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# Crowdfrauding: How Michigan's Crowdfunding Security Exemption Fares for Small Business Owners

Natalie O'Keefe

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*Crowdfunding: How Michigan's Crowdfunding Security Exemption Fares for Small Business  
Owners*  
by  
Natalie O'Keefe

Submitted in partial fulfillment of the requirements of the  
Kings Scholar Program  
Michigan State University College of Law  
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## INTRODUCTION

The floodgates may have opened in June of 2011 when the Ohio Division of Securities filed a cease and desist order against SoMoLend and its CEO, Candice Klein.<sup>1</sup> SoMoLend is a small startup business in Cincinnati, Ohio that provides an online funding platform connecting small business borrowers with corporate, institutional, organizational, and individual lenders much like other popular crowdfunding companies like Kickstarter or Indiegogo.<sup>2</sup> For many small business owners, another company like SoMoLend offering crowdfunding opportunities looked like a godsend.<sup>3</sup> In an attempt to gather investors for its crowdfunding portal, SoMoLend claimed during projection presentations that their current profit of \$44 thousand would increase dramatically to \$71 million by 2016.<sup>4</sup> SoMoLend claimed to have forty-three banks lending through its online portal.<sup>5</sup> Moreover, SoMoLend stated to Entrepreneur Magazine that it raised \$15 million for one-hundred businesses.<sup>6</sup>

However, Ohio's Division of Securities told a much different story of SoMoLend's financial prosperity.<sup>7</sup> The cease and desist order states that SoMoLend only provided twenty-five loans for eighteen businesses, which in the aggregate totaled only \$234,000. Moreover, as of the time of the order, there was only one bank lending on SoMoLend's funding portal.<sup>8</sup> Additionally, the state says SoMoLend had only generated \$3,404 in revenue from their business

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<sup>1</sup> Devin Thorpe, *Somolend's Investors to Regulators: 'Where's the Beef?'*, FORBES.COM (August 14, 2014) <http://www.forbes.com/sites/devinthorpe/2013/08/14/somolends-investors-to-regulators-wheres-the-beef/>

<sup>2</sup> *Id.*

<sup>3</sup> Josh Pichler, *Exclusive: State Alleges Fraud by Key Cincy Startup Lender*, CINCINNATI.COM (August 13, 2014) <http://www.cincinnati.com/article/AB/20130811/NEWS/308110092/EXCLUSIVE-State-alleges-fraud-by-key-Cincy-startup-lender>.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> Andy Brownfield, *Investors: SoMoLend Likely to Liquidate*, CINCINNATI BUSINESS COURIER (December 17, 2013) <http://www.bizjournals.com/cincinnati/news/2013/12/17/investors-somolend-likely-to-liquidate.html?page=all>.

opportunities—a far cry from \$71 million.<sup>9</sup> The state also argued the small company and its CEO were selling unregistered securities and making fraudulent financial projections.<sup>10</sup> Allegations like the ones levied against Klein and SoMoLend show how easy it is for unsophisticated small business owners and investors to be fooled by fraudulent crowdfunding opportunities.<sup>11</sup> In SoMoLend's case, the cease and desist order has put the small company into peril.<sup>12</sup> Investors of SoMoLend contend the startup will most likely liquidate within the next few months.<sup>13</sup>

The creation of equity crowdfunding was an idea that combined a company's continual need for capital financing with the newly minted idea of crowdsourcing.<sup>14</sup> As Internet use continues to grow, the idea of allowing companies to tap into the popular crowdfunding presence online helped alleviate concerns about credit crunches and lack of liquidity in volatile securities markets.<sup>15</sup> In one of the first attempts at allowing companies to sell securities over the Internet, President Obama signed into law the Jumpstart Our Business Startups Act, or the JOBS Act.<sup>16</sup> The goal of the Act was to help create capital for medium to small-scale business owners.<sup>17</sup> Part of the legislation includes a new exemption known as crowdfunding.<sup>18</sup> It directs the Securities and Exchange Commission (SEC) to draft a rule to allow small to medium size business owners

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* (“if you're making a pitch, if you're passionate about something, there's a natural tendency for everybody to be overly optimistic”).

<sup>12</sup> <http://www.bizjournals.com/cincinnati/news/2013/12/17/investors-somolend-likely-to-liquidate.html?page=all>

<sup>13</sup> *Id.*

<sup>14</sup> Alan Farnham, *New Legal: Buying Stock in Start-Ups Via Crowdsourcing*, ABC NEWS (September 14, 2013) <http://abcnews.go.com/Business/dark-side-crowdfunding-startup-companies/story?id=20343963>.

<sup>15</sup> Charles Luzar, *How Crowdfunding's Secondary Market Could Evolve*, VENTURE BEATS (Feb. 6, 2013) <http://venturebeat.com/2013/02/06/how-crowdfundings-secondary-market-could-evolve/>.

<sup>16</sup> David McDaniel, Geoffrey Neal, *Jobs Act Seeks to Ease Restrictions on Access to Capital for Small and Medium-Sized Businesses*, ARK. LAW. WINTER 2013, at 26.

<sup>17</sup> Ryan Caldbeck, *Happy Second Anniversary JOBS Act*, FORBES (April 22, 2014) <http://www.forbes.com/sites/ryancaldbeck/2014/04/22/happy-2nd-anniversary-jobs-act/>.

<sup>18</sup> David McDaniel, Geoffrey Neal, *Jobs Act Seeks to Ease Restrictions on Access to Capital for Small and Medium-Sized Businesses*, ARK. LAW., WINTER 2013, at 2726.

sell their equity through Internet crowdfunding portals.<sup>19</sup> However, as of 2012, the SEC has failed to implement a rule to allow the use of the federal exemption.<sup>20</sup> Nonetheless, many states have jumped on the crowdfunding bandwagon and created their own crowdfunding exemptions.<sup>21</sup>

As a potential financial tool, crowdfunding is an attractive alternative to current options available to small business owners.<sup>22</sup> It is efficient, doubles as a marketing tool, and has the ability to help a business gain loyal advocates.<sup>23</sup> The fact is traditional methods of raising capital are not truly beneficial to small business owners with limited resources.<sup>24</sup> The concern by critics of crowdfunding is if the opportunity were to come across an issuer's desk, a small business owner might be inclined to use crowdfunding without considering the drastic ramifications.<sup>25</sup> Crowdfunding as currently enacted gives the impression of creating a fast and easy avenue for businesses to raise capital.<sup>26</sup>

States have been too hasty in enacting crowdfunding exemption without properly evaluating the economic climate of their State.<sup>27</sup> As a state, which is dominated by small businesses, a significant portion of the small business economy could end up using Michigan's

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<sup>19</sup> *Id.*

<sup>20</sup> <http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/>

<sup>21</sup> <http://www.businessweek.com/articles/2014-01-07/state-lawmakers-are-getting-on-the-crowdfunding-bandwagon>

<sup>22</sup> Lawton Ursrey, *Before You Launch Your Crowdfunding Campaign, Read This*, FORBES (March 18, 2014)

<http://www.forbes.com/sites/lawtonursrey/2014/03/18/before-you-launch-your-crowdfunding-campaign-read-this/>.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* (“Where reaching out to a bank for financing used to be status quo, many small businesses believe that banks aren't doing enough to help and I agree 100%. According to the Sage Small Business Index, 67% of small businesses are looking at alternative sources of funding”).

<sup>25</sup> Ryan Calbeck, *The Biggest Crowdfunding Criticisms*, FORBES (October 12, 2013)

<http://www.forbes.com/sites/ryancalbeck/2013/10/20/the-biggest-crowdfunding-criticisms/>.

<sup>26</sup> Deborah Jacobs, *The Trouble With Crowdfunding*, FORBES (April 17, 2013)

<http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding/> (“the risks, burdens and limitations of crowdfunding render it almost completely useless”).

<sup>27</sup> Rick Haglund, *Michigan Makes Crowdfunding For Entrepreneurial Businesses an Easy Step*, MLIVE (February 2, 2014) [http://www.mlive.com/business/index.ssf/2014/02/rick\\_haglund\\_small\\_business\\_se.html](http://www.mlive.com/business/index.ssf/2014/02/rick_haglund_small_business_se.html) (“Some critics say crowdfunding gives unscrupulous business people an easy way to rob unsophisticated investors”).

crowdfunding exemption.<sup>28</sup> Thus, Michigan's legislators and judges would be wise to craft this exemption with small businesses in mind. This Article argues it is important to assess three issues to strengthen Michigan's crowdfunding exemption. Those issues are: (1) the risks inherent in small business activity, (2) the use of crowdfunding portals as intermediaries between investors and businesses, and (3) the need for added protection for investors willing to invest in a volatile small business market. By taking into considerations these issues, Michigan's crowdfunding exemption could be strengthened and play a fundamental role in shifting Michigan's economy into higher prosperity.

Part I of this Article explores how lending institutions and the SEC define small businesses.<sup>29</sup> It also examines how small business owners shape Michigan's economy.<sup>30</sup> Part II examines traditional capital raising options available to small business owners.<sup>31</sup> Part III discusses the world of equity issuance and the purpose of the securities laws.<sup>32</sup> Part IV analyzes why the exemption is the best financial tool available for small business owners who need capital. Additionally, it addresses how Michigan's current exemption fails to account for (1) risks associated with small businesses, (2) crowdfunding portals as liaisons between investors and business, and (3) lack of protection for Michigan investors.<sup>33</sup> It concludes by suggesting ways that Michigan can reinforce its exemption to benefit both small businesses and investors alike. Generally, capital is desperately needed for small business owners, especially within Michigan.<sup>34</sup> However, crowdfunding as it is currently implemented in Michigan and elsewhere may not be

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<sup>28</sup> *Id.* ("Crowdfunding could appeal to expanding small businesses in fast-growing industries").

