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Crowdfunding Signals

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CROWDFUNDING SIGNALS

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Entrepreneurs can now "crowdfund," or sell securities to unaccredited investors over the Internet, to raise capital. But will these companies be able to attract the follow-on investors (angels and venture capitalists) that are necessary for long-term success? Angels and VCs face extreme levels of information asymmetry when deciding whether to fund a company. Signals can reduce this asymmetry. Early commentary argues a company only crowdfunds as a last resort for fear of sending a negative signal about the company's quality to follow-on investors. This Article argues the inverse. This Article argues a successful crowdfunding campaign can send a positive signal of a company's quality to angels and VCs.

As this Article explains, crowdfunding can be a savvy move for entrepreneurs for both social and financial reasons. Crowdfunding, perhaps more than any other strategy, shows real-world demand for a company's product or service. For this and other reasons explored in the Article, crowdfunding sends a positive signal of firm quality, and thus should not disadvantage entrepreneurs without wealth or connections who depend on crowdfunding to raise funds. The Article also posits that crowdfunding signals may reduce the need for crowdfunding disclosures, thus making the process more affordable to entrepreneurs.

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TABLE OF CONTENTS

I. INTRODUCTION

Crowdfunding is the hot new method by which new companies can raise their first capital.[1] Selling unregistered securities over the Internet was prohibited in the past because it constituted a "general solicitation" of investors.[2] In short, entrepreneurs could only solicit investments from those previously known to them. Then came the Jumpstart Our Business Startups Act of 2012 (JOBS Act), which allowed general solicitation of "accredited" (i.e., wealthy) investors in so-called Title II offerings.[3] It was not until October 2015 that the Securities and Exchange Commission (SEC) passed the final rules implementing Title III of the JOBS Act, dubbed "Regulation Crowdfunding" (Regulation CF), which allowed general solicitation—and thus Internet sales—to unaccredited investors.[4]

While companies primarily crowdfund to raise capital, this Article reveals that a crowdfunding campaign serves important, ancillary purposes. Just as patents primarily allocate rights and rents while secondarily sending "signals" about firm quality and productivity,[5] crowdfunding campaigns serve the same dual

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[1] *See* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 569 (2015) [hereinafter Ibrahim, *Equity Crowdfunding*] ("In equity crowdfunding, investors contribute money" over the internet "in exchange for a tangible interest in the venture they are funding. . . .").

[2] *See* 17 C.F.R. § 230.502(c) (2017). Rule 504 allows general solicitation, but issuers must comply with potentially burdensome state law requirements. *See* C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 33 (2001) [hereinafter Bradford, *Rule 504*] ("[S]tates remain free to regulate offerings that Rule 504 exempts from the federal registration requirements.").

[3] Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 201(a), 126 Stat. 306, 313 (2012) (codified as amended at 15 U.S.C. § 77d (2012)) (instructing the SEC to remove the "prohibition against general solicitation or general advertising" under Rule 506 for sales to accredited investors). An "accredited investor" under the securities laws means the investor has over $1 million in net worth, or income over $200,000 in each of the last two years (or $300,000 with spouse) and reasonably expects to reach the same income level in the current year. 17 C.F.R. § 230.501(a) (2017).

[4] *See* 17 C.F.R. § 230.506 (2017); Jumpstart Our Business Startups Act §§ 301–05, 126 Stat. at 315-23; *see also* 15 U.S.C. § 77d(a)(6) (2012) (noting that investors making less than $100,000 annually can invest up to $2,000, or 5% of annual income or net worth while investors making over $100,000 annually can invest up to 10% of annual income or net worth).

[5] *See* Clarisa Long, *Patent Signals*, 69 U. CHI. L. REV. 625, 637 (2002) (arguing that viewing patents as a tradeoff between rents and rights likewise "presents an incomplete

functions for new companies. Signals serve to inform potential investors about a company's quality when that quality is otherwise difficult to observe.[6] Thus, despite early commentary predicting that crowdfunding will be an option of last resort for entrepreneurs,[7] a successful crowdfunding campaign can actually send a positive signal about firm quality to follow-on investors, namely angels and venture capitalists (VCs).[8]

Some companies that crowdfund may not seek follow-on investors, instead being content to exist as so-called "lifestyle" companies run for the benefit of the entrepreneur and the entrepreneur's family.[9] Early companies who have conducted crowdfunding campaigns have been in the food, beverage, and other consumer products industries and do not fit the technically-innovative mold of Apple or Tesla.[10] However, rapid-growth companies that go on to seek angel or VC investment[11] have also

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picture of the value and function of patents"); *id.* (exploring "the value of patents as informational mechanisms").

