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Join the Crowd – Is Franchising Uniquely Suited for Crowdfunding?

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On April 5, 2012, President Obama signed into law the "Jumpstart Our Business Startups" Act (the JOBS Act). The intended purpose of the JOBS Act is to spur job creation by small companies and start-ups by relaxing the regulatory burdens of raising capital. In this article, we focus on Title III of the JOBS Act, otherwise known as "crowdfunding," and how franchisors and franchisees are uniquely suited to take advantage of this new registration exemption under the Securities Act of 1933, as amended, to sell unregistered securities to the public.

Crowdfunding enables small or start-up businesses that may not have access to traditional methods of capital financing to raise capital via the Internet and social media, typically from small-dollar investors.¹

At first glance, crowdfunding appears to be an innovative and easy way for start-ups to obtain financing by using the vast reach of the internet. However, Congress's concerns over investor protection and fraud prevention are evident throughout Title III. Issuers, brokers and funding portals must comply with substantial informational disclosure requirements and undertake affirmative fraud prevention measures.² Aspiring crowdfunding issuers should note that the JOBS Act requires the Securities and Exchange Commission (SEC) to adopt "such rules as the [SEC] determines may be necessary or appropriate for the protection of investors" within 270 days after the JOBS Act being signed into law. Thus, the SEC, which openly expressed its opposition to crowdfunding prior to the passage of the JOBS Act (including criticism by SEC Chairwoman Mary Schapiro that crowdfunding regulation would be akin to "walking backwards"), will most likely implement burdensome compliance and disclosure requirements.³

Why is this good news for franchises? Unlike other potential issuers, franchisors, and to a lesser extent franchisees, are already subject to rigorous disclosure requirements.⁴ Much of the disclosure mandated by Title III is already encompassed in a franchise disclosure document ("FDD").⁵ Therefore, while complying with the extensive disclosure requirements of the JOBS Act may be cost prohibitive and time consuming for most startups, franchisors will have a leg up in that they've already prepared most of the disclosure.⁶ From the franchisee side, much of the business planning, financial reporting and financial statement preparation mandated by a franchisor can provide the disclosure necessary to meet the likely standards, or at least provide the basis for rapid development of the necessary information.

The basics of crowdfunding are fairly simple. Crowdfunding offerings are capped at \$1 million per year. The issuer must be a U.S. company and cannot be a reporting (i.e., filer of periodic reports under the Securities Exchange Act of 1934) or investment company. There are caps on annual investment amounts for investors. Investors with an annual income or net worth below \$100,000 may only be permitted to invest, in the aggregate, the greater of \$2,000 or 5 percent of such investor's annual income or net worth. For an investor with an annual income or net worth greater than \$100,000, the aggregate annual investment is limited to 10 percent of such investor's annual income or net worth, with a maximum aggregate amount capped at \$100,000. Except under certain circumstances, crowdfunded securities are restricted securities with a one-year holding period.

Conducting a crowdfunding offering requires substantial issuer and offering information disclosure. Issuers are required to file certain information with the SEC, and must provide the same to potential investors and intermediaries, including information regarding their business, ownership and capital structure, and the offering itself. A condensed version of some of the issuer disclosure requirements and liability risks appears below.

- Issuers must make an initial filing with the SEC which contains, among other things, (i) name, legal status, physical and website addresses; (ii) the names of directors, officers and 20 percent stockholders; (iii) a business plan and description of the business; (iv) financial information, which, depending on the size of the offering, may only include a certified income tax return for an offering of \$100,000 or less, or audited financial statements for offerings of \$500,000 or more; (v) a description of the purpose and intended use of the offering proceeds, the target offering amount, the price of the securities and the method of their valuation; (vi) the ownership and capital structure of the business, including the terms of the offered securities as well as each class of the issuer's securities, a description of how the issuer's principal stockholders' rights could negatively affect the purchasers of the crowdfunded securities, risks associated with minority ownership and examples of how future securities will be valued; and (vii) any other information required by the SEC.
- At least once a year, issuers must also file with the SEC and provide to investors their financial statements and reports of results of operations, as the SEC deems appropriate.
- Purchasers of crowdfunded securities will have a private right of action against an issuer's officers or directors for material misstatements and omissions in connection with the offering. An issuer will be liable if it makes an untrue statement of a material fact or omits a material fact required to be stated or necessary to make a statement not misleading, provided the purchaser did not know of the untruth or omission. Though crowdfunded securities are considered "covered securities," and thus not required to be registered with any state agency, an issuer will still be liable under state securities laws prohibiting fraudulent or unlawful conduct in connection with a securities transaction.

Issuers are also prohibited from advertising the terms of a crowdfunding offering, except for notices directing investors to the funding portal or broker, and may not compensate any thirdparty promoters without disclosing the compensation to investors.

Does this mean that a franchisor can slap a new coversheet on an FDD and launch a crowdfunding offering? No, but with a modest supplement describing the corporate documents and attributes not otherwise covered in the FDD, a franchisor can be quickly compliant with the likely SEC rules and the launch of the offering will be achieved more quickly. Additional considerations will include obtaining consent from the auditors to use the franchisor's financial statements and audit opinion for such purpose, and creation of an investor questionnaire, modeled in many respects on the franchise application, that will elicit the eligibility and limitations of potential investors.

How often does a franchisee ask whether he or she can invest in the franchisor? With public companies, the answer is simple. With a new or small franchisor, the answer is usually not often, because the franchise and securities offering are separate. Crowdfunding offers franchisors the opportunity to consider paired or "paperclip" offerings, where the prospective franchisee is also offered the opportunity to invest in the franchisor's equity.⁷ Existing franchisees who are successful and committed to the success of the franchise concept offer another readily available pool of potential investors. The FDD Item 20 information about franchisee contact information is a potentially useful tool for a crowdfunding offering.⁸ The regular communications vehicles between franchisor and franchisee offer the opportunity to promote the offering to a group of potential investors without the need for any public solicitation. That communication pipeline, together with the franchisor's extranet accessible only to franchisees with authorized access, could be a major benefit for the issuer-franchisor.

From a legal theory perspective, the legal duties, obligations and interests of the parties in a crowdfunded franchisor where franchisees are participating investors will need some further thought and guidance. The franchisor and its officers are not fiduciaries for its franchisees, but the officers are indeed fiduciaries for their franchisee-investors and the franchisor. Will a franchisee who is an investor be able to assert an aggressive position under the franchise agreement that can harm the franchisor without liability to co-investors? Defining these roles and the associated legal conduct standards will evolve as SEC enabling regulations permit crowdfunding to commence.

¹ JOBS Act: Crowdfunding Summary, Practical Law Company (last visited Jun. 8, 2012), <http://us.practicallaw.com/6-518-7396>.

² See H.R. 3606 §§ 302(b), 304(a).

³ Benn Protes, Regulator Seeks Feedback on JOBS Act, NYTimes.com (Apr. 11, 2012, 4:16 PM), <http://dealbook.nytimes.com/2012/04/11/regulator-seeks-feedback-on-jobsact>

⁴ FTC Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5 (2012).

⁵ Compare H.R. 3606 § 302(b), with 16 C.F.R. § 436.5 (2012).

⁶ 16 C.F.R. § 436.5 (2012).

⁷ Franchisors would need to review and comply with state securities laws, often administered by the same regulatory authority as franchising in merit review registration states, before undertaking such an offering.

⁸ |16 C.F.R. § 436.5(t)(4) (requiring disclosure of "the names, and the address and telephone number of each of their outlets"). Franchise agreements routinely designate a legal notice contact for official notices, which is another source of the information.