

2017

Follow the Yellow Brick Road: A Guide for Improving Issuer and Investor Appreciation of Risks in Creative Arts Crowdfunding Campaigns

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Nazgole Hashemi and Tannaz H. Hashemi, *Follow the Yellow Brick Road: A Guide for Improving Issuer and Investor Appreciation of Risks in Creative Arts Crowdfunding Campaigns*, 17 J. BUS. & SEC. L. 43 (),
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FOLLOW THE YELLOW BRICK ROAD: A GUIDE FOR IMPROVING ISSUER AND INVESTOR APPRECIATION OF RISKS IN CREATIVE ARTS CROWDFUNDING CAMPAIGNS

*Nazgole Hashemi** & *Tannaz H. Hashemi***

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I. INTRODUCTION

Just like Dorothy, issuers and investors of crowdfunding campaigns are not in Kansas anymore. As crowdfunding continuously grows in numbers since the passage and implementation of Regulation Crowdfunding under the Jumpstart Our Business Startups (“JOBS”) Act,¹ the risks, complications, and ambiguities associated therewith become more prevalent in everyday life. Today, there are various types of funding portals offering all kinds of projects. Sometimes these portals center around a particular type of campaign,² such as AngelList, an equity-based only funding portal, or a particular field, such as Kickstarter and FanFunded, funding portals exclusively for creative projects. This article explores the disclosures made by funding portals on their websites in an effort to help find language that best articulates the risks to issuers and investors in the context of creative arts crowdfunding campaigns.

Where there is a creative arts project, such as an offering for a movie, composition, painting, or sculpture, investment-based crowdfunding creates a challenge for the issuer and investor based on the subjective nature of artistic expression.³ An issuer could, without any fraudulent intention, endeavor to create a hip-hop album, but fail to produce a final work product.⁴ Or an issuer may develop, in good faith, a

¹ Anthony Zeoli, *Crowdfunding: A Look at 2015 & Beyond!*, CROWDFUND INSIDER (Dec. 31, 2015, 2:00 PM), <https://perma.cc/BZ3K-D84Z>.

² Crowdfunding is either investment-based or donation-based. Shahrokh Sheik, *Fast Forward on Crowd Funding*, 36 L.A. LAW. 34, 39 (2013). Investment-based crowdfunding may be further divided into two types: equity or debt. Benjamin P. Siegel, Note, *Title III of the JOBS Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 786-88 (2013). Equity crowdfunding is where an investor acquires an ownership interest in the campaign, similar to how common stock is bought and sold on the stock market. *Id.* at 788. Debt crowdfunding is the lending of money to a company with the understanding that the loan will be repaid with interest. *Id.* Donation-based crowdfunding also splits into two types: reward or charity. *Id.* at 787. Reward crowdfunding occurs when there is an exchange of money for non-monetary rewards, such as a t-shirt, recognition, or simple “thank you.” *Id.* Charity crowdfunding takes place when a company accepts charitable donations; there is no exchange, as with reward crowdfunding. *See id.*

³ Michael M. Epstein & Nazgole Hashemi, *Crowdfunding in Wonderland: Issuer and Investor Risks in Non-Fraudulent Creative Arts Campaigns Under the Jobs Act*, 6 AM. U. BUS. L. REV. 1, 4 (2016).

⁴ *Id.* at 10.

theatrical production that he believes is brilliant, but everyone else finds distasteful.⁵ In these scenarios, investors are not able to prosecute their disappointment with the project under anti-fraud laws because the issuer has no bad faith, or “scienter.”⁶ The investors’ only legal recourse would be to show a breach of a specific promise under contract law or a breach of the fiduciary duty of care under business and securities laws.⁷ Further, these scenarios also create great risks for creative artists with good intentions, but failed or unsuccessful projects.⁸ While jilted investors will probably not be able to impose liability for a mere disagreement in artistic taste, the artist still carries the risk of having to defend him/herself in lengthy, expensive fact-based litigation.⁹ In addition to these risks to the issuers and investors, this legal challenge could encourage savvy fraudsters to retain monies funded for a project that is ultimately unsuccessful under the guise of subjective artistry.¹⁰

This article examines the language used by certain funding portals to alert issuers and investors to the risks imposed by crowdfunding in general, and comments on the effectiveness and sufficiency of the current language in the context of creative arts campaigns in particular. The funding portals we examine are not necessarily limited to, or even ideal for, creative arts campaigns, nor are they necessarily investment-based. We examine those portals that provide a useful starting point for developing disclosures that serve to inform issuers and investors of the risks associated with creative arts projects and to manage their expectations. This article provides a guide for funding portals to establish disclosures that both enlighten and protect issuers and investors of creative arts crowdfunding campaigns. Just as Dorothy needed guidance from her compadres to complete her journey, issuers and investors need guidance from funding portals before embarking on their journey to success.

II. TO INVEST OR NOT TO INVEST? MAKING FULLY INFORMED DECISIONS

As crowdfunding grows in numbers, it is important to highlight the potential risks to investors. While the funding portals do attempt to

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 11-16.

⁸ *Id.* at 14.

⁹ *Id.* at 14, 16 & 17.

