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Cinema Law: Why Moviemakers Should be Very, Very Careful About Equity Crowdfunding

By David Albert Pierce, Esq. on January 6, 2016

Just days before the American Film Market began last November, the Securities and Exchange Commission (SEC) finally promulgated regulations (after a two-year delay) that allow companies to solicit investments from the general public over the Internet–i.e. equity-based (or "for profit") crowdfunding.

While many are touting this as an exciting new means of raising revenue for films, the lawyers and financiers in attendance at AFM were all of the unanimous opinion that equity crowdfunding, as applied to independent filmmaking, sucks. Why?

There is a big difference between traditional donor crowdfunding, like Kickstarter, and this new profit-motivated financing technique, an expensive and dangerous proposition. While equity crowdfunding may work for potentially high-reward investments in the tech world, it'll likely be disastrous for the world of high-risk/low-reward film investments. And it is invitation for moviemakers to be sued when their investors don't see their money back. By contrast, old-fashioned donor-based crowdfunding remains useful, provided you understand its limitations.

How Does Equity Crowdfunding Work, Exactly?

Prior to the federal Jumpstart Our Business Startups (JOBS) Act, businesses were allowed to solicit investors for their companies or projects via only two distinct means—public offerings, governed by SEC Reg A, or private placement exemptions to the public offering rules, commonly set forth by SEC Reg D. In the private placement world, independent producers generally were limited by regulations regarding whom they could approach and, depending on the exemption, how many potential investors they could approach.

For example, the private placement exemptions can (depending on the exemption) require a preexisting relationship between the producer and the potential investors. Similarly, in certain situations investors can be approached only if they are "accredited investors" (i.e. those who either earn over $200,000 a year or have a net worth, excluding their primary residence, of over $1 million). These private placement rules were designed to help protect those most vulnerable to fraud and prevent them from getting involved in investments that had not undergone the full vetting of the SEC through the public offering process.

The new so-called equity crowdfunding rules, which have been dubbed "Reg A+," now allow companies to raise up to $50 million, split into two tiers: up to $20 million in 12 months (Tier 1), and up to $50 million in 12 months (Tier 2). And, unlike the existing Reg D rules governing private placements, Reg A+ rules allow stock promoters to solicit funds from random unaccredited investors on the Internet, where the potential investor has no prior connections or relationship to the producer looking to raise the money.

Donor-based Internet crowdfunding sites, like Kickstarter or Indiegogo, allow individuals to contribute toward a fundraiser's project because they believe in the purpose of the fundraising, and they are donating with no expectation of returns on their investments. Rather, the most a donor receives is a guaranteed item of appreciation, depending on the level of the donation—a hat, a DVD, or perhaps an invitation to a film premiere.

Unlike these proven donor-based crowdfunding sites, equity-crowdfunding producers can sell securities with the promise of a monetary return on the investment to nearly anyone who can come up with the money. If the film is a success, presumably, the investors will profit from their investments. If the film is a failure, the investors will not see a return on their money and the investments will be lost.

Why is This Dangerous?

Equity crowdfunding regulations do require that a company offering securities create a disclosure document which describes the terms of its offer, stating the nature of its business; how the proceeds from the securities will be used; information about the company's officers, directors, and owners, as well as information about the company's competition; the tax consequences of the investment; and a discussion of all risks that may affect the investment. In short, the producer must provide (and must not omit) any information that a reasonable, prudent investor would deem material prior to tendering an investment into the film project. These protective measures, which parallel the traditional private placement rules, continue to exist.

In addition, unlike a traditional private placement offering, the new equity crowdfunding rules recognize the "public" nature of these Internet offerings and that vulnerable, unaccredited investors may be drawn to them. Therefore, companies are obliged to file annual reports and financial audits with the SEC, and to make these documents available to the investors. These financial documents come with a substantial cost. Few, if any, independent film production companies will be able to bear the heavy costs of annual accounting statements that need to be prepared by a CPA following a rigorous public audit. Moreover, like traditional public offering, the SEC requires equity crowdfunding to be managed by either a traditional, licensed securities broker-dealer, or via a registered equity crowdfunding portal.

So, in short, whereas donor crowdfunding has very little compliance rules, since it's a pure donation with no expectation of profit in the eyes of the donor, equity Crowdfunding has significant compliance rules, and compliance will be expensive. Even if a filmmaker is able to comply in good

faith, the basic rule that investors must be provided all material information about the investment prior to rendering the investment makes equity crowdfunding an almost guaranteed litigation trap for producers.

While the SEC tends to devote its enforcement activities to cases that involve significant losses or significant matters of public policy concern, for most small independent filmmakers, the real threat of not complying with SEC rules is the threat of civil action from investors. In the case of equity crowdfunding, the nature and extent of potential civil actions will be significantly greater than from those under a traditional private placement regime. Remember that Reg A+ allows potentially thousands of people to contribute to a project. By contrast, the limited nature of the traditional private placement offering system means that a company (usually) knows exactly who its investors are, and can assess them prior to accepting their money. Under Reg A+, the anonymous nature of the Internet could see producers with good intentions falling prey to trolls waiting to file a class action, asserting that, somehow, the producer failed to reveal all risks and information that a reasonable investor would consider material. Do you really want that type of troll investing a few bucks in your film and, when profits aren't generated, having a class action attorney file a lawsuit against you on behalf of all similarly situated investors?

Ergo, Avoid Reg A+ Like the Plague

Moviemaking is unique in that it is generally an industry of high risks and low rewards. Allowing investments by investors who expect to generate a high reward is dangerous; it will disappoint those investors. Reg A+ may be fantastic for the world of high tech and Internet start-ups—those companies produce, with some regularity, incredibly high rewards for their investors. Film investment is different—high rewards are rare. Reg A+ opens production companies to liability from unsophisticated investors who have no prior affiliation to the filmmakers and who can now invest in a very high-risk, low-reward endeavor.

The reality is that, in order to comply with the SEC requirements for a Reg A+ equity crowdfunder, production companies will need to spend every bit as much money as they would for a traditional Reg D private placement offering. In fact, the producers will spend even more under Reg A+ because of the additional compliance requirements that necessitate the services of lawyers and accountants.

So, while owners of these new for-profit crowdfunding portals may tout equity crowdfunding, stick with good ol' donor crowdfunding on Kickstarter, Indiegogo and the like. Donor-based crowdfunding is a high-tech way of passing the hat around friends, family members and fans. Complete strangers to a project rarely ever donate. (The prospects are, I believe, similarly low that complete strangers will benevolently invest in a project via equity crowdfunding!) Donor crowdfunding is an important, though relatively small, component in the overall jigsaw puzzle that is film finance. The remaining pieces are loans based against pre-sales, tax credits, co-production opportunities, and traditional equity financing utilizing traditional Reg D private offerings.

Remember: Equity crowdfunding sucks because: (1) The cost of structuring a legally compliant offering will be prohibitive, and (2) Producers will be inviting trolls into the company's investor ranks and thereby possibly opening the company up to future liability. **MM**

David Pierce is an entertainment finance attorney and vice president and legal counsel for MovieMaker Magazine. The information provided here is for general education and information purposes only, and is not legal advice or legal opinions. The information provided in this article is not intended to create a lawyer-client relationship between Mr. Pierce and a reader.

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