<sup>29</sup> *See infra* Part I.

<sup>30</sup> *See infra* Part I, Section

<sup>31</sup> *See infra* Part II

<sup>32</sup> *See infra* Part III

<sup>33</sup> *See infra* Part IV

<sup>34</sup> *See infra*

the silver lining for which all small business owners are hoping.<sup>35</sup> By implementing specific safeguards designed with small business offerings in mind, Michigan may be able to fashion a crowdfunding exemption, which stimulates its economy and revitalizes its prosperity.

## II. SMALL BUSINESSES DEFINED

The term small business tends to be a misused phrase, frequently used to describe a wide range of businesses.<sup>36</sup> There is no one definition for what constitutes a small business.<sup>37</sup> However, there are many guideposts in different settings that would be useful to understand for this Article.<sup>38</sup> The main agencies involved with federal lending and equity offerings have two definitions of what constitutes a small business with much overlap, which will help to draw the boundaries of what comprises a small business for this Article.<sup>39</sup> This Part explores those two definitions and then ends by surveying the economy of Michigan and whether a concern for small businesses is necessary.<sup>40</sup>

### A. Small Business Administration

On the lending side, businesses have the Small Business Administration (SBA).<sup>41</sup> The SBA is a federal executive agency whose purpose is to “aid, counsel, assist, and protect, insofar as is possible, the interest of small business concerns.”<sup>42</sup> Since its inception in 1953, SBA has grown into a highly relevant financing option for small business owners looking for capital and

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<sup>35</sup> *See infra*

<sup>36</sup> Holly Magister, *Need Money? Business Loan Options For Entrepreneurs in 2014*, FORBES (April 7, 2014)

<http://www.forbes.com/sites/hollymagister/2014/04/07/business-loan-options-for-entrepreneurs-in-2014/>

<sup>37</sup> *Id.* (“Part of the confusion when searching for a business loan is related to the fact that a consistent definition of the size of a small business vs. lower-middle market vs. middle market business simply doesn’t exist”).

<sup>38</sup> *See infra* Section A & B.

<sup>39</sup> *Id.*

<sup>40</sup> *See infra* Section C.

<sup>41</sup> *See infra*

<sup>42</sup> *Our History*, SBA.GOV, [http://www.sba.gov/about-sba/what\\_we\\_do/history](http://www.sba.gov/about-sba/what_we_do/history).



counseling for their company.<sup>43</sup> In 2013, the SBA helped over 14,300 entrepreneurs, provided counseling to 111,000 clients, and trained 430,000 client employees.<sup>44</sup> The SBA has provided over twenty-eight billion dollars in financing for small businesses in 2012.<sup>45</sup>

The SBA has an in-depth process for determining whether a company qualifies as a small business.<sup>46</sup> The SBA has established numerical definitions of small businesses, or "size standards," for all for-profit industries.<sup>47</sup> A size standard is usually stated in the number of employees or average annual receipts. The size standard denotes the largest size a business—including its subsidiaries and affiliates—may be if they wish to be classified as a small business for the SBA.<sup>48</sup> The definition of "small" varies by business sector and industry in order to avoid rigid regularity across the nation's economy.<sup>49</sup> For example, within the construction sector, businesses that remodel homes are limited to 33.5 million in annual receipts for their business in order to qualify as a small business, whereas, within the oil and gas extraction sector, small business owners are limited to 500 employees as opposed to limiting it to annual receipts.<sup>50</sup> A good indication of whether a business qualifies as a small business for the SBA requires that the business employ less than 500 employees or generate less than 75 million in annual receipts.<sup>51</sup>

## B. Securities and Exchange Commission

On the equity side, companies should be aware of the Security and Exchange

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<sup>43</sup> SMALL BUSINESS RESOURCE, NATIONAL FALL 2013 SBA (2013), available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf).

<sup>44</sup> SMALL BUSINESS RESOURCE, NATIONAL FALL 2013 SBA (2013), available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf).

<sup>45</sup> John Tozzi, *The SBA's \$1.5 Billion Franchise Loan Problems*, BUSINESSWEEK (November 14, 2013), <http://www.businessweek.com/articles/2013-11-14/the-sbas-1-dot-5-billion-franchise-loan-problem>

<sup>46</sup> 7(a) Loan Program Eligibility, SBA.GOV, <http://www.sba.gov/content/7a-loan-program-eligibility>.

<sup>47</sup> *Small Business Size Standards*, SBA.GOV, <http://www.sba.gov/category/navigation-structure/contracting/contracting-officials/small-business-size-standards>.

<sup>48</sup> *Id.*

<sup>49</sup> *Table of Small Business Size Standards*, SBA.GOV, <http://www.sba.gov/content/small-business-size-standards>

<sup>50</sup> [http://www.sba.gov/sites/default/files/files/Size\\_Standards\\_Table.pdf](http://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf).

<sup>51</sup> *Id.*

Commission's (SEC) definition of a smaller reporting company.<sup>52</sup> If a company qualifies, it may choose to prepare its company's disclosure in the prospectus relying on disclosure requirements scaled for smaller companies.<sup>53</sup> These requirements are within Regulation S-K and in Article 8 of Regulation S-X.<sup>54</sup>

A company will qualify as a "smaller reporting company" if its public equity float is less than \$75 million or, if it cannot calculate its public equity float, it has less than \$50 million in annual revenue.<sup>55</sup> For the SEC's purposes, public equity float is determined by multiplying the number of common shares held by the public by the share's market price.<sup>56</sup> In the case of an initial public offering (IPO), public equity float is determined by multiplying the total number of common shares covered by the registration statement by their estimated public offering price.<sup>57</sup> In terms of disclosure requirements for smaller reporting companies, the disclosures are scaled back to avoid disclosures deemed to be unnecessary for small businesses.<sup>58</sup> For example, smaller reporting companies do not have to provide detailed executive compensation; audited financial statements for three years rather it is only required to supply two years; or an auditor's opinion of internal control over financial reporting.<sup>59</sup>

Accordingly, looking at the broad coverage of the SBA and the SEC definitions for small business, it becomes apparent that a significant percentage of businesses actually qualify as small businesses.<sup>60</sup> These two definitions will be the boundaries of what this Articles means when

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<sup>52</sup> *Smaller Reporting Company Compliance and Disclosure Interpretations*, SEC.GOV, <http://www.sec.gov/info/smallbus/src-cdinterps.htm>.

<sup>53</sup> *Small Business and the SEC*, SEC.GOV, <http://www.sec.gov/info/smallbus/qasbsec.htm#capital>.

<sup>54</sup> *Id.* See also 17 CFR 240.12B-2.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> See 17 CFR 229.10(f).

<sup>60</sup> Ami Kassir, *How Big Can a Small Business Be? (And Why It Matters)*, NYTIMES (June 18, 2012),

talking about small businesses. Moreover, these numerical and profit based definitions will help illuminate the current difficulties that small businesses face when attempting to finance additional capital needs.

### C. Small Business Statistics in Michigan

Before delving into financing options available to small businesses, it will be helpful to illustrate the small business landscape within the State of Michigan. The SBA collects a wide variety of statistics about small businesses within each state.<sup>61</sup> As of 2010, the SBA's statistics show most of Michigan's small businesses were in fact very small, since 79% of all businesses had no employees, and the employers who did have employees had fewer than twenty.<sup>62</sup> As stated by Oakland County Executive L. Brooks Patterson, "small businesses are the backbone of our economy . . . when businesses start investing more, it's a sign that they are confident about the future."<sup>63</sup> In terms of employment, small business owners represent 98% of all employers and employ 52% of the private-sector workforce.<sup>64</sup>

Michigan small business owners had a combined income of twenty-two billion dollars in 2010.<sup>65</sup> Small business owners in Michigan typically use traditional commercial lending to meet their capital needs. In 2010, Michigan small businesses had around 78,000 loans valued under \$100,000.<sup>66</sup> In 2010, Michigan small business loans equaled roughly 1.5 billion dollars.<sup>67</sup> In

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[http://boss.blogs.nytimes.com/2012/06/08/how-big-can-a-small-business-be-and-why-it-matters/?\\_php=true&\\_type=blogs&\\_r=0](http://boss.blogs.nytimes.com/2012/06/08/how-big-can-a-small-business-be-and-why-it-matters/?_php=true&_type=blogs&_r=0) ("There is little dispute that there are some 27 million small businesses in the United States").

<sup>61</sup> SMALL BUSINESS ADMINISTRATION: OFFICE OF ADVOCACY-STATE ECONOMIC PROFILES, *available at* <http://www.sba.gov/advocacy/848>.

<sup>62</sup> SMALL BUSINESS ADMINISTRATION: OFFICE OF ADVOCACY-SMALL BUSINESS PROFILE: MICHIGAN, (2013) *available at* <http://www.sba.gov/sites/default/files/mi12.pdf>.

<sup>63</sup> Khalil AlHajal, *Metro Detroit Stats: Oakland County Triples Small Business Investment as Region Grows Population*, MLIVE.COM (March 13, 2014), [http://www.mlive.com/news/detroit/index.ssf/2014/03/metro\\_detroit\\_stats\\_oakland\\_co.html](http://www.mlive.com/news/detroit/index.ssf/2014/03/metro_detroit_stats_oakland_co.html).