¹⁰ *Id.* at 17.

set forth these risks on their websites, as currently stated, the portals do not capture their true extent. AngelList and Kickstarter are two separate funding portals that perform a decent job of conveying investor risks, though the disclosures are still insufficient to fully inform investors, especially those of creative artistry. This section analyzes various statements or non-statements on AngelList's and Kickstarter's websites and addresses their strengths and shortcomings. With respect to each perceived deficiency, we offer an alternative way to convey investor risks so that investors are better informed before backing a creative arts campaign.

A. Reconstructing AngelList's Disclosures to Serve as an Effective Model for Investor Risks

AngelList is an investment-based funding portal that lays out the risks to investors nicely. Many funding portals include the risks to investors in the "Terms of Service" section or the equivalent section of their website. AngelList has dedicated an entirely separate link, labeled as "Risks." This is highly recommendable for all funding portals, rather than the current common practice of burying this pertinent information in a webpage that people hardly ever read. It is important to note that AngelList allows participation only to an "accredited investor," as defined by Rule 501 of Regulation D under the Securities Act of 1933.¹¹ It is therefore unlikely that an issuer of creative artistry would use the portal. This is especially true of an entrepreneur taking advantage of

¹¹ Under Regulation D, an "accredited investor" is (1) 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; (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 person's primary residence; (3) a director, executive officer or general partner of the company selling the securities; (4) a business in which all the equity owners are accredited investors; (5) a charitable organization, corporation or partnership with assets exceeding \$5 million; (6) a bank, insurance company, registered investment company, business development company or small business investment company; (7) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; or (8) a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes. *See* Securities Act of 1933 Reg. D, 17 C.F.R. § 230.501(a) (2016).

Regulation Crowdfunding, which allows issuers to turn to the masses, typically non-accredited investors, to establish and grow their businesses. The entire appeal of creative arts crowdfunding is the ability to reach out to a wide crowd and appeal to an audience for funding and support. Nevertheless, AngelList effectively delivers some of the risks to investors and its concurrent shortcomings help to create an appropriate and effective model that could be used by other portals to convey investor risks in creative arts campaigns.

i. Modifying AngelList's "Risks" Page

AngelList's "Risks" page starts by stating:

Every investor ("Investor") should be aware that an investment in a single company or multiple companies on the AngelList platform (each, a "Startup") involves a high degree of risk . . . There can be no assurance that (i) a Fund's investment objectives will be achieved, (ii) a Startup will achieve its business plan, (iii) a Lead Angel has experience in investing, or (iv) an Investor will receive a return of any part of its investment.¹²

AngelList immediately alerts investors that any investment carries "a high degree of risk."¹³ Although this comes off as a boilerplate statement, it carries a lot of weight. For a savvy or accredited investor, this statement may be obvious, but for the masses it is not and it is a good idea for funding portals to make it clear from the outset. In the creative arts context, the funding portals should elaborate that the degree of risk is much higher than in a non-creative arts campaign since the success of an artistic product is based on individual preference, rather than measured objectively.¹⁴ The funding portals should indicate that in addition to the risk of no return, there is also a risk of mere dissatisfaction with the work product. A more effective statement would read:

Every investment carries a high degree of risk. This risk could be complete failure in terms of developing a final work product or mere investor, consumer, or public dissatisfaction with the final work product.

¹² *Risks*, ANGELLIST, <https://perma.cc/7CLQ-726Z> (last visited July 6, 2016).

¹³ *Id.*

¹⁴ Epstein & Hashemi, *supra* note 3, at 18.

Moreover, AngelList's disclosure that a fund's objectives may not be achieved and that a startup may not achieve its *business plan* is a mundane statement that may not alert an investor to the right degree. While even an average investor probably understands that the "business plan" could fall apart, a more elaborate statement may be necessary. With respect to creative artistry, failure to achieve the "business plan" resonates more as a catastrophic situation, such as where the issuer cannot complete the project at all and the investor loses, rather than as a mere difference in artistic expression, such as where the issuer is an extremist and the investor is a moderate. The warning, as is, suggests only the worst-case scenario and does not capture mere differences in artistic process or taste. Of course, an investor will not be happy if the project fails to finish or launch. Even a less savvy investor can predict disappointment in that scenario. The less obvious scenario is where the investor is not happy because he/she believes that the work process or product does not capture the *business plan*.

The case of *Purdum v. Wolfe*¹⁵ effectively illustrates this risk with respect to the work process. Four entrepreneurs launched a campaign on Kickstarter for high-end men's shorts.¹⁶ Three of the entrepreneurs were co-owners and founders of an established men's clothing company called Taylor Stitch.¹⁷ They repeatedly advertised and touted this experience on their Kickstarter campaign.¹⁸ For this reason, many of the investors of the new business were also customers of Taylor Stitch.¹⁹ The entrepreneurs eventually had a disagreement over the finalization of the company's operating agreement. This led to one entrepreneur taking over the Kickstarter campaign, including changing passwords, and thereby essentially ousting the Taylor Stitch entrepreneurs.²⁰ However, none of this information was ever conveyed to the approximately 3,300 investors.²¹ Although the court case was ultimately a breach of contract claim between the entrepreneurs,²² surely the customers-turned-investors would not be happy to learn that the Taylor Stitch entrepreneurs had lost control of and involvement in the

¹⁵ *Purdum v. Wolfe*, No. C-13-04816 (DMR), 2014 WL 171546, at *1 (N.D. Cal. Jan. 15, 2014).