[6] *See generally* Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

[7] *See infra* notes 81–86 and accompanying text.

[8] *See infra* Part III.C.

[9] Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 111–12 ("A startup company is a new venture with an innovative product or business model that targets rapid growth. This definition distinguishes startup companies from 'livelihood businesses,' which generate income for the company founders and employees, but lack significant prospects for generating large returns to outside investors through an initial public offering of stock ('IPO'), or by being acquired.") (quoting John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting,* 37 ARIZ. ST. L.J. 861, 862 (2005).

[10] *See* Darian M. Ibrahim, *Crowdfunding Without the Crowd*, 95 N.C. L. REV. 1481, 1506 (2017) ("[P]erhaps [startups that crowdfund] are not the type of companies that will attract angels or VCs at all."); *see, e.g.*, *Invest in Native American Natural Foods: Buffalo Based Meat and Fruit Bars Based on the Wasna Tradition of the Lakota*, WEFUNDER, https://wefunder.com/tankabar (last visited Oct. 19, 2018); *Invest in San Francisco East Bay Brewing Inc.: Bringing San Francisco Craft Beer to Untapped Asian Markets*, WEFUNDER, https://wefunder.com/sfebb (last visited Oct. 19, 2018).

[11] There may be distinctions to draw between crowdfunding companies that later seek angel as opposed to VC financing. Because angels have non-financial as well as profit motives for investing, they are less likely to be concerned with some of the problems discussed *infra*, such as an unwieldy capitalization table, that VCs will care about. *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1439 (2008) [hereinafter Ibrahim, *Angel Investors*] ("[A]ngels also have nonfinancial reasons for investing. A distinguishing characteristic of angel investment is that angels 'usually develop an emotional attachment to the business venture.'").

first looked to the crowd. Both tech[12] and non-tech companies[13] are trying to raise money through crowdfunding. For growth companies, attracting follow-on investment is the key to success.[14] Virtual-reality pioneer Oculus is a notable success.[15] Oculus began with a successful crowdfunding campaign on Kickstarter,[16] raised $16

[12] For example, Zenefits (a human resources software firm) got early funding through WeFunder and later received funding from Fidelity, Andressen Horowitz, and Venrock. *See* Alex Patriquin, *Zenefits $500m Series B Nets 4,000% Unrealized Return to Wefunder Investors*, WEFUNDER (June 3, 2014), https://wefunder.com/post/44-zenefits-delivers-over-4-000-unrealized-return-to-wefunder-investors; Jeremy Quittner, *How This $4.5 Billion Benefits Startup Plans to Maintain Its Dominance*, INC. (Dec. 1, 2015), https://www.inc.com/jeremy-quittner/zenefits-top-ranking-unicorn-for-2015-must-keep-innovating-to-win.html; Geoff Weiss, *Zenefits, a 2-Year Old Startup, Is Now Valued at $4.5 Billion*, ENTREPRENEUR (May 6, 2015), https://www.entrepreneur.com/article/245937. However, Zenefits got caught up in a scandal over whether its agents were selling insurance without a license (among other improper behavior), and its valuation fell from $4.5 billion to $2 billion. *See* Heather Somerville, *Software Startup Zenefits Changes Course Under New CEO*, REUTERS (Sept. 21, 2017, 8:01 AM), https://www.reuters.com/article/us-zenefits-broker/software-startup-zenefits-changes-course-under-new-ceo-idUSKCN1BW1NS; Claire Suddath & Eric Newcomer, *Zenefits Was the Perfect Startup. Then It Self-Disrupted: What Happened When an HR Firm Had Some Epic HR Problems.*, BLOOMBERG BUSINESSWEEK (May 9, 2016), https://www.bloomberg.com/features/2016-zenefits/.