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

terms of private capital, Michigan has about forty venture capital firms and about eight angel investor groups.<sup>68</sup> Tim Peterson, the outgoing chair of the Michigan Venture Capital Associate, stated that “in Michigan, we’ve accelerated venture under management and are getting more deals done compared to most of the rest of the country.”<sup>69</sup> In terms of venture capital supply, the typical preferred initial investment size across Michigan venture funds is \$1 to \$3 million.<sup>70</sup> Moreover, the amount of capital under management in Michigan since 2000 has grown by almost 75%.<sup>71</sup> While accounting for 98% of all employers and 79% of the Michigan’s economy as well as twenty-two billion dollars in income and 1.5 billion dollars in commercial loans, it becomes evident that these businesses are crucial to Michigan’s economic health and well being.<sup>72</sup>

### III. NON-EQUITY CAPITAL-FINANCING

#### A. Financial Options Inside the Company

Companies are not always forced to rely on commercial lending to finance their capital needs.<sup>73</sup> There are options available to a company, which allow it to finance itself by using its own assets or selling its own debt.<sup>74</sup> In reality, each of the options listed within this Section are used sparingly, and require a unique asset in order to be utilized.<sup>75</sup> Thus, even though these

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<sup>67</sup> THE MICHIGAN VENTURE CAPITAL REPORT: CREATING THE FOUNDATION FOR BUSINESS GROWTH IN MICHIGAN, (2007), available at <http://www.cfe.umich.edu/files/mvcreport.pdf>.

<sup>68</sup> *Id.* THE MICHIGAN VENTURE CAPITAL REPORT: CREATING THE FOUNDATION FOR BUSINESS GROWTH IN MICHIGAN, (2007), available at <http://www.cfe.umich.edu/files/mvcreport.pdf>.

<sup>69</sup> *Outgoing MVCA Chair Tim Petersen: VC in Michigan Bucking National Trend, Inspiring Startup Culture in State*, MICHIGANVCA.ORG (last visited March 25, 2014), <http://michiganvca.org/blog/tag/tim-petersen/>.

<sup>70</sup> THE MICHIGAN VENTURE CAPITAL REPORT: CREATING THE FOUNDATION FOR BUSINESS GROWTH IN MICHIGAN, (2007), at 12, available at <http://www.cfe.umich.edu/files/mvcreport.pdf>.

<sup>71</sup> *Id.* at 9.

<sup>72</sup> SMALL BUSINESS ADMINISTRATION: OFFICE OF ADVOCACY-SMALL BUSINESS PROFILE: MICHIGAN, (2012) available at <http://www.sba.gov/sites/default/files/mi12.pdf>.

<sup>73</sup> *Financing Options Described*, SBDCMICHIGAN.ORG, (last visited February 28, 2014) available at <http://www.sbdcmichigan.org/wp-content/uploads/2014/01/Financing-Options-Described.pdf>.

<sup>74</sup> See *infra* Section A and B.

<sup>75</sup> *Securitization An Attractive Option for Closing the Liquidity Gap*, PNC BANK available at

options are available, they are typically used in conjunction with other financing methods.<sup>76</sup> Nonetheless, their structures and benefits will be discussed below in order to compare and contrast their advantages against modern crowdfunding options like the one recently enacted by Michigan.

### *1. Personal Savings, Friends, and Family*

Financing a start-up or company may be achieved by obtaining personal loans from friends and family. Typically, this is the first avenue of financing small business owners tap before venturing out for more commercial loans.<sup>77</sup> In addition, small businesses owners tend to use a significant amount of their personal savings in order to finance their business expansions or startup needs.<sup>78</sup> The likelihood of successful results when small business owners utilize personal savings or loans from friends and family varies on a case-by-case basis.<sup>79</sup> For startups seeking financing, these two options may be the only ones available as many banks are unlikely to provide financing for companies or entrepreneurs without any track record.<sup>80</sup> As such, many companies will start by using personal loans, but quickly will move on to other financial options in order to operate.

### *2. Asset Securitization*

The last forty years have shown how valuable asset-based financing can be for capital

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[http://content.pncmc.com/live/pnc/corporate/pncideas/articles/Receivables\\_Securitization.pdf](http://content.pncmc.com/live/pnc/corporate/pncideas/articles/Receivables_Securitization.pdf).[http://content.pncmc.com/live/pnc/corporate/pncideas/articles/Receivables\\_Securitization.pdf](http://content.pncmc.com/live/pnc/corporate/pncideas/articles/Receivables_Securitization.pdf). Securitization may be a source of financing if a company maintains total domestic receivables of \$50 million or more. *Id.*

<sup>76</sup> Tiffany Wright, *Can Sole Proprietorships Issue Bonds?*, HOUSTON CHRONICLE <http://smallbusiness.chron.com/can-sole-proprietorships-issue-bonds-71750.html>.

<sup>77</sup> *Borrowing from Friends and Family*, , ENTREPRENEUR.COM (last visited March 25, 2014) *available at* <http://www.entrepreneur.com/article/24334> (“After self-financing, the second most popular source for startup money is composed of friends, relatives and business associates”).

<sup>78</sup> *Id.*

<sup>79</sup> *The Ins and Outs of Raising Money From Friends and Family*, ENTREPRENEUR.COM (last visited March 25, 2014) *available at* <http://www.entrepreneur.com/article/228103>.

<sup>80</sup> Paul Sullivan, *Financing Start-Up Dreams With Retirement Savings*, NYTIMES (September 13, 2013) <http://www.nytimes.com/2013/09/14/your-money/financing-start-up-dreams-with-retirement-savings.html>.

raising.<sup>81</sup> The most highly recognized asset-based financing options are mortgage-backed securities.<sup>82</sup> Securitization requires a company to have assets that have rights to future payments.<sup>83</sup> These are commonly called receivables<sup>84</sup> For example, a company that originates mortgages can securitize those mortgages.<sup>85</sup> Other typical assets suitable for securitization are car-finance loans; credit card receivables; medical receivables; factored trade receivables; equipment leases; consumer receivables; royalty payment streams; and student loans.<sup>86</sup> Once particular assets have been identified, the company will transfer these assets into a special purpose vehicle (SPV).<sup>87</sup> Essentially, the purpose of this transaction is to separate the risk inherent in the company's business from those wishing to invest in the securities.<sup>88</sup> The security is then offered to investors in public offerings or private placements.<sup>89</sup>

There are many benefits companies may receive from securitization. Securitization provides the company with instant cash for financing.<sup>90</sup> Instead of a mortgage originator waiting thirty years to regain the investment used in a loan, the company is selling their receivables and getting cash necessary to foster more business and make more loans.<sup>91</sup> Investors prefer securitized assets to normal business assets because there is a level of bankruptcy remoteness.<sup>92</sup> The remoteness means that if the company were to become insolvent, the investors would still be

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<sup>81</sup> *Ins and Outs of Asset-Based Loans*, ENTREPRENEUR.COM (last visited March 25, 2014) available at <http://www.entrepreneur.com/article/52726>.

<sup>82</sup> Leslie Shaffer, *Are Notorious Asset-Backed Securities Back in Favor?* CNBC (September 25, 2013) <http://www.cnbc.com/id/101061028>.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 136.

<sup>86</sup> *Realizing Value Through Asset Securitization*, WILMINGTON TRUST (last visited March 25, 2014) available at <https://www.wilmingtontrust.com/wtcom/index.jsp?fileid=3000127>.

<sup>87</sup> *Supra* note 70, Schwarcz at 136.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 403.

<sup>90</sup> *Id.* at 137

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 135.

entitled to their share of the periodic payments from the receivables because the SPV is a different entity than the company that originated the loans.<sup>93</sup> The periodic payments are valuable to investors looking for a steady stream of payments.<sup>94</sup> Additionally, since the company will be pooling a significant amount of receivables into one SPV, these SPV's can pool together lower grade receivables with higher-grade receivables in order to receive a higher rating for interest rate purposes.<sup>95</sup> The company also benefits because securitization is not recorded as a liability on their balance sheet, which avoids raising the business's debt-to equity ratio.<sup>96</sup>

Nevertheless, there are limitations of securitization. First, not all assets can be securitized, and thus not all companies can use this option of financing. Additionally, because of the recent mortgage-backed securities crisis, many investors now require that assets within an SPV be rated as a high quality investment in order to avoid losses.<sup>97</sup> Small business owners with assets, which would qualify for future payments, may be too risky for current investors to consider.<sup>98</sup> Unless a small business has a particular asset, which would qualify for securitization, the small business would still have to deal with the fact it has less collateral, a shorter track record, and financial statements that are not audited.<sup>99</sup>

### 3. *Debentures and Bonds*

Bonds and debentures are very similar financial tools. The only difference between them is whether they are secured by collateral. Bonds are typically secured, whereas debentures are

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<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* at 137.

<sup>96</sup> *Id.* at 135.

<sup>97</sup> James Wilcox, *FRSSF Economic Letter: Securitization and Small Business*, FEDERAL RESERVE BANK OF SAN FRANCISCO July 18, 2011, <http://www.frbsf.org/economic-research/publications/economic-letter/2011/july/securitization-small-business/>.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

unsecured.<sup>100</sup> Both can be privately or publically placed.<sup>101</sup> Debt securities issued by a company are inherently riskier than government bonds.<sup>102</sup> A bond is essentially an obligation of a company to pay back the investor's money with interest over a specific period of time.<sup>103</sup> The issuance of bonds is controlled by a contract known as an indenture.<sup>104</sup> The indenture is typically negotiated between the company and the trustee of the bondholders.<sup>105</sup> The indenture controls the duties and rights of the respective parties to the contract.<sup>106</sup> Since it is a right to payment in the future, investors typically ask for a variety of assurances in order to make sure they will be paid.<sup>107</sup> Examples of protections include call protection and sinking funds, as well as securing the bond issuance with particular company assets.<sup>108</sup>

From the perspective of a small business owner, the benefits of issuing bonds do not outweigh the disadvantages. In practice, only large companies and institutional investors issue bonds.<sup>109</sup> Issuance of bonds requires complying with a wide variety of federal regulations.<sup>110</sup> It also requires marketing and solicitation in order to find a sufficient number of investors interested in the transaction.<sup>111</sup> As a result, small business owners are unlikely to issue bonds or debentures because investors are not likely to want to take the risk inherent with a small

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<sup>100</sup> CAMBRIDGE DICTIONARY ("a type of loan, often used by companies to raise money, that is paid back over a long period of time and at a fixed rate of interest. In the UK, but not in the US, debentures are secured against property or other assets owned by the borrower").