¹⁶ *Id.*

¹⁷ *Id.* at *1-2.

¹⁸ *Id.*

¹⁹ *Id.* at *2.

²⁰ *Id.* at *3.

²¹ *Id.*

²² *Id.* at *4.

project. Presumably, the “business plan” was to use the expertise and experience of the Taylor Stitch entrepreneurs to develop a separate, high-end line, but that plan had changed. To capture this sort of risk related to the “business plan,” the funding portals need to add more language. A more effective statement would read:

A startup may not achieve its business plan. This could mean that the startup completely fails to launch or complete its business goals, or that the startup changes the work process or business goals. Even if the startup does achieve a business plan, whether the original plan or a later plan, this does not mean that the investor will 100% be satisfied with the quality of the startup’s efforts, the startup’s process, or the final work product.

Further, AngelList’s disclosure that the Lead Angel may not have experience in investing exists on its site because the portal engages in syndicate crowdfunding in addition to equity crowdfunding. “A syndicate is an investment vehicle that allows investors (backers) to co-invest with relevant and reputable investors (leaders) in the best startups in the market.”²³ While other types of crowdfunding include only the issuer and investor, syndicate crowdfunding consists of three parties: the issuer, the lead investor, and the backers.²⁴ Syndicate crowdfunding is a form of social proof, as explained in the next section of this article. “Syndicate leaders are business angels with vast experience in selecting investment opportunities.”²⁵ “They tend to be angels - or successful startup founders - who have been part of the industry for many years and know its ins and outs.”²⁶ Any portal that engages in syndicate crowdfunding should make the same disclosure as AngelList regarding the Lead Angel’s experiences, or lack thereof.

Even other types of funding portals should provide a similar disclosure with respect to the more common issuer/investor relationship. AngelList moderately does so later on the same page in a section titled “Future and Past Performance,” which states:

²³ Jamie Novoa, *The Basics of Startup Syndicate Funding*, STARTUP XPLORE (Nov. 18, 2014), <https://perma.cc/CD2C-TDRB>.

²⁴ Jamie Novoa, *Key Differences Between Startup Syndicate Funding & Equity Crowdfunding*, STARTUP XPLORE (Jan. 21, 2015), <https://perma.cc/68SA-6BF8>.

²⁵ *Id.*

²⁶ Novoa, *supra* note 23.

The past performance of a Startup or its management, a Lead Angel, or principals of Advisor, is not predictive of a Startup's or a Fund's future results. There can be no assurance that targeted results will be achieved. Loss of principal is possible, and even likely, on any given investment.²⁷

AngelList ultimately outlines two risks: there may not be any investment experience and experience is nonetheless not determinative of future failure or success. In addition to these risks, the investor should also be made aware that the issuer might not have any experience in the field or subject of the offering. For example, an entrepreneur may endeavor to create a satiric film, but only has experience in romantic comedies or even no experience in any kind of filmic production. Because the portals' background checks relate only to financials and past compliance with securities laws and regulations,²⁸ they should fully disclose that no background check is conducted with respect to the issuer's capabilities to complete the sort of project that he or she is offering. The portals should further elaborate that even a previously successful artist may not be able to develop another product that appeals to the masses. It should be noted that art's beauty varies in the eyes of each beholder and with each project. Therefore, an issuer's status as an amateur or expert is irrelevant to the success or appreciation of the final work product in a subsequent venture. A more effective statement would read:

The issuer may not have experience in investing, or even in the field of the offering. This portal does not conduct any background check with respect to the issuer's capabilities to develop the project in question. Investors should conduct independent research before engaging in any offering, but also keep in mind that past performance is not predictive of future performance. There can be no assurance that targeted results will be achieved. Loss of principal is possible, and even likely, on any given investment.

²⁷ ANGELLIST, *supra* note 12.

²⁸ See Crowdfunding, 80 Fed. Reg. 71388, 71518 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 200, 227, 232, et. al.)

Finally, AngelList’s warning that an investment may not receive a return is a boilerplate statement similar to the warning that every investment carries a high degree of risk. Again, for the savvy investor, this statement is so obvious that it is probably even overlooked. For the general public, this warning is useful and appropriate. But in the creative arts context, it is insufficient because it does not capture the risk of dissatisfaction with the work product, and instead alludes only to the possibility of outright failure to deliver any work product at all. A more effective statement would read:

An investor may not receive a return on any part of its investment, even if the issuer fully develops the work product. The final work product may be deemed dissatisfactory or unappealing to investors, consumers, and/or the general public, which could prevent any return on the investment.

ii. *Using Social Proof to Influence Investment Decisions*

AngelList engages in a practice commonly referred to as “social proof” in the form of syndicate crowdfunding. Social proof is the concept of knowing who or how many individuals back a campaign in an effort to sway other potential investors. The idea is that “people will conform to the actions of others under the assumption that those actions are reflective of the correct behavior.”²⁹ Social proof exists in all avenues of daily life and takes various forms, including expert, celebrity, and “wisdom of the crowds” or friends.³⁰ For example, application to a country club typically involves a waitlist, building “the perception that membership is an exclusive privilege.”³¹ Even nightclubs “limit entry and make patrons wait in line outside,” increasing the perception of popularity.³² Many companies also get approval or endorsements from celebrities with “overall likable image[s].”³³ The purpose of social proof is to make an endeavor more attractive to others through popularity.