[13] *See* Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 578 (describing the Title II site CircleUp, which "does not raise money for tech-based companies, instead focusing on consumer products companies, but, importantly, it still caters to growth startups as opposed to lifestyle firms") (citing Lora Kolodny, *Collaborative Fund, CircleUp Partner To Invest $4 Million in B Corps*, WALL ST. J.: VENTURE CAPITAL DISPATCH (Aug. 18, 2014), http://blogs.wsj.com/venture capital/2014/08/18/collaborative-fmd-circleup-partner-to-invest-4-million-n-b-corps)*; id.* ("As CircleUp's co-founder explains, '[w]e don't have any companies on the site who are looking at it as a lifestyle business,' noting that 'typically these companies will exit to a private equity fund or strategic acquisition.'") (alteration in original) (internal marks omitted) (quoting Christine Lagorio-Chafkin, *CircleUp Draws More Investors as Equity Crowdfunding Gains Ground*, INC. (Mar. 26, 2014), http://www.inc.com/chrstine-lagorio/circleup-bright-spot-crowdfunding.html).

[14] *See* Ibrahim, *Angel Investors*, *supra* note 11, at 1411 (discussing work by Paul Gompers and Josh Lerner that "found that ninety percent of start-ups that were unable to attract venture capital within the first three years failed, while the failure rate dropped to thirty-three percent for those that did attract venture capital") (citation omitted).

[15] *See*, *e.g.*, OCULUS, https://www.oculus.com/ (last visited Nov. 8, 2017).

[16] Kickstarter crowdfunding is different than the crowdfunding discussed in this Article in that it does not involve the sale of securities. *See* Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 568-569 (distinguishing broadly between equity and non-equity crowdfunding). However, for signaling purposes, this legal distinction may hold little relevance. Although it would affect this Article's sub-arguments regarding capitalization tables, potential lawsuits, and the like. *See infra* notes 122–126 and accompanying text.

million from VCs after the crowdfunding campaign, and was sold to Facebook for $2 billion.[17]

In this Article, I apply the economic literature on signaling to crowdfunding and show that an entrepreneur's decision to crowdfund—if that crowdfunding campaign is successful[18]—can send a better signal of firm quality to angels and VCs than pre-crowdfunding signals. Because it adds a signaling function on top of the capital-raising function, crowdfunding can send a better signal for success than "friends-and-family" money.[19]

In an environment rife with information asymmetry, signaling takes on added importance.[20] Although crowdfunding is still in its infancy, early commentators predict that it is destined for failure.[21] Those commentators suggest that crowdfunding, to the extent it signals anything, signals a weak company.[22] Companies that crowdfund, the argument goes, are being shunned by the traditional sources of entrepreneurial finance—early-stage angels, VCs, even friends and family—and opt to crowdfund only as a means of last resort.[23] In short, these companies are the lemons of the startup world that have little staying power and little chance to become household names.

Arguing the opposite, this Article contends that crowdfunding can be viewed as a positive, rather a negative signal—and, in important respects, is a better alternative than other means of early financing, most notably friends-and-family money. As explained in this Article, crowdfunding can be a savvy move for entrepreneurs for social and financial reasons.[24] Crowdfunding also does more than perhaps any other move an early-stage company can make to

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[17] *See* Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543, 548–550 (2017) (discussing the Oculus trajectory).

[18] See *infra* Part III.A for signaling effects of successful versus unsuccessful crowdfunding campaigns.

[19] *See* Christopher W. Cole, Note, *Financing an Entrepreneurial Venture: Navigating the Maze of Corporate, Securities, and Tax Law*, 78 UMKC L. REV. 473, 482–83 (2009) (discussing friends-and-family investments). Although it is true that friends-and-family money can show the entrepreneur has "skin in the game" and may work harder for the company's success.

[20] *See infra* notes 46–49.

[21] *See id.*

[22] *See infra* Part II.B.

[23] *See id.*

[24] *See infra* Part III.C.

signal real-world demand for its product or service.[25] A successful crowdfunding campaign shows follow-on investors that the company has a real customer base.[26] Crowdfunding can help democratize entrepreneurship and make it more affordable for entrepreneurs to pursue their innovations.[27]

This Article proceeds as follows. Part II discusses the economic literature on signaling: when signaling is important and what makes a signal effective; why signaling is especially important in entrepreneurial finance; and what signals angels and VCs relied on in choosing companies to fund pre-crowdfunding. Part III introduces crowdfunding as a new signal for angels and VCs to use in selecting their investments and argues that, despite early predictions about crowdfunding's inevitable failure, a successful crowdfunding campaign can reflect positively on a company to angels and VCs. Part IV discusses the normative and legal implications of crowdfunding properly viewed as a positive rather than a negative signal. Part V concludes.