<sup>101</sup> William Carney, CORPORATE FINANCE: PRINCIPLES AND PRACTICE, Foundation Press 2nd ed.

<sup>102</sup> *Id.* See also Corporate Bonds Explained, YAHOO FINANCE (last visited March 29, 2014) available at [http://finance.yahoo.com/education/bond/article/101190/Corporate\\_Bonds\\_Explained](http://finance.yahoo.com/education/bond/article/101190/Corporate_Bonds_Explained).

<sup>103</sup> See *supra* Carney, at 357-58.

<sup>104</sup> *Id.* at 358.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> Tiffany Wright, *Can Sole Proprietorships Issue Bonds?*, HOUSTON CHRONICLE <http://smallbusiness.chron.com/can-sole-proprietorships-issue-bonds-71750.html>.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*



business.<sup>112</sup> Much like securitization, if a company lacks sufficient assets, investors will be unlikely to invest with the company.<sup>113</sup>

All three options are available to companies looking to finance capital by using their own balance sheets or assets.<sup>114</sup> However, these options are not always possible for most companies.<sup>115</sup> Personal loans typically will not be large enough to cover the operational needs of the small business, securitization requires particular assets, and bonds involve providing sufficient collateral, business savvy, and a large pool of potential investors.<sup>116</sup> As a consequence, many small businesses tend to rely heavily on commercial loans.<sup>117</sup>

## B. Commercial Bank Lending

Commercial bank lending is one of the oldest forms of financing available.<sup>118</sup> Banks most often will lend through a process called secured lending.<sup>119</sup> This is typically performed when a bank provides a company with a loan in return for security.<sup>120</sup> The security takes a form of assets in the company's possession.<sup>121</sup> Any asset of value may be collateralized, including accounts and healthcare receivables, company equipment and fixtures, stocks and negotiable instruments, and

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<sup>112</sup> U.S. Department of State, *How Corporation Raise Capital*, (last visited April 7, 2014) available at [http://economics.about.com/od/smallbigbusiness/a/corp\\_capital.htm](http://economics.about.com/od/smallbigbusiness/a/corp_capital.htm) (“if investors doubt a company's ability to meet its interest obligations, they either will refuse to buy its bonds or will demand a higher rate of interest to compensate them for their increased risk. For this reason, smaller corporations can seldom raise much capital by issuing bonds”).

<sup>113</sup> *Id.*

<sup>114</sup> See *supra* Section A and B.

<sup>115</sup> *Id.*

<sup>116</sup> See *supra* note 113.

<sup>117</sup> J.D. Harrison, *Small Business Guide: Where to Find Capital*, WASHINGTON POST (April 20, 2014) [http://www.washingtonpost.com/business/on-small-business/small-business-guide-where-to-find-capital/2014/04/20/22547126-c58d-11e3-bf7a-be01a9b69cf1\\_story.html](http://www.washingtonpost.com/business/on-small-business/small-business-guide-where-to-find-capital/2014/04/20/22547126-c58d-11e3-bf7a-be01a9b69cf1_story.html).

<sup>118</sup> Rohit Arora, *Why Big Banks are Lending More to Small Businesses*, ENTREPRENEUR (January 15, 2014) <http://www.entrepreneur.com/article/230819>.

<sup>119</sup> *Id.*

<sup>120</sup> *Ins and Outs of Asset-Based Loans*, ENTREPRENEUR.COM (last visited March 25, 2014) available at <http://www.entrepreneur.com/article/52726>.

<sup>121</sup> *Id.*

the company's inventory.<sup>122</sup> A lender will take a security interest and perfect it by filing a financing statement to set up its priority as to other secured creditors.<sup>123</sup> In the event of the company's default, the creditor has the right to repossess the goods or assets collateralized and cover any losses by holding a redemption sale.<sup>124</sup> In terms of small businesses, almost every loan granted requires a collateralized asset to cover the value of the loan.<sup>125</sup> Even where the government is offering to guarantee the loan provided, security is still required in order to effectuate the loan processes.<sup>126</sup>

### *1. SBA Loans*

A typical small business may receive a loan from any lending institution. However, SBA loans are preferable to direct lenders because the SBA provides a government guarantee to the lender for any losses suffered.<sup>127</sup> If a company qualifies as a small business, the SBA provides a wide variety of services, but their most unique is the financing available for small business owners.<sup>128</sup> The most significant loans are those provided under 7(a) Loan Program and the Microloan Program.<sup>129</sup> The SBA also provides loans for the Certified Development Company or 504 Loan Program, and the Small Business Investment Company Program, although the latter are not used as frequently.<sup>130</sup>

The loans are unique in that they alter the lending process by inserting the SBA as a party

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<sup>122</sup> Eric Markowitz, *5 Tips for Using Collateral to Secure a Small Business Loan*, INC. (January 31, 2011) <http://www.inc.com/guides/201101/5-tips-using-collateral-to-secure-a-small-business-loan.html> ("Most commonly, collateral is real property (i.e. an owner-occupied home), but it can also be represented by your business's inventory, cash savings or deposits, and equipment").

<sup>123</sup> Whaley and McJohn, *PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS*, 8<sup>th</sup> Ed. at 100-101.

<sup>124</sup> *Credit Factors: Collateral*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/collateral>

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Small Business Resource-Fall 2013*, SBA.GOV (last visited March 25, 2014) available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf).

<sup>128</sup> *Id.* at 11-12

<sup>129</sup> *Id.* at 11.

<sup>130</sup> 13 CFR, 12(f)

to the lending contract.<sup>131</sup> Typically, the SBA acts as the guarantor of the loan to the lender in order to help incentivize the lender to provide loans to the small business.<sup>132</sup> Depending on the size of the loan, the SBA will guarantee as much as 85% of the loan.<sup>133</sup> The interest rates attached to the loans are typically negotiated between the lender and the borrower.<sup>134</sup> The maximum rate comprises two parts: (1) a base rate, like LIBOR; and (2) an allowable spread, which is determined by the lender, but is limited to 2.25% to 2.75% depending on the maturity for the loan.<sup>135</sup> To qualify for an 7(a) Loan the loan must be going to a business, not an individual.<sup>136</sup> Eligibility concerns the income of the business and not the individual.<sup>137</sup> At the maximum, 7(a) loans max out at \$5 million.<sup>138</sup> However, there is no set minimum loan amount.<sup>139</sup> During the fiscal year of 2012, the average loan amount was \$337,730.<sup>140</sup>

As with any commercial lending program, there are some seemingly draconian drawbacks. Every 7(a) loan must be fully secured, but a company will not be declined a loan if the only unfavorable factor is inadequate collateral—provided the company puts up all the collateral it does possess.<sup>141</sup> This means both corporate and personal assets must secure the loan until the recovery amount equals the loan amount or until all the owner's assets have been

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<sup>131</sup> *Small Business Resource-Fall 2013*, SBA.GOV (last visited March 25, 2014) available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf) at 12.

<sup>132</sup> *Id.* at 11.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* at 12.

<sup>135</sup> *Id.* LIBOR stands for “the London Inter-Bank Offered Rate” and “is supposed to indicate what a bank would pay to borrow dollars for three months from other banks at 11 am on the day it is set.” *The Rotten Heart of Finance*, THE ECONOMIST (July 7, 2012) <http://www.economist.com/node/21558281>.

<sup>136</sup> *7(a) Loan Program Eligibility*, SBA.GOV, (last visited March 24, 2014) available at <http://www.sba.gov/content/7a-loan-program-eligibility>.

<sup>137</sup> *Small Business Resource-Fall 2013*, SBA.GOV (last visited March 25, 2014) available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf) at 12.

<sup>138</sup> *7(a) Loan Amounts, Fees & Rates*, SBA.GOV, (last visited March 24, 2014) available at <http://www.sba.gov/content/7a-loan-amounts-fees-interest-rates>.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Small Business Resource-Fall 2013*, SBA.GOV (last visited March 25, 2014) available at [http://www.sba.gov/sites/default/files/files/resourceguide\\_national.pdf](http://www.sba.gov/sites/default/files/files/resourceguide_national.pdf) at 12.

provided.<sup>142</sup> Personal guarantees are also required from the business owners holding 20% equity or more.<sup>143</sup> Thus, the owners of a company with insufficient assets will most likely mortgage their houses along with any other asset of value in order to provide sufficient collateral for the business loan.<sup>144</sup>

## *2. Michigan Economic Development Commission*

Most states or regions within states have economic development associations or commissions.<sup>145</sup> Michigan is no different. The Engler Administration created the Michigan Economic Development Commission (MEDC) in 1999.<sup>146</sup> It is a quasi-public department of state government, which helps to provide Michigan business owners with capital resources.<sup>147</sup> Their options range from grant funding programs, debt and equity funding, and even federal matching programs.<sup>148</sup> What is unique about MEDC is it often hosts start up competitions, where idea are pitched and the winning competitors receive funding.<sup>149</sup> The benefit of these programs is the validation of business plans and a subsequent increased likelihood that other lenders will be willing to lend in the future.<sup>150</sup> The MEDC also maintains connections to angel and venture capital funds.<sup>151</sup> Ultimately, each option available through MEDC varies in its requirements and the MEDC does not play any role in the lending process, but merely aids in the networking

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<sup>142</sup> *7(a) Loan Repayment Terms*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/7a-loan-repayment-terms>.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Economic Development Agencies*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/economic-development-agencies> (“Every state and many local governments have economic development agencies dedicated to assisting new and established businesses”).

<sup>146</sup> Michael D. LaFaive and James M. Hohman, *What Is the Michigan Economic Development Corp.?*, MACKINAC CENTER FOR PUBLIC POLICY, available at <https://www.mackinac.org/10923>.