²⁹ Ed Hallen, *The Science of Social Proof: 5 Types & the Psychology Behind Why They Work*, BUFFER SOCIAL (Jan. 5, 2014), <https://perma.cc/3RBS-4HDT>.

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

The concept of social proof exists in all funding portals, whether in the form of expert, celebrity, or “wisdom of the crowds” or friends. An issuer is able to demonstrate that others believe in his/her project when potential customers or investors show interest via the funding portals.³⁴ Social proof is useful for crowdfunding because it is a form of marketing for a business that has little to no revenue or fame.³⁵ The principle is that “[o]nce early adopters vet and buy into an idea, others are more likely to follow suit.”³⁶ AngelList pushes social proof primarily in the form of expert and celebrity, or syndicate crowdfunding. AngelList typically sends an email to its network of potential investors and includes the names of sophisticated investors or firms who have committed to a particular investment. Other sites, such as Kickstarter, push social proof in the form of “wisdom of the crowds.” These portals display the number of backers, the minimum funding, and the total amount of funding.

While social proof may reasonably carry weight during an investment decision, it can also be misleading. For example, AngelList only accepts investments from accredited investors, but also does not fully verify accredited investor status. To sign up as an investor on AngelList, an individual must submit an Accredited Investor/Sophistication Questionnaire.³⁷ To prove accreditation based on income, the investor needs to provide documentation of income for the past two years.³⁸ To prove accreditation based on assets, the investor must provide proof of assets and value thereof, and the site also pulls the investor’s credit report to deduct any non-mortgage debts on assets to determine the net assets.³⁹ An alternative for the investor is to obtain a letter from a Certified Public Accountant, attorney, investment advisor, or investment broker.⁴⁰ Thereafter, if an investor is accepted, AngelList provides a private link of the accreditation report, which the investor can share with others.⁴¹ However, AngelList only requires proof of accreditation to be updated periodically and investors need only to

³⁴ *The Benefits of Crowdfunding*, FUNDABLE (Jan. 21, 2014), <https://perma.cc/QJ3A-EY8Y>.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *See Accreditation Reports*, ANGELLIST, <https://perma.cc/URX2-N9JT> (last visited July 29, 2016).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

“swear” accreditation each time they generate a link to share the accreditation report.⁴²

Although AngelList takes steps to ensure that an investor is accredited, the site also states in its “Terms of Service” that it is “not responsible for verifying that any Investor is accredited.”⁴³ This creates a risk for investors relying on social proof and should be articulated explicitly in the “Risks” section of AngelList’s website rather than buried in the “Terms of Service.” The concern is that an investor will jump onboard an investment because of an individual or firm who is not as sophisticated as claimed. For example, a public figure can claim accreditation and back an investment, but really only recently lost accredited investor status based on a series of bad investment choices. This is misleading for the potential inventor who is swayed into the investment in reliance on social proof of the public figure.

Moreover, social proof may also serve as a form of peer pressure with respect to portals similar to Kickstarter. Imagine a scenario where the written description of a project is not too appealing. The issuer requires minimum funding of \$100,000.00, but has exceeded and nearly doubled this minimum with the support of thousands of investors. The risk that the project may ultimately be unsuccessful and not generate any profit for the investors is at least the same as with any other investment. However, when a potential investor sees that thousands of individuals have backed the campaign, he/she feels pressured to back the project under the false impression that it must be lucrative since so many individuals have gotten involved. The reverse scenario would be a crowdfunding campaign that presents a great opportunity but has zero backers.⁴⁴ Investors are less likely to back such a campaign despite its great qualities.⁴⁵ The “psychological principle [is] that people are much more prone to do something when they see others doing the same thing.”⁴⁶ This sort of social proof creates a “form of social anxiety,” mainly, the fear of missing out on an opportunity.⁴⁷ This fear is exasperated by the time limits that portals, such as Kickstarter, place for backers to support each project. This time limit “creates a sense of

⁴² *Id.*

⁴³ *Terms of Service*, ANGELLIST, <https://perma.cc/W3RH-QHHV>(last visited July 6, 2016).

⁴⁴ Dave Lavinsky, *Why Social Proof is Critical to Crowdfunding Success*, ALLBUSINESS (Dec. 11, 2013), <https://perma.cc/SHR4-BDM5>.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Hallen, *supra* note 29.

urgency,”⁴⁸ stripping potential investors of time to make a more informed decision.

Further, while the risks connected to social proof exist with all types of projects and with respect to all funding portals, none of the portals seem to address the issue. This is especially problematic in the context of creative artistry where the risk is much graver. For example, a sophisticated investor may back an art project that was religious in nature merely because of his utmost faith. However, the project was doomed from the outset because of some perceived deficiency that was unappealing to the masses. Or perhaps thousands of investors backed a horror movie with an innovative story line, but really the final project turns out to be too mundane for the masses. Whether an expert, celebrity, or crowd of individuals, these backers could be relying on their own idiosyncrasies in making a particular investment even if they are skeptical or indifferent about its future success. These risks should be made known to all investors since social proof exists on all funding portals. An effective statement would read:

Just because a project is backed by a sophisticated or celebrity investor or a crowd of investors does not necessarily mean that the project will be successful or lucrative. All sorts of reasons drive investment decisions, and these reasons may not be in line with your own reasons for investment. You should conduct independent research to determine why investors have backed a project before relying on their investment and making your own investment.

