunding web site to contribute funds to a business or project or may contract with financial or diligence experts, among others, to help vet potential businesses or projects they may desire to fund. Each contract establishes the intermediary's transactional role and duties and the amount and form of his, her, or its compensation, among other things.

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Ultimately, then, all forms of crowdfunding are built on contracts. Contracts are legally recognized forms of agreement between two or more individuals or entities, typically referred to as "parties." The basic rules of contract law are, therefore, important to the legal context of crowdfunding.

The Nature of Contract Law

Parties are incentivized to enter into contracts because they can rely on courts and others to uphold them against challenges to their validity, hold the parties to the benefit of their bargain, and enforce that bargain. The law governing the establishment, interpretation, and applied force of a contract determines whether the contract is valid, binding on the parties, and enforceable against them. A review of the basics of contract law, learned by most law students in their first year of law school, demonstrates that most aspects of crowdfunding contracts are straightforward.

Contract law is principally state common law, made through state judicial opinions rather than in legislatures. Most of the fundamental facets of the law differ only slightly, if at all, from state to state. This part of the chapter summarizes core aspects of contract law that may be important in the context of crowdfunding contracts. The text notes where there are variances in the law from state to state or where the law is unsettled for other reasons.

Elements of a Contract

A party desiring to enforce a contract in court must prove that one exists. This is trickier than it sounds. Judges and lawyers do not always agree on the central elements of a valid contract. Moreover, because judges in each state determine the matters required to be proven in that state, there is bound to be variety from state to state. The following items, however, appear on many commonly available lists of contract elements:

- *Offer*—a promise of action or forbearance on the part of one individual or entity.
- *Acceptance*—unambiguous assent to an offer made by another.
- *Consideration*—the lawful surrender of something of value.
- *Mutuality*—a meeting of the minds—evidence of agreement on the substance of the agreement between or among the parties.
- *Capacity to contract*—the state of being legally competent to contract.
- *Intent to contract*—the objective to create a legally enforceable agreement, which may be/often is presumed in business contracts.
- *Lawful subject matter*—terms and provisions that do not violate law.

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The first three elements are absolutely essential. A claimant proving these elements of a contact establishes a *prima facie* case (effectively, a presumption) that a contract exists. Without any one of these elements, a court may find that the asserted contract is invalid.

Defenses to Contract Formation

Those who desire to challenge the existence of a valid contract may rebut proof of any of the elements of a contract. Depending on the circumstances, the contract may be void or voidable. Some rebuttals are straightforward—for example, proof that there was, in fact, no offer or acceptance or a failure of consideration, proof that the parties did not intend to create a legally binding agreement (e.g., where the parties sign an agreement to agree—a letter of intent or other contract providing for the execution of a later agreement on specified terms or subject to specified conditions), or proof that the subject matter of the contract is unlawful. Others are less obvious.

For example, a mistake on the part of both parties to an asserted contract about a fact vital to the agreement tends to rebut the element of mutuality and render an asserted contract void. Fraud in the inducement (misstatements that prompt a party to enter into a contract) also refutes mutuality. Similarly, when one party signs an agreement under duress or as a result of undue influence or agrees to terms that are unconscionable, mutuality may be rebutted. Also, if a party to an avowed contract is mentally ill, a minor, or otherwise legally incompetent or incapacitated at the time the asserted contract is entered into, the contract may be voided.

Binding Nature of a Contract

A valid contract may not bind all parties under all circumstances. For example, a valid contract may exist as to one or more parties on either side of an agreement, but may be void as to one of them because of incapacity. Also, a party may assert that performance of the contract is not required because the very purpose of the contract is frustrated or because of impossibility—a radical change in conditions or events that renders the party unable to perform under the contract. In addition, the fraudulent misrepresentation of a material term of the contract to a party may excuse that party from performance.

Enforceability of a Contract

A void or voidable contract is not enforceable against the parties, and a court will not enforce an agreement against a party who is not bound. A court also

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may refuse to enforce an otherwise valid and binding contract, however. This often occurs when formalities are required for a specific type of contract, and there is noncompliance with those formalities. For instance, the statute of frauds in a jurisdiction may require that certain contracts be in writing to be enforceable. Moreover, a party that excuses another party's performance under a valid and binding contract will be estopped from enforcing the contract against that party as to the excused performance. Also, a court may decline to enforce a valid and binding contract that violates public policy.

Contract Law Issues in Crowdfunding

Although we do not yet have much experience with crowdfunding contracts, in most cases, they will raise issues no different from those associated with contract formation, performance, and enforcement in other areas of business. In particular, contracts between those desiring funding and their agents (including intermediaries that they may retain, such as crowdfunding web sites) are likely to be somewhat run-of-the-mill, unless the parties contract to do something that is illegal such as investment crowdfunding outside the parameters of federal or state securities law. Claims and controversies relating to these kinds of contracts should look much like the traditional contracts cases.