<sup>147</sup> *Id.*

<sup>148</sup> *Capital*, MEDC (last visited April 14, 2014) available at <http://www.michiganbusiness.org/start-up/capital/>.

<sup>149</sup> *Id.*

<sup>150</sup> *Capital*, MEDC (last visited April 14, 2014) available at <http://www.michiganbusiness.org/start-up/capital/>.

<sup>151</sup> *Id.*

process for business owners and investors.<sup>152</sup>

### *3. Non-Traditional Debt Alternatives*

While the majority of small business owners rely heavily on bank loans, they will supplement their capital needs with a wide-variety of other options including personal savings, home equity loans, and personal and business credit cards.<sup>153</sup> Credit card financing accounts for 7% of startup capital debt.<sup>154</sup> Personal savings are used roughly 70% of the time, which is to be expected when most loans require deposits or advance fees.<sup>155</sup> The statistics from the SBA show small businesses are more willing to use credit cards when other credit options are limited.<sup>156</sup> Home equity loans account for about 4 to 8% depending on whether the owner is an employer or not.<sup>157</sup>

The statistics and information within this Section show how current non-equity financing fails to provide small business owners with realistic options for financing their operational needs. If within every non-equity option the prospective lender or investor requires assets as security, a business looking to acquire assets through a loan or investment may be out of luck. As such, this lack-of-credit concern was recognized as an issue even before the turn of the twentieth century.<sup>158</sup> And, back in the 1930s, the entire market was affected by the lack of available credit.<sup>159</sup> Thus, equity issuance within the last 100 years has increased dramatically as another

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<sup>152</sup> *Id.*

<sup>153</sup> *Frequently Asked Questions about Small Business Finance*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/sites/default/files/files/Finance%20FAQ%208-25-11%20FINAL%20for%20web.pdf>

<sup>154</sup> *Id.*

<sup>155</sup> *Id.* at 2.

<sup>156</sup> *The Basics of Using Credit Cards to fund Your New Business*, ENTREPRENEUR (lasted visited March 23, 2014) available at <http://www.entrepreneur.com/article/228193>.

<sup>157</sup> *The Basics of Home Equity Financing*, ENTREPRENEUR (lasted visited March 23, 2014) available at <http://www.entrepreneur.com/article/228451>.

<sup>158</sup> Ayşegül Şahin *et al.*, *Why Small Businesses Were Hit Harder by the Recent Recession*, FEDERAL RESERVE BANK OF NEW YORK, (last visited April 8, 2014) available at [http://www.newyorkfed.org/research/current\\_issues/ci17-4.pdf](http://www.newyorkfed.org/research/current_issues/ci17-4.pdf).

<sup>159</sup> *Equity vs. Sub-Debt Financing*, ENTREPRENEUR (lasted visited March 23, 2014) available at

potential capital raising option.<sup>160</sup>

#### IV. EQUITY ISSUANCE

##### A. Securities Registration or Exemption

Equity financing is a viable option for businesses that manage to attract a wide variety of investors.<sup>161</sup> Equity financing is simply a “method of financing in which a company issues shares of its stock and receives money in return.”<sup>162</sup> Typically the main reason a company considers equity financing is the dramatic increase in financing.<sup>163</sup> However, an increase in capital will typically include an increase in consequences.<sup>164</sup> This Section explores how issuing securities, whether publically or privately, may negatively impact a small business.

Before the Great Depression the securities market was analogous to the lawlessness that existed in the wild-west.<sup>165</sup> It took the complete financial collapse of the Great Depression for any reform to take place.<sup>166</sup> The regulatory restructuring, which took place afterwards fell within two main security overhauls. The first overhaul occurred when Congress enacted the Securities Act of 1933 to encourage disclosure and corporate candor in the purchase and sale of

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<http://www.entrepreneur.com/article/72734>.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Equity Financing*, ENTREPRENEUR (lasted visited March 23, 2014) available at

<http://www.entrepreneur.com/encyclopedia/equity-financing>.

<sup>163</sup> *Should Your Small Business Go Public? Consider the Benefits and Risks of Becoming a Publicly Traded Company*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/community/blogs/community-blogs/business-law-advisor/should-your-small-business-go-public-consider-0>.

<sup>164</sup> *Id.*

<sup>165</sup> Allen Boyer, *The Great Gatsby, the Black Sox, High Finance, and American Law*, 88 MICH. L. REV. 328, 340 (1989) (“[I]t is eerie how well *The Great Gatsby* predicted the end of the Twenties. Arnold Rothstein died in 1928, mortally wounded as he left a poker game in a Manhattan hotel. Documents found among his papers showed the connection between Tammany Hall and the underworld. These scandals brought to office the reform administration of Fiorello LaGuardia, and brought to national prominence New York Governor Franklin Delano Roosevelt. The Liberty Bond boom of the early 1920s touched off the stock market speculation which characterized the rest of the decade. This helped cause the Great Depression, and led, in turn, to the securities legislation of 1933 and 1934”).

<sup>166</sup> Brian Murray & Donald J. Wallace, *You Shouldn't Be Required to Plead More Than You Have to Prove*, 53 BAYLOR L. REV. 783, 784 (2001).

securities.<sup>167</sup> Investors now had a remedy where they could ask for strict liability against issuers of public securities, who issued materially false or misleading registration statements.<sup>168</sup> The second was the passage of the Securities Act of 1934, which imposed reporting requirements on specific companies.<sup>169</sup> The 1934 Act helped to increase the amount of publically available information regarding investments in the market.<sup>170</sup>

### *1. Public or Private Equity*

Although equity financing provides investors with a massive potential for unrestrained capital, in reality it is far from easy.<sup>171</sup> A company first choice is to decide between registering its security as publically traded or finding an exemption.<sup>172</sup> Regardless, a company's decision to issue equity is expensive. Some numbers range as high as \$1 million, but more commonly are around \$250,000, depending on the particular circumstances.<sup>173</sup> The costs are a combination of legal, accounting, and filing fees as well as underwriting expenses.<sup>174</sup> If a company decides to register their security and go public, the company will be closely scrutinized by market analysts, will qualify as a '34 Act reporting company requiring quarterly financial reports, and will be exposed to liability for securities fraud.<sup>175</sup> Since the costs and negative consequences of issuing public securities often outweigh the monetary benefits derived therefrom, many small businesses

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<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* at 785.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Should Your Small Business Go Public? Consider the Benefits and Risks of Becoming a Publicly Traded Company*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/community/blogs/community-blogs/business-law-advisor/should-your-small-business-go-public-consider-0>.

<sup>173</sup> *The Advantages and Disadvantages of Going Public*, LEWIS-KAPPES (last visited April 12, 2014) available at <http://www.lewis-kappes.com/CM/FSDP/PracticeCenter/Securities/Securities--Business-Focus.asp?focus=topic&id=3>.

<sup>174</sup> *Considering an IPO? The Costs of Going Public and Being Public May Surprise You*, PWC (last visited March 23, 2014) available at [http://www.pwc.com/en\\_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf](http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf).

<sup>175</sup> *The Advantages and Disadvantages of Going Public*, LEWIS-KAPPES (last visited April 12, 2014) available at <http://www.lewis-kappes.com/CM/FSDP/PracticeCenter/Securities/Securities--Business-Focus.asp?focus=topic&id=3>.

opt for private placement of their securities.<sup>176</sup> Private issuance requires small business owners to issue securities that fit within an exemption.<sup>177</sup> However, even with private equity, small businesses may encounter trouble.<sup>178</sup>

Companies that opt for private equity run into the issue that private equity is not abundantly available or easily located. Venture capital funds, angel investor groups, or large institutional investors tend to be the major players involved with private equity offerings.<sup>179</sup> Angel investors are typically the first source of outside funding that small business will try to attract.<sup>180</sup> An angel investor is broadly considered anyone who provides his or her personal funds to finance a new business enterprise.<sup>181</sup> However, a more narrow definition aligns angel investors with the SEC's definition of accredited investors.<sup>182</sup> In 2011, angel investors provided roughly \$8.9 billion going to 26,300 startups, for an average investment of \$338,400.<sup>183</sup> Angel investors are individuals who have entrepreneurial experience of their own and tend to invest in industries with which they are familiar.<sup>184</sup> Angel investors tend to provide more than just capital as many entrepreneurs look to their angel investors for counseling and guidance.<sup>185</sup> Comparably, angel investors are attracted to the start-up's non-financial aspects, they will be more likely to invest in

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<sup>176</sup> *SBIC Program: Seeking Financing for your Small Business*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/sbic-program>.

<sup>177</sup> Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 Del. J. Corp. L. 1, 10-11 (2008).

<sup>178</sup> *Id.* at 9.

<sup>179</sup> *Id.* at 10-11 (“[P]rivate equity firms rely on “professional” investor exemption under U.S. securities law by focusing exclusively on “professional” or “sophisticated” investors, such as pension funds, insurance companies, large charitable endowments, and high net worth individuals”).

<sup>180</sup> Darian M. Ibrahim, *Should Angel-Backed Start-Ups Reject Venture Capital?*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 251, 253 (2013)

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> Dave Mielach, *15 Creative Financing Methods for Startups*, BUSINESS NEWS, (last visited April 8, 2014) available at <http://www.businessnewsdaily.com/1733-small-business-financing-options-.html>.

<sup>184</sup> *Venture Capital*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/venture-capital> (“the typical business angels are often former entrepreneurs or executives who cashed out and retired early from ventures that they started and grew into successful businesses”).