B. Elaborating on Kickstarter’s Recitation of “How Projects Work”

Kickstarter is one of the most popular funding portals and allows only for donation-based creative projects. All projects submitted to Kickstarter must fit within one of the following categories: Art, Comics, Dance, Design, Fashion, Film, Food, Games, Music, Photography, Publishing, Technology, or Theater.⁴⁹ Kickstarter’s “Terms of Use” is

⁴⁸ Samuel Hum, *I’ll Have What She’s Having: 26 Examples of Social Proof Used in Marketing*, REFERRAL CANDY (Oct. 31, 2014), <https://perma.cc/JW65-KVZ9>.

⁴⁹ *Our Rules*, KICKSTARTER, <https://perma.cc/EV6N-4FP7> (last visited July 6, 2016).

made up of eighteen distinct provisions.⁵⁰ The provision most relevant to investor risks is number four, i.e., “How Projects Work.”⁵¹ Although this provision is very important for investors and even issuers, Kickstarter has buried it in its “Terms of Use.” A more effective delivery would have been to create a separate page, or at the very least, make it stand out on the “Terms of Use” page by providing it first. In addition, it is important to note that because Kickstarter is not an investment-based portal, the “Terms of Use” does not capture the less obvious risks associated with investing in creative arts projects. However, Kickstarter provides a useful analog for the dos and don’ts for funding portals.

Approximately three paragraphs into the section, Kickstarter states:

When a project is successfully funded, the creator must complete the project and fulfill each reward. Once a creator has done so, they’ve satisfied their obligation to their backers. / Throughout the process, creators owe their backers a high standard of effort, honest communication, and a dedication to bringing the project to life. At the same time, backers must understand that when they back a project, they’re helping to create something new — not ordering something that already exists. There may be changes or delays, and there’s a chance something could happen that prevents the creator from being able to finish the project as promised.⁵²

Kickstarter makes it clear that the issuer owes duties to investors, but does not explain the effect of these duties. The duty of “honest communication” may be measured objectively. A communication is either truthful or it is not. However, the duties of “a high standard of

⁵⁰ *Terms of Use*, KICKSTARTER, <https://perma.cc/5GBV-DFGX> (last visited July 6, 2016). Kickstarter is unique in its delivery of investor risks, which are outlined in the “Terms of Use” section of its website, because it provides an explanation, though very brief, of each term in non-legal language. The page starts by stating, “This page explains our terms of use. When you use Kickstarter, you’re agreeing to all the rules on this page. Some of them need to be expressed in legal language, but we’ve done our best to offer you clear and simple explanations of what everything means — hence the brief summaries in these blue boxes. The summaries, for the record, are not part of the official legal terms.” *Id.*

⁵¹ *Id.*

⁵² *Id.*

effort” and “a dedication to bringing the project to life” are different because they require a more subjective analysis.

In the context of litigation, these duties equate to the duty of due care, i.e., the duty to behave as a reasonably prudent person in similar circumstances.⁵³ What is considered reasonable in one circumstance may be viewed as unreasonable in another. This analysis is especially difficult in the creative arts context. For example, if two artists each spend one hour developing a modern composition, and later only one piece is successful, it would be presumptuous to conclude that the unsuccessful issuer did not contribute enough *effort* or *dedication*. There would need to be a more detailed examination of the issuer’s capabilities and circumstances.⁵⁴ Perhaps, the unsuccessful issuer was a novice in the field and the successful issuer was an expert. Or the unsuccessful issuer is actually the expert, clouded by mere arrogance. Or the unsuccessful issuer was innovative and could not appeal to the masses.

To fully capture these risks, funding portals should inform investors that the degree of effort and the amount of time expended on each project will differ depending on the nature of the project and the background of the issuer. Kickstarter almost captures this risk by indicating that investors are “helping to create something new[;]”⁵⁵ therefore, “[t]here may be changes or delays.”⁵⁶ However, as stated, this risk focuses more on the issue of timing than it does on the risk of too much subjectivity in the analysis of effort and dedication. A more effective statement would read:

Creators owe their backers a high standard of effort, honest communication, and a dedication to bringing the project to life. Whether a creator has dedicated a high standard of effort and a dedication to bringing the project to life will differ with each project, depending on the nature of the project and the capabilities of the creator. A creator’s effort and dedication are not always measured by the amount of time spent completing or attempting to complete the project. A change or delay in a project, or failure to complete a project, is typically also not an appropriate measure of the creator’s effort or dedication.

⁵³ *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005).

⁵⁴ Epstein & Hashemi, *supra* note 3, at 16 & 17.

⁵⁵ *Terms of Use*, Kickstarter, <https://perma.cc/5GBV-DFGX> (last visited July 6, 2016).

⁵⁶ *Id.*

Backers should conduct independent research to help to adjust their expectations of creators, but also keep in a mind that a creator's past performance is not predictive of future performance.