Agreements between those desiring funding or crowdfunding web sites, on the one hand, and funders, on the other, may raise more novel contract law claims and concerns. These agreements are, in most cases, standardized and conveyed wholly over the Internet, without personal negotiations or other interactions among the parties. In general, these forms of agreement may be classified as either click-wrap or browse-wrap contracts. A click-wrap agreement is characterized by terms and provisions conveyed through a web site to which a party may agree by clicking a button that indicates assent. A browse-wrap agreement consists of terms and provisions conveyed on a web site that allegedly bind users of the web site merely by browsing its contents or making use of some of the web site's tools or services.

The use of these types of agreements in crowdfunding may raise a number of basic contract law issues. For instance, a crowdfunding web site or crowdfunded business (or the principals behind a crowdfunded project) desiring to enforce a click-wrap or browse-wrap agreement as a valid contract may be challenged by a funder on the grounds that there was never any acceptance of the offer made through the crowdfunding web site or that there was a lack of mutuality or intent to contract. As a general matter, these arguments should have more force in claims involving browse-wrap agreements than those involving click-wrap agreements, since the funders have the ability to read

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the terms and conditions and affirmatively indicate a decision to agree in the case of a click-wrap agreement. Yet, a browse-wrap agreement with a funder still may be valid, binding, and enforceable if the funder has clear, up-front notice of the agreement and proceeds with use of the web site on that basis.

The use of the Internet in crowdfunding also creates other opportunities for contract law challenges to Internet-based agreements. The faceless nature of the Internet may encourage the participation of minors and others lacking the legal capacity to contract and may make it hard to locate parties for enforcement purposes and extract damages or other remedies in the event of a breach of contract. Funders desiring to avoid click-wrap or browse-wrap agreements also may be more prone to raise claims of unconscionability or undue influence. Even if these claims are ultimately unsuccessful, the need for crowdfunding web sites or crowdfunded business or projects to defend against these claims increases the cost of crowdfunding and may discourage some potential market entrants.

Other Potential Legal Issues

Other basic legal issues worthy of consideration in connection with crowdfunding abound. Some are specific to particular types of businesses and projects. Others are common to all or most business ventures. A few are mentioned briefly here.

Tax laws other than federal income tax laws (such as state income tax laws, franchise or excise tax laws, sales tax laws, and property tax laws) also impose costs on businesses and projects. Businesses should determine the nature and timing of these payments and budget for them as a matter of course. Venturers considering crowdfunding should take these costs into account in determining what they can offer to funders.

Intellectual property laws—the laws governing patents, trademarks, copyrights, and trade secrets—can be very important to crowdfunding. This topic is covered in detail in another chapter of this book. Suffice it to say that even a simple logo used in marketing a crowdfunded offering can create heartache and legal expenses if intellectual property laws are not taken into account in planning a venture.

Crowdfunders also should be mindful of bankruptcy and reorganization law. Many small business firms fail, and structuring a business in a manner that provides options in the event of failure is generally a good investment of resources. In particular, ventures financing businesses or projects through crowdfunding will want to determine how their promises to funders may be

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renegotiated in a voluntary, nonbankruptcy reorganization and how they may be treated in a bankruptcy.

Businesses always should pay attention to federal and state antitrust law as well. Antitrust laws protect businesses from anticompetitive behaviors like price fixing and market splitting. Although there is nothing about crowdfunding that makes it a particular risk under antitrust laws, both crowdfunding intermediaries and crowdfunded businesses should take care in constructing their business models to avoid problems under these laws.

Conclusion

The legal basics relating to crowdfunding are broad and varied and apply to both those seeking financing through crowdfunding and the intermediaries with whom they work to obtain that funding. The basic laws and regulations that impact crowdfunding are those that govern businesses more generally. Three key areas for focus are securities regulation, business associations law, and contract law. But other areas of law such as taxation, intellectual property, bankruptcy and reorganization, and antitrust, also are worthy of attention.

A number of legal matters addressed in this chapter are noteworthy, but two key issues are worth reviewing here. By offering investors a profit-sharing interest in a business or project in a crowdfunded offering, crowdfunders may be offering a security (invoking federal and state securities laws) and, absent the organization of a different legally recognized form of entity, may be making those investors partners in their business. Also, without the proper notice, browse-wrap contracts may not be valid contracts and, therefore, may not bind crowdfunding web site users or be enforceable against them.

Finally, and this may go without saying, although all business participants should be familiar with basic legal principals in constructing and operating a business, legal counsel is necessary to the establishment of a strong foundation for a business venture. In particular, in crowdfunding—a new type of business with multiple business models—both ventures seeking financing through crowdfunding and businesses seeking to sell crowdfunding services should retain lawyers to help them navigate untested waters. An experienced business lawyer can help crowdfunding-related businesses assess the application of various laws to their particular venture and establish crowdfunding models with strong legal foundations. In other words, legal counsel should be considered an essential investment rather than a discretionary transaction cost for firms planning to engage in, as well as those already engaged in, crowdfunding.

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