<sup>185</sup> *Id.*



a company that has a higher risk while lacking a fail-safe investment return.<sup>186</sup>

Venture capitalists are considered to be the professional investors, who use other people's money to finance young, private companies with the potential for rapid development, sometimes even allowing for unsecured commitments.<sup>187</sup> In 2011, the venture-capital industry made 2,725 investments totaling \$21.2 billion.<sup>188</sup> Venture funds will typically opt for an active involvement in the company; the best way to achieve that is by having a seat on the board of the company.<sup>189</sup> Depending on the size of the investment, a fund may be granted more than one seat on the board.<sup>190</sup> The reality is that venture capitalists are predominantly concerned with profit and a return on their investment.<sup>191</sup> Thus, venture capitalists may be involved with the company for a significant period of time, but will always provide themselves with an exit plan in case their investment goes sour.<sup>192</sup> Typically though, private investment from angel investors or venture capital funds occurs during the start up stage.<sup>193</sup> Although not unheard of, it is less likely that an existing business will find private equity to assist in its expansion goals.<sup>194</sup>

Nevertheless, equity financing has played a revolutionary role in helping small businesses raise the necessary capital for their operational needs.<sup>195</sup> The vast majority of the time the small business owner will be hard pressed to find private equity without some assistance.<sup>196</sup> This is

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<sup>186</sup> *Id.*

<sup>187</sup> *Id.* (“investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk”).

<sup>188</sup> See Mielach, *supra* note 185, at 1.

<sup>189</sup> Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 112 (2010).

<sup>190</sup> *Id.*

<sup>191</sup> *Id.*

<sup>192</sup> *Venture Capital*, SBA.GOV (last visited March 25, 2014) available at <http://www.sba.gov/content/venture-capital>

<sup>193</sup> *Id.*

<sup>194</sup> *Id.* (“Typically, angel capital and venture capital investors provide capital unsecured by assets to young, private companies”).

<sup>195</sup> Steven M. Davidoff, *Black Market Capital*, 2008 Colum. Bus. L. Rev. 172, 217 (2008).

<sup>196</sup> Dileep Rao, *Why 99.95% of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital*, FORBES July 22, 2013 <http://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time->

why the demand for a crowdfunding exemption began to develop.<sup>197</sup> The idea is crowdfunding will help to bridge the gap between private equity financing and a small business's financial needs.<sup>198</sup> The whole process begins with the issuer finding an exemption.<sup>199</sup>

## 2. Michigan's Small Business Crowdfunding Exemption

Regardless of whether or not an issuer must register the sale of securities with the federal government, the issuer may still be subject to state securities laws.<sup>200</sup> The idea of a crowdfunding exemption has more appreciation within the realm of state security laws than it currently does in the federal regime.<sup>201</sup> There are currently four states, which provide for crowdfunding exemptions from their state security laws.<sup>202</sup> The states all allow for intrastate crowdfunding exemptions<sup>203</sup> in order to help boost their local economies by providing an alternate and easier form of funding for small business owners.<sup>204</sup> Michigan was the latest state to enact a version of the crowdfunding exemption. The newly enacted exemption is found in Public Act 264.<sup>205</sup>

The legislation establishes an intrastate exemption for crowdfunding, which occurs within the state of Michigan.<sup>206</sup> The Michigan law allows businesses that reside within the state

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seeking-venture-capital/.

<sup>197</sup> Scott Shane, *Why Equity Crowdfunding Isn't A Threat to Venture Capital*, ENTREPRENEUR October 7, 2013 <http://www.entrepreneur.com/article/228738>

<sup>198</sup> *Id.* ("Equity crowdfunding portals will complement venture capital by broadening the "friends and family" slice of informal investing").

<sup>199</sup> *See* note 197.

<sup>200</sup> Amanda Lewan, *Michigan's Crowdfunding Bill Passes the Senate*, MICHIPRENEUR (last visited April 12, 2014) available at <http://www.michipreneur.com/michigans-crowdfunding-bill-passes-the-senate/>.

<sup>201</sup> Seth Ashby *et al.*, *Legislation Allows Michigan Companies to Raise Capital, Avoid Federal Crowdfunding Rules*, NATIONAL LAW REVIEW (last visited April 8, 2014) available at <http://www.natlawreview.com/article/legislation-allows-michigan-companies-to-raise-capital-avoid-federal-crowdfunding-ru>.

<sup>202</sup> *Id.*

<sup>203</sup> Since the offering is an intrastate offering, the issuance of the security will fit within the SEC's intrastate offering. This is how the state's crowdfunding law avoid the federal regime.

<sup>204</sup> *Id.*

<sup>205</sup> *Id.* *See* also M.C.L.A. § 451.2202a.

<sup>206</sup> Alan McGlade, *Michigan Governor Signs Intrastate Crowdfunding Exemption*, FORBES, December 31, 2013 <http://www.forbes.com/sites/alanmcglade/2013/12/31/michigan-governor-signs-intrastate-crowdfunding-exemption/>.

to circumvent SEC filing requirements and is expected to go into effect by late 2014.<sup>207</sup> Under the Michigan law, a Michigan business will be allowed to raise up to \$2 million from Michigan investors if the transaction meets certain requirements.<sup>208</sup>

The first requirement is the intrastate requirement. It requires the issuer be an entity domiciled in Michigan and all investors be Michigan residents.<sup>209</sup> The intrastate requirement is a harsh one in that a single offer to a non-resident would void the entire transaction to all investors, and would subject the issuer to litigation.<sup>210</sup> The intrastate requirement is how the issuance will avoid the SEC's filing and disclosure requirements because the offering must meet the requirements of Section 3(a)(11) of the federal Securities Act.<sup>211</sup> In order to determine if the investors are residents they must demonstrate they are domiciled within the State.<sup>212</sup> Comparably, the issuer's residency is determined by using the "80%" test, which states that "the issuer must (i) derive at least 80% of its gross revenues from Michigan; (ii) have 80% of its assets in Michigan; (iii) use at least 80% of the net proceeds of the offering in Michigan; and (iv) have its principal office in Michigan."<sup>213</sup>

Since the intrastate offering is an important aspect of the law, there is a limitation of reselling the security within nine months of the closing to any non-Michigan resident.<sup>214</sup> It allows for the sale of the investment to a Michigan resident, and if the sale occurs after nine

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<sup>207</sup> *Id.*

<sup>208</sup> Amanda Lewan, *Michigan's Crowdfunding Bill Passes the Senate*, MICHIPRENEUR (last visited April 12, 2014) available at <http://www.michipreneur.com/michigans-crowdfunding-bill-passes-the-senate/>.

<sup>209</sup> Seth Ashby *et al.*, *Legislation Allows Michigan Companies to Raise Capital, Avoid Federal Crowdfunding Rules*, NATIONAL LAW REVIEW (last visited April 8, 2014) available at <http://www.natlawreview.com/article/legislation-allows-michigan-companies-to-raise-capital-avoid-federal-crowdfunding-ru>.

<sup>210</sup> *Id.*

<sup>211</sup> *Intrastate Offering Exemption*, SEC.GOV, <http://www.sec.gov/info/smallbus/qasbsec.htm>.

<sup>212</sup> M.C.L.A. § 451.2202a(b)

<sup>213</sup> 15 USC 77c(a)(11)

<sup>214</sup> Seth Ashby *et al.*, *Legislation Allows Michigan Companies to Raise Capital, Avoid Federal Crowdfunding Rules*, NATIONAL LAW REVIEW (last visited April 8, 2014) available at <http://www.natlawreview.com/article/legislation-allows-michigan-companies-to-raise-capital-avoid-federal-crowdfunding-ru>.

months to any investor.<sup>215</sup> However, since this transaction qualifies as an exemption, the purchaser of the security wishing to sell their Michigan crowdfunded security will need to comply with the securities law themselves and either register the security or find their own exemption.<sup>216</sup>

The Michigan law provides for a range of offering amounts depending whether the issuer provides audited financial statements.<sup>217</sup> If the issuer provides audited financial statements to investors as part of the offering, the issuer has a maximum offering ceiling of \$2 million.<sup>218</sup> However, if the issuer does not make available audited financial statements, the maximum amount is limited to \$1 million.<sup>219</sup> What is important to note is the law aggregates sales of securities by the issuer within the prior twelve months.<sup>220</sup> Thus, an issuer who has already issued 2 million in securities within a twelve-month period would be prohibited for selling securities under this exemption.<sup>221</sup>

The issuer must also pay attention to the solicitation and sale requirements.<sup>222</sup> The law allows for general solicitation, but with a few caveats.<sup>223</sup> If the investor is not an "accredited investor"<sup>224</sup> then the issuer may not accept more than \$10,000 from such investor.<sup>225</sup> If the

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<sup>215</sup> *Id.*

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

<sup>223</sup> *Id.*

<sup>224</sup> *Accredited Investor Defined*, SEC.GOV, <https://www.sec.gov/answers/accred.htm>. Typical examples of accredited investors include "(1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person; or (3) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year."

<sup>225</sup> *Id.*

investor qualifies as an accredited investor then there is no limit on how much the issuer can accept.<sup>226</sup> Second, the issuer must provide a copy of the disclosure statement to each investor at the time the offer is made.<sup>227</sup>

If the issuer wishes to sell through the Internet, it must notify the State of Michigan.<sup>228</sup> Additional requirements are placed on the operator of the website.<sup>229</sup> The website must file a written notice with the State of Michigan that includes certain information about the operator.<sup>230</sup> Moreover, the website will not be required to meet Michigan's broker-dealer requirements, which is different from the federal crowdfunding exemption.<sup>231</sup> However, the website operator will be required to meet the broker-dealer criteria if the website solicits investors, handles any funds or securities, or receives compensation conditioned on the amount of securities that are sold in the offering.<sup>232</sup>

The issuer is still required to make continuing disclosures to the investors and the State of Michigan.<sup>233</sup> The reporting is required for as long as the securities remain outstanding.<sup>234</sup> The reports to the investors and the State of Michigan are quarterly.<sup>235</sup> The last requirement states the issuer must file a written or electronic notice to the State of Michigan at least ten days before it make an offer or use any website in connection with the crowdfunding exemption.<sup>236</sup> Although the requirements make the Michigan crowdfunding exemption seem easy, there are still aspects

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<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> *LARA Corporations, Securities & Commercial Licensing Bureau Offers Tips on Intrastate Equity Crowdfunding; 2013 PA 264 Streamlines Process for Michigan Investors to Invest in Michigan's Small Businesses*, LARA, (last visited April 20, 2014) [http://www.michigan.gov/lara/0,4601,7-154-10573\\_11472-320144--,00.html](http://www.michigan.gov/lara/0,4601,7-154-10573_11472-320144--,00.html).