Further, immediately following the paragraph analyzed above, Kickstarter states:

If a creator is unable to complete their project and fulfill rewards, they've failed to live up to the basic obligations of this agreement. To right this, they must make every reasonable effort to find another way of bringing the project to the best possible conclusion for backers. A creator in this position has only remedied the situation and met their obligations to backers if:

1. They post an update that explains what work has been done, how funds were used, and what prevents them from finishing the project as planned;
2. They work diligently and in good faith to bring the project to the best possible conclusion in a timeframe that's communicated to backers;
3. They're able to demonstrate that they've used funds appropriately and made every reasonable effort to complete the project as promised;
4. They've been honest, and have made no material misrepresentations in their communication to backers; and
5. They offer to return any remaining funds to backers who have not received their reward (in proportion to the amounts pledged), or else explain how those funds will be used to complete the project in some alternate form.

The creator is solely responsible for fulfilling the promises made in their project. If they're unable to satisfy the terms of this agreement, they may be subject to legal action by backers.⁵⁷

⁵⁷ KICKSTARTER, *supra* note 50.

In this section of the “Terms of Use,” Kickstarter essentially lays out the legal standards for determining whether an investor may pursue litigation in response to an artist’s failure to complete the project, fulfill awards, and/or ensure the best possible conclusion for investors. Although Kickstarter is a donation-based portal, in the context of investment crowdfunding, “fulfilling awards” may be deemed as the equivalent of obtaining a return on one’s investment.

For creative arts campaigns, while this information is useful, it is also misleading because it suggests objectivity in determining issuer liability. For example, Kickstarter states that creators have met their obligations to backers if “they post an update that explains . . . how funds were used”⁵⁸ and “they’re able to demonstrate that they’ve used funds appropriately.”⁵⁹ Whether funds have been used appropriately could be difficult to ascertain in the creative arts context. There could be a scenario where the producer collects investment funds for a film, spends the funds extravagantly on film props, and is later unable to complete the film. If the producer is an extremist who intended to create a grandiose film, then it will be hard for the unhappy investor to question the producer’s expenditures on pricey items. After all, the investor cannot impede on the producer’s creativity.

By providing the issuer’s obligations in list format, Kickstarter suggests that an unhappy investor can simply check off a list of duties to determine if there has been a breach of some sort. The analysis, however, is much more complicated and funding portals should ensure that investors appreciate this complication. To capture this risk, after providing the language above, funding portals should add:

Investors may disagree with the creator’s execution of the project in its original or alternate form, the creator’s claims of diligence and reasonable effort, or the creator’s treatment of the funds. The creative process and the degree of diligence and reasonable effort vary for each project. Also, a creator’s treatment of investment funds may be justifiable in some projects, but not others. Although investors could have grounds for legal action, mere disagreement that relates ultimately to the artistic process or expression is probably not legally actionable.

Lastly, this section of Kickstarter’s “Terms of Use” leaves out

⁵⁸ *Id.*

⁵⁹ *Id.*

important information relating to Kickstarter's application process for issuers. To showcase an offering on Kickstarter, the site requires issuers to submit an application, which Kickstarter accepts or rejects without providing any explanation to the issuer.⁶⁰ Kickstarter does not mention this application process in its "Terms of Use." However, any funding portal that engages in this sort of application process should disclose it to the investor. An effective disclosure would read as follows:

To showcase a campaign on our website, entrepreneurs must complete and submit an application. Not all applications are approved for campaigning, and various reasons could cause a rejection. Just because a campaign currently appears on our website does not mean that it was not previously rejected.

In addition to this disclosure, the funding portals should actually inform potential investors of any previous rejections. If an issuer's application has been rejected multiple times or even once, then an investor would want to know. While issuers may be deterred from using the site knowing that potential investors will be informed of any rejections, the funding portals could balance the interests of the parties by creating and defining various categories of rejection so as to inform the investor but not discredit the issuer. For example, rejections could be for failure to meet offering guidelines of portal, meaning that the portal does not support the type of project being offered or the minimum of the offering; for a technical shortcoming, meaning that the issuer filled out the application improperly; or for noninterest, meaning that the portal simply was not interested in the offering at the time or did not believe the project would appeal to the public.

III. ISSUER CONSIDERATIONS BEFORE LAUNCHING A CAMPAIGN

When broaching the topic of risks associated with crowdfunding, the intuitive approach is to analyze the risks to investors, rather than to issuers. It is probably for this reason that funding portals do not fully or as explicitly highlight the risks to issuers in the same way that they do for investors. Nonetheless, there are serious risks to issuers of crowdfunded campaigns as well, and especially those of creative artistry. This section analyzes those risks in an effort to create language for funding portals to

⁶⁰ Christopher Null, *6 Kickstarter Nightmares and How to Prevent Them*, PCWORLD (Nov. 5, 2012, 3:30 AM), <https://perma.cc/YR95-MQXU>.

add to their sites and thereby inform and protect issuers of creative artistry.

A. Protecting Intellectual Property Interests Absent a Non-Disclosure Agreement

Non-disclosure agreements (“NDAs”), also known as confidentiality agreements, are “instruments to protect and preserve trade secrets and other valuable confidential information.”⁶¹ NDAs “are vital to the exchange of technological and business ideas.”⁶² NDAs are routinely used by businesses, whether a startup or established, to protect their business ideas, copyrights, and patents while pitching them to potential investors, developers, or vendors. NDAs prevent a party from stealing or using information without the other party’s approval. In the crowdfunding context, when issuers apply to campaign a project or actually campaign a project on a funding portal, neither the portals, the general public, nor potential investors sign an NDA. This is contrary to the routine practice of having outside parties sign an NDA before conveying any ideas. Because no NDA is signed, issuers risk the possibility of having their business ideas stolen or used without their permission.