II. SIGNALING THEORY

Signaling is an important concept in the law-and-economics literature.[28] This Part has three objectives: to discuss (1) why signals are an important tool in helping to combat information asymmetry; (2) why extremely high levels of information asymmetry make signaling paramount in entrepreneurial finance; and (3) what signals are used in entrepreneurial finance pre-crowdfunding, as well as the shortcomings of using those signals.

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[25] *See infra* Part III.C.1.

[26] This may not be as true for pure tech companies as it is for consumer product companies. However, apps and the like will probably have dedicated users. *See infra* note 104 and accompanying text.

[27] *See infra* Part IV.A.

[28] *See* Jonathan M. Barnett, *Certification Drag: The Opinion Puzzle and Other Transactional Curiosities*, 33 J. CORP. L. 95, 101 (2007) ("[T]he law and economics literature widely cites Nobel Prize winner Michael Spence for the proposition that signaling opportunities can generate efficiency gains by enabling uninformed parties to distinguish between higher- and lower-quality counterparties . . .") (emphasis and citation omitted); Spence, *supra* note 6, at 358–59 (explaining how potential employees signal quality by engaging in costly activities, such as obtaining a degree).

A. WHY DO MARKET PARTICIPANTS NEED SIGNALS, AND WHAT MAKES A SIGNAL EFFECTIVE?

"Insiders know more than outsiders. Both have incentives to mitigate the asymmetry."[29] This incentive is especially true in financial transactions when insiders attempt to sell company securities to outsiders.[30] Information asymmetry exists in varying degrees in financial markets. For the largest and most well-known blue-chip companies, information asymmetry is remedied in numerous ways: analysts rate the company's securities,[31] securities law forces insiders to disclose information about the company,[32] newspapers cover the company's major moves,[33] and reputational concerns influence the company's actions.[34]

But information asymmetry persists, especially with lesser-known companies.[35] The cost of remedying information asymmetry can be high: investors must find, process, and verify information.[36] Apart from large mutual funds and hedge funds, most investors do not have the time or motivation to process all the information that

[29] Roy Shapira, *Corporate Philanthropy as Signaling and Co-optation*, 80 FORDHAM L. REV. 1889, 1906 (2012).

[30] Bernard S. Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 92 (1998) ("[T]he single largest cost that stands between issuers and investors is the problem of asymmetric information. The issuer knows the quality of the securities being offered, but the investor does not and cannot easily find out.") (emphasis omitted).

[31] Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1038 (2003) ("[C]ourts and commentators argued that selective disclosure to securities analysts is beneficial to the securities markets because it increases the dissemination and incorporation of information into stock price.").

[32] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 674 –75 (1984) (arguing that voluntary information disclosures reduce information costs).

[33] *See* Merritt B. Fox, Lawrence R. Glosten, & Paul C. Tetlock, *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y.L. SCH. L. REV. 645, 646 (2010) (discussing the connection between releasing false news and short selling).

[34] *See* Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 764 (2000) ("Transaction costs in financial markets are low, liquidity high. Parties interact in continuous relationships governed by reputational considerations.").

[35] Even with the best-known companies, inside information is non-public and thus unknown to investors. *See* Manuel A. Utset, *Fraudulent Corporate Signals: Conduct as Securities Fraud*, 54 B.C. L. REV. 645, 649 (2013) (distinguishing between market and insider information for signaling in corporate finance).

[36] *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 597, 611 fig. 4 (1984) (displaying the high information costs in acquiring, processing, and verifying market information).

is available on a company.[37] The behavioral law-and-economics literature indicates that investors exhibit bounded rationality, meaning they use shortcuts when making decisions.[38] Thus, investors' reliance on signals about a company's quality can be efficient and useful.

Signals are a proxy for a company's quality when that quality is difficult or costly to discern.[39] The use of signals in financial markets is well documented. For example, hiring a top investment bank when undertaking an initial public offering (IPO) signals a company's quality when the company to-date has been privately-held and therefore opaque to the market at large.[40] Similarly, a stock buyback by a public company signals to the market that the company's managers believe the company's stock is undervalued.[41]

For a signal to be effective, it must be both *observable* and *costly*. Signals work precisely because they are easier to discern than

[37] Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures . . . .").

[