<sup>234</sup> M.C.L.A. § 451.2202a(3)(c).

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

that cause analysts concern over whether the crowdfunding exemption is opening the doors for securities fraud.<sup>237</sup> The next Section explores the protections provided to investors and how experts interpret fraud allegations in reference to crowdfunding exemptions.<sup>238</sup>

## B. Securities Protection for Investors

Too often analysts endorsing the benefits and necessity of the crowdfunding exemption forget the main purpose of the securities laws, which is to protect the investors from fraudulent misrepresentations by the issuer.<sup>239</sup> The securities laws were not created as an effort to help increase issuer capital, nor were the laws created so issuers could easily raise financial assistance at the expense of their investor's trust.<sup>240</sup> It is not just fraud claims that issuers and small business owners have to be concerned about—analysts are concerned that investors are taking on a higher degree of risk without a proportionally higher requirement of reporting.<sup>241</sup> The concern is that for the “securities markets to work, it is critical to maintain investor trust in the integrity of the market . . . without a broad-based investor perception of legitimacy, people will not invest in the market, but put their money elsewhere.”<sup>242</sup> As such, the essential framework for a crowdfunding exemption should in mind the idea that investor's trust and perception of the market will control its legitimacy and integrity.

Complaints fall within three categories. First, crowdfunding or social networking sites

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<sup>237</sup> LARA Corporations, *Securities & Commercial Licensing Bureau Offers Tips on Intrastate Equity Crowdfunding; 2013 PA 264 Streamlines Process for Michigan Investors to Invest in Michigan's Small Businesses*, LARA, (last visited April 20, 2014) [http://www.michigan.gov/lara/0,4601,7-154-10573\\_11472-320144--,00.html](http://www.michigan.gov/lara/0,4601,7-154-10573_11472-320144--,00.html).

<sup>238</sup> Commissioner Luis A. Aguilar, *Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors*, SEC.GOV (last visited April 8, 2014) <http://www.sec.gov/News/Speech/Detail/Speech/1370540003081>.

<sup>239</sup> Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws-Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741 (2012)

<sup>240</sup> *Id.*

<sup>241</sup> Andrew C. Fink, *Protecting the Crowd and Raising Capital Through the Crowdfund Act*, 90 U. DET. MERCY L. REV. 1, 27 (2012)

<sup>242</sup> Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 936-37 (2011).

will not properly serve as intermediaries between the issuer and the investor.<sup>243</sup> A second cause for concern is the lack of sophistication of investors that are a part of the crowdfunding exemption.<sup>244</sup> Lastly, small businesses that are using crowdfunding as a financial tool have a significant higher prediction rate of failure, which could lead to more securities litigation.<sup>245</sup>

## V. ANALYSIS

### A. Michigan Crowdfunding Exemption Is Necessary for Small Businesses In Need of Capital

The lack of financial options for small businesses is not a new phenomenon. It is not just small businesses that are looking for financing for expansion; it is also that small businesses are looking for a capital source to start.<sup>246</sup> While larger companies spend a significant amount of their time disputing what the right ratio of debt to equity is, small businesses simply struggle to find either equity or debt financing to begin with.<sup>247</sup> This Section will demonstrate how current options available for small business owners are not ideal for the financing needs of small businesses.

When looking at non-equity options, such as loans, securitization, and bond issuance, small businesses rarely will have the necessary assets in order to utilize these options fully. In terms of balance sheet financing it is unlikely that small businesses will be able to use securitization or debt issuance as an option for raising capital. With respect to securitization, it is unlikely that small businesses will have sufficient annual receivables to use securitization as a

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<sup>243</sup> Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws-Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1759 (2012).

<sup>244</sup> C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, at 83.

<sup>245</sup> Eric Wagner, *Five Reasons 8 out of 10 Businesses Fail*, FORBES, September 12, 2013, <http://www.forbes.com/sites/ericwagner/2013/09/12/five-reasons-8-out-of-10-businesses-fail/> (“inability to nail a profitable business model with proven revenue streams”).

<sup>246</sup> Bonnie Kavoussi, *Small Businesses Struggling To Get Loans: Federal Reserve Study*, HUFFINGTON POST, August 15, 2012, [http://www.huffingtonpost.com/2012/08/15/small-business-loans\\_n\\_1778206.html](http://www.huffingtonpost.com/2012/08/15/small-business-loans_n_1778206.html).

<sup>247</sup> *Id.*

method of supplementing their financial needs. As of late, the use of securitization has been used by many medium-sized business, but it is sparingly used. Looking at bonds and debentures, it is a rare option for small business owners. Aside from the fact that small businesses do not have assets to use as collateral, nor do they have the business savvy necessary to organize, negotiate, and issue bonds, but typically bond issuance will require the help of an investment analyst to help gather investors willing to purchase the bonds.

In reference to loans, whether personal loans or from commercial lenders, family and friends are used relatively often. Loans from family and friends can be more lax than other financing options. There are no set requirements in terms of family loans. Thus, this tends to be the first place that startups and owners hoping to expand will look. However, personal debt and equity contributions are not sufficient enough to cover more startup costs. Average startup costs anywhere between \$10,000 to \$300,000.<sup>248</sup> Commercial loans are the most traditional financing option available. However, commercial loans require assets to be used as collateral. A new business would looking for a loan would be required to have the principal collateralize their personal assets as security for the business loan.

Crowdfunding can help with these issues because crowdfunding does not necessarily need assets. Although it would be wise and highly recommended that the business have some assets, there is no requirement, rather the security received is that the investors will have equity ownership in the company. Besides, unlike with bonds, where the issuer is required to pay back the amount of the bond after a fixed period, crowdfunding has no such requirement. Moreover, crowdfunding was implemented with the intention of streamlining a business capital-raising

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<sup>248</sup> Nicholas Carlson, *Turns Out It's Much cheaper To Build a Company Almost Anywhere Other Than San Francisco*, BUSINESS INSIDER, March 6, 2014 <http://www.businessinsider.com/san-francisco-is-expensive-for-startups-2014-3>.



methods. As a financial tool crowdfunding has the potential to alleviate issues for small businesses that lack sufficient collateral for loans, bonds, or securitization.

On the equity side, small business owners are first confronted with whether they will register a security offering with the SEC and have a public offering or find an exemption and offer through a private sale. In terms of a public offering, a small business may not have the necessary capital to pay the lawyer, accounting, and filing fees. Filing an IPO takes time and small business owners typically do not have much time, and in many cases need capital assistance much faster than equity offerings can provide. Additionally, filing a public offering will subject the small business owner to the 1934 Act, and the small business will then be reporting their quarterly financial reports, which also increase costs to the business overtime.

A small business utilizing an angel investor or venture capital fund has increased over the years. However, private equity investors work on an individual basis. Thus, unless a small business is aware of potential private equity investor or the business garnishes enough attention as to attract the investor's attention, it is unlikely that the two will become aware of each other. Small business loans in 2010 aggregated to the amount of \$652.2 billion, whereas angle investors only provided \$8.9 billion in financial assistance.<sup>249</sup>

In reality, angel investors are extremely beneficial for small business owners, angel investors tend to be those investors that have entrepreneurial experience and often provide hands on assistance and counseling to the small business. An effort to provide a higher chance to network angel investors with small business owners, would help to increase financial assistance from angel investor to companies. With venture capital funds, the funds are similar to a commercial lending operation, but without the specific requirement of collateralization. In terms

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<sup>249</sup> *SBA-Small Business Lending in the United States, 2009-2010*, SBA.GOV (last visited April 8, 2014) [http://www.sba.gov/sites/default/files/files/sbl\\_10study.pdf](http://www.sba.gov/sites/default/files/files/sbl_10study.pdf)

of financial assistance, venture capital funds only provided \$21.2 billion in equity financing in 2011.

When comparing the current process for private equity offerings it becomes apparent that there are problems of networking and facilitating loaning between two parties. Crowdfunding helps by placing all of the interested parties to a transaction together on one funding website. There the investors will have the opportunity to analyze and compare multiple businesses at once. This helps increase the interaction between small businesses and investors. Furthermore, it has the ability to decrease the amount of money that private investors spend on researching and locating the right companies. Since crowdfunding will help to bring investors together with businesses, this will help to increase competition between private equity investors and banks looking to make loans to small businesses. As such, crowdfunding helps to increase the likelihood that private equity investors will invest more frequently in small businesses.

Consequently, the current options of either non-equity or equity financing for small business are extremely limited. Although most companies will want a mix between equity and debt in order to help maximum profit for shareholders, many small business owners are left with a limited option of potential financial tools. Given this financial climate for small business owners, it does seem necessary that legislation be enacted in order to provide alternative options specifically geared for small businesses. Crowdfunding as an alternative has a variety of potential benefits that could increase capital to small businesses; as such it is a beneficial tool to consider for businesses that have limited options.

#### B. How Michigan's Crowdfunding Exemption Might Hurt Small Businesses

There are some benefits to Michigan's crowdfunding law as it is currently enacted. The

first is the limited costs associated with the offering.<sup>250</sup> An issuer will only have to pay a \$100 filing fee and any transactional costs associated with using the crowdfunding portal and legal advice.<sup>251</sup> Some numbers state that the transactional costs could add fall within the range of \$10,000 to \$40,000.<sup>252</sup> However, its not the money issues that are the cause for concern. The real concerns with this exemption stem from the many ancillary issues arise out of complying with the Michigan exemption. These issues and concerns make utilization of this financial tool a bad idea for the time being.