Although there is still no NDA, AngelList is unique from other portals because it has a feature called “Locked Information.” This feature allows entrepreneurs to designate those investors who may see certain information about the business idea, either by listing specific investors or by indicating categories of unrestricted investors.⁶³ On its “Terms of Service” page, AngelList states:

We will do our best to display information you have designated as “Locked” only to Investors who have told us that they fit within the categories you have identified. We cannot, however, guarantee that Investors who see your Locked Information do not to [sic] distribute that information. We also cannot guarantee that there will never be a software bug or a hacker attack that allows

⁶¹ Ryan M. Philp, Comment, *Silence at Our Expense: Balancing Safety and Secrecy in Non-Disclosure Agreements*, 33 SETON HALL L. REV. 845, 850 n. 34 (2003).

⁶² David L. Hoffman & Robert J. Lauson, *Tailoring Nondisclosure Agreements to Client Needs*, 23 L.A. LAW. 57, 57 (2000).

⁶³ ANGELLIST, *supra* note 43.

unauthorized viewing of material or that Investors actually fit within the categories they have identified themselves under.⁶⁴

Despite actually allowing issuers to restrict certain information, unlike other funding portals, AngelList's process still has its shortcomings. For example, it is the investors who categorize themselves, and not AngelList. The issuer, therefore, risks access to those investors who are not actually a part of the described category, but have merely placed themselves therein. Also, there is a possibility of reproduction and distribution by investors to third parties and of hacking by third parties. Fortunately, AngelList makes these risks clear in its disclosures to issuers.

Nonetheless, in the creative arts context, these risks are much heavier because the issue of copyright ownership is hard to litigate. "Copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression."⁶⁵ To establish a copyright, there must be fixation, originality, and expression.⁶⁶ The element of fixation requires an idea to be "fixed" in one of two types of material objects, i.e., phonorecords or copies.⁶⁷ Phonorecords are "material objects in which sounds, other than those accompanying a[n] . . . audiovisual work, are fixed . . . and from which the sounds can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device"⁶⁸ "Copies are material objects, other than phonorecords, in which a work is fixed . . . and from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine."⁶⁹ Because a creative arts campaign has yet to fixate the project in one of these forms, a copyright cannot be established. For example, there is no possibility of copyright protection for a musical composition until there is an actual sound recording or a written sequence of notes.⁷⁰ Copyright protection only extends to the expression of ideas, not the ideas themselves.⁷¹ "Facts and ideas are the public's

⁶⁴ *Id.*

⁶⁵ 17 U.S.C. § 102(a) (2012).

⁶⁶ *Id.*

⁶⁷ 17 U.S.C. § 101 (2012).

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ See *Swirsky v. Carey*, 376 F.3d 841, 852 (9th Cir. 2004); see also *Tempo Music, Inc. v. Famous Music Corp.*, 838 F. Supp. 162 (S.D.N.Y. 1994).

⁷¹ *Baker v. Seldon*, 101 U.S. 99 (1879); *Meshwerks, Inc. v. Toyota Motor Sales*

domain and open to exploitation to ensure the process of . . . the useful arts.”⁷² For example, in *Curtin v. Star Editorial Inc.*,⁷³ the court found no copyright protection for the plaintiff’s “idea” to display photographs of Elvis Presley with celebrities. Similarly, a filmmaker will not be able to claim copyright protection for his idea to produce a drama with a particular storyline. Because of this, entrepreneurs typically require investors, developers, and vendors to sign an NDA before conveying their ideas. The lack of an NDA in the crowdfunding context exposes entrepreneurs to the possibility of having their creative ideas fixated by another individual who is thereby able to establish his or her own copyright.

Another concern in the creative arts context arises from this second element of originality. Originality means that the author independently creates the work and that there is some degree of creativity.⁷⁴ Originality signifies that “the work owes its origin to the author.”⁷⁵ When an NDA is signed, there is a presumption as to where a project or idea originated because one party inherently seeks to protect some interest that it created. However, where there is no NDA, the issues of originality and ownership become more complex because it is less clear as to where the project or idea originated. This is especially true in the creative arts context because copyright ownership, unlike patent protection, does not require novelty.⁷⁶ There exists the possibility that two separate authors independently create the same work and each receive copyright protection.⁷⁷ All that is needed for originality is a modicum of creativity.⁷⁸ In addition, a work is protected by copyright no matter how artistically lacking it may be because aesthetic quality is not relevant to copyright protection.⁷⁹ For example, copyrightable subject matter may be fixated in various ways, and a particular fixation could be more aesthetically pleasing and, therefore, more lucrative than others. It is relatively easy for an individual to fixate a sequence of events described in the issuer’s campaign, such as the storyline for a play, in a

U.S.A., Inc., 528 F.3d 1258, 1265 (10th Cir. 2008).

⁷² *Id.*

⁷³ *Curtin v. Star Editorial Inc.*, 2 F. Supp. 2d 670, 672 (E.D. Pa. 1998).

⁷⁴ *Feist Publications Inc. v. Rural Tele. Serv. Co., Inc.*, 499 U.S. 340, 345 (1991).

⁷⁵ *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99, 102 (2d Cir. 1951).

⁷⁶ *Robert R. Joes Assocs. v. Nino Homes*, 858 F.2d 274, 278 (6th Cir. 1988).

⁷⁷ *Id.*

⁷⁸ *Feist*, 499 U.S. at 345.

⁷⁹ *Bleistein v. Donaldson Lithographing Co.*, 188 U.S. 239, 250 (1903).

way that also fulfills the requirement of originality and thereby suggests ownership. This is because a basic story line, no matter how novel or distinctive, is not copyrightable.⁸⁰ Even the subject matter of a photograph, for example, is not copyrightable.⁸¹

To better inform and protect issuers of all campaigns, and creative arts campaigns in particular, the funding portals should articulate and elaborate on these risks to issuers. An effective statement would read:

Neither the funding portals, the general public, nor the portal users owe to the creators any confidentiality or duty of non-disclosure to third parties. When a creator submits or uploads content to the portal, whether as an application or campaign, there is no guarantee that a third party will refrain from reproducing, distributing, or using the content without the permission of the creator. Creators should fully inform themselves of the laws regarding trademark, copyright, and patent ownership, protection, and infringement before submitting or uploading any content to this portal.

B. Committing to a Large Group of Individuals

When entrepreneurs engage in crowdfunding, they commit themselves to a large group of investors. This is especially true of the more popular campaigns, which attract thousands of investors. Despite this commitment, “[s]ome fundraisers simply are [not] prepared to handle the demand that comes with thousands of new backers and hundreds of thousands of dollars.”⁸² To prepare issuers, funding portals should elaborate on the obligations and duties that are expected of issuers with respect to launching and fulfilling a project. Kickstarter does so in the “How Projects Work” section described earlier herein. Although Kickstarter’s disclosure of “How Projects Work” is quite detailed in explaining the obligations of the issuer to complete the project or to otherwise prevent liability for failure to complete the project, it captures only the business and legal risks associated with crowdfunding. There is, however, also a more personal risk for the issuer.

⁸⁰ *Berkic v. Crichton*, 761 F.2d 1289, 1293 (9th Cir. 1985).

⁸¹ *Leigh v. Warner Bros.*, 212 F.3d 1210, 1214-15 (11th Cir. 2000).

⁸² Laura Brothers, *3 Kickstarter Campaigns That Went Horribly Wrong*, INC. (June 25, 2013), <https://perma.cc/C8JJ-JYNT>.

The campaign for the board game “Glory to Rome” illustrates this risk. The issuer, Ed Carter, sought to raise \$21,000 to fund his board game, but ended up losing his house and job.⁸³ “At the end of his 21-day funding period in the summer of 2011, Carter had raised \$73,102 from 1,600 board game enthusiasts,” which was more than three times his goal.⁸⁴ “In return for the donation, Carter promised his backers free shipping of his game.”⁸⁵ One year later, “Carter was in deep trouble” because “[h]is backers-turned-customers still had [not] seen their board games.”⁸⁶ Although the games were ready for shipment, they “were crushed in transit after Carter forgot to indicate that the packages were fragile.”⁸⁷ The blows did not end there.⁸⁸ “Carter was laid off from his full-time job with Staples.”⁸⁹ “As he ran out of money, he had to dip into his personal savings account to pay for the game production and subsequently stopped making payments on his mortgage,” causing Carter to lose him home.⁹⁰ Carter bankrupted himself, but eventually managed to deliver all of the games.⁹¹

Carter’s story is a sad reality of crowdfunding for even the most honest and ambitious issuers. When the business plan falls apart despite the issuer’s good faith efforts, the issuer is still responsible for pleasing investors to some degree, creating pressure for the issuer. In the context of creative artistry, these pressures are probably much harder to manage and battle due to the subjective nature of the arts. As more investors back a particular campaign, the number of idiosyncrasies also grows, which in turn increases the likelihood of having unhappy investors. To capture the severity of the commitment imposed on issuers and also disclose the risks associated with having a large group of individuals to please, funding portals should provide the following language:

When entrepreneurs launch a project, they commit themselves to investors, and owe both legal and ethical duties to investors. These duties last at least as long as the project is pending. Entrepreneurs should take caution as

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

the number of investors increases. As more investors back a particular campaign, the number of idiosyncrasies also grows. Entrepreneurs should be prepared to handle the increase in demands and personal tastes that accompany a large group of investors. Entrepreneurs should not launch a project if they anticipate any personal shortcomings. Even if unanticipated, the personal or familial issues, changes, or controversies of the issuer do not excuse the issuer of any duties, obligations, or commitments to investors.

IV. CONCLUSION

Funding portals may be reluctant to adopt the disclosures suggested by this article for fear of deterring issuers and investors from using their websites for the offering. The funding portals may believe that too many disclosures intimidate and discourage issuers and investors, pushing them toward other platforms with less frightening information about the risks associated with crowdfunded campaigns. Even if this fear is warranted, however, funding portals have a moral and ethical duty to ensure that issuers and investors appreciate the risks, complications, and ambiguities connected to investment crowdfunding, especially those for creative arts projects. Clear and elaborative statements disclosing these issues will help to create a better crowdfunding atmosphere in the years to come, where issuers and investors are not pressured into creating or backing projects without fully understanding the ramifications of these decisions.