The role that accredited investors' play is one of initial reasons for concern. From its creation, an accredited investor was considered to be a sophisticated and business savvy financier.<sup>253</sup> The creation of the accredited investor was used in order to give an issuer the ability to presume that certain investors should know certain aspects about risk and business concerns. The Michigan exemption does not specifically require that sales be performed to accredited investors; rather the issuer that sells to non-accredited investors is limited to a \$10,000 maximum investment and cannot solicit investments from non-accredited investors. The problem is that the low investment amount does not correlate to safety for the non-accredited investor. The lack of sophistication does not require any more disclosures than what the issuer would otherwise be required to provide. Thus, the monetary limitation does nothing more than curb damages against an issuer for a later sue filed by the non-accredited investor.

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<sup>250</sup> See *infra* Part III Section B.

<sup>251</sup> *Id.*

<sup>252</sup> Deborah Sweeney, *Will Small Businesses Benefit From SEC's New Crowdfunding Rules?*, HUFFINGTON POST, November 20, 2013 [http://www.huffingtonpost.com/deborah-sweeney/will-small-businesses-benefit\\_b\\_4298388.html](http://www.huffingtonpost.com/deborah-sweeney/will-small-businesses-benefit_b_4298388.html). *It Might Cost You \$39K to Crowdfund \$100K under the SEC's New Rules*, VENTURE BEAT (last visited March 23, 2014) <http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/>.

<sup>253</sup> Timothea Xi, *The Advantages of an Accredited Investor*, CHRON (last visited April 8, 2014) <http://smallbusiness.chron.com/advantages-accredited-investor-65336.html> (“they meet Securities and Exchange Commission criteria for wealth and sophistication, accredited investors get the green light to invest in vehicles such as private placements for small businesses”).

The Michigan crowdfunding law requires that the issuer provide a lot of documentation to investors.<sup>254</sup> However, the requirement that the issuer disclose all of this information it may be of little value. Non-accredited investors are unlikely to have the necessary investment skill and business knowledge required in assessing the risks of the issuer. Additionally, over providing for disclosures may lead an unsophisticated investor to believe that all is well with their investment. The purpose of securities laws has always been to provide sufficient candor and disclosure to investors, and to prevent the sale of the “blue sky” to less knowledgeable investors. There is nothing in the current Michigan exemption that helps to facilitate that goal.

Another concern stems from the fact that startup businesses using the crowdfunding exemption have a higher chance of their business failing. Regardless of the legal merit of an investor’s claim when a business becomes insolvent, small businesses simply do not have the capital necessary to defend itself against securities claims by vexatious investors. Aside from the lack of necessary funds to defend lawsuits, the fact that startups are new enterprises, means their

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<sup>254</sup> M.C.L.A. § 451.2202. Specifically it states the following: “The disclosure statement must contain all of the following: (A) A description of the issuer, including its type of entity, the address and telephone number of its principal office, its formation history, its business plan, and the intended use of the offering proceeds, including any amounts to be paid, as compensation or otherwise, to any owner, executive officer, director, managing member, or other person occupying a similar status or performing similar functions on behalf of the issuer. (B) The identity of each person that owns more than 10% of the ownership interests of any class of securities of the issuer. (C) The identity of the executive officers, directors, and managing members of the issuer, and any other individuals who occupy similar status or perform similar functions in the name of and on behalf of the issuer, including their titles and their prior experience. (D) The terms and conditions of the securities being offered and of any outstanding securities of the issuer, the minimum and maximum amount of securities being offered, if any, and either the percentage ownership of the issuer represented by the offered securities or the valuation of the issuer implied by the price of the offered securities. (E) The identity of any person that the issuer has or intends to retain to assist the issuer in conducting the offering and sale of the securities, including the owner of any websites, if known, but excluding any person acting solely as an accountant or attorney and any employees whose primary job responsibilities involve the operating business of the issuer rather than assisting the issuer in raising capital, and for each person identified in response to this sub-subparagraph, a description of the consideration being paid to that person for that assistance. (F) A description of any litigation or legal proceedings involving the issuer or its management. (G) The name and address of any website that the issuer intends to use in connection with the offering, including its uniform resource locator or URL. If the issuer has not engaged a website described in this sub-subparagraph at the time the issuer files the disclosure statement described in this subparagraph with the administrator under this subdivision but subsequently does engage a website for use in connection with the offering, the issuer shall provide the information described in this sub-subparagraph to the administrator by filing a supplemental notice” *Id.*

securities are likely to be illiquid for some time. Thus, even where an investor becomes aware of unsuitable risks after purchasing security, without any viable market to resell their crowdfunded security, an investor will be stuck with a losing hand, without the ability to protect himself.

Another major concern is that crowdfunding portals will be serving as intermediaries between investors and small businesses. Prior to the Michigan exemption, highly sophisticated investment firms and their broker dealer departments occupied the intermediary spot between investors and businesses. Investment firms and their broker dealers are a highly regulated industry. No crowdfunding exemption to date has addressed the lack of regulation in terms of funding portals. Simple restrictions such as solicitation, handling funds, and conditioning compensation on the amount of securities sold is not sufficient enough to prevent fraud by these websites. As shown in the case of SoLoMend, funding portals can be problematic, and generate assertions that are hard to detect without extensive due diligence.

### C. Improving the Michigan Crowdfunding Exemption

The Michigan exemption is a great start for helping small businesses start or expand their enterprise. With a few adjustments the exemption would help strengthen the Michigan economy for small businesses for years to come. Starting with the most glaring issue of unregulated funding portals. In reality, history has displayed countless examples of what happens when society leaves an area of the market unregulated, and in the long run it never ends by benefiting society. Crowdfunding portals play a fundamental role in private equity offerings; however, the role is analogous to broker dealers. Although applying broker dealer requirements ad hoc to funding portals would not solve all of the issues, some form of regulation should be implemented. A simple solution would be to create a new securities department within Michigan's securities division to help evaluate fraud claims exclusively associated with crowdfunded securities. The

SEC has already expressed concern about the solicitations with these intrastate offerings; as such states should be on guard.<sup>255</sup> Aside for creating a department to overlook the funding portals, Michigan could enact legislation similar to the requirements placed on broker dealers. The reality is that Michigan cannot leave this area of the market unregulated with hopes that there will be no negative consequences.

In addition, Michigan as a pioneer of the state crowdfunding exemption needs to create an environment where investors feel safe when making their investments. As such, Michigan may be wise to limit the use of crowdfunding to only investors who qualify as accredited investors. This will naturally include both venture capital funds and angel investors. Accredited investors were created so that issuers could be certain that particular investors had the requisite sophistication and market savvy necessary when making risky investments. Since Michigan is a state whose economy is equally controlled by small businesses, creating an exemption that takes that into account is essential. Small businesses are inherently riskier than other enterprises. Startups looking for capital are especially risky. As such, investors allowed to use the crowdfunding exemption should be limited to the type of investors that can stand to lose their investment as well as investors that have the necessary skills in order to evaluate a business's strengths and weaknesses. A \$10,000 limitation to non-accredited investors does not prevent foolish investments without the necessary forethought about the implications of such investments. A limitation solely to accredited investors also rules out any concern that an issuer may have about soliciting or advertising to investors.

The State of Michigan has made news headlines with its newly minted crowdfunding

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<sup>255</sup> Charles Luzar, *SEC: Intrastate Crowdfunders Need To Be Careful When Advertising Via Social Media, Web*, CROWDFUND INSIDER, (last visited April 20, 2014) <http://www.crowdfundinsider.com/2014/04/35966-sec-intrastate-crowdfunders-need-careful-advertising-via-social-media-web/>.

exemption. The exemption currently enacted in Michigan has many benefits that help increase financial options for businesses in Michigan. With a few adjustments, the Michigan exemption could provide a prosperous financial opportunity for small businesses strapped for capital. By regulating the funding portals and limiting the exemption to accredited investors, the exemption will help to increase faith in Michigan's intrastate securities market and calm any concerns about issuer and crowdfunding fraud. Michigan has the potential to create an exemption that increases private equity in the state, and also expand and strengthen Michigan's financial economy. By keeping a keen eye towards protecting investors, the integrity of Michigan's crowdfunding market will be greatly enhanced.

## VI. CONCLUSION

Currently, options available for small business to financial their operational needs are dismal at best. Small businesses tend to be the first that are negatively affected during a financial crisis. Since they rely heavily on credit cards, personal loans, and commercial loans, providing an alternative capital raising option has always been an ideal goal of financial regulators. The latest attempt at creating a new financial tool involves crowdfunding small business securities. It's a tech-savvy option for small businesses that are strapped for cash and need help quick. Currently, four states have jumped on the bandwagon, and have passed crowdfunding exemptions for intrastate offerings.

The State of Michigan passed their crowdfunding exemption in February of 2014, with the hopes of bolstering funding to local small businesses. The problem is that issues with crowdfunding are more veiled and convoluted and may be overlooked by small businesses. In theory, crowdfunding offers small business the best opportunity to place angel and venture capital funds at the feet of needy small business owners. The reality however, is that the lack of

sophistication, concern over increased fraud allegations against small business, and issues regarding proper protections for investors should cause small business owners concern. If crowdfunding is to work as a viable option, that consideration must be taken into account in terms of the special protections needed for small business investors and also the protections needed for small business owners who lack of corporate sophistication to withstand the securities regulatory scheme. Hopefully, in the meantime, Michigan drafters and legislators in other states who are looking to help the success of their small business economies, can take these considerations into account so that business owners and investors alike can have an adequate market for capitalization. While the national and state economies won't heal overnight, fixing these laws would be a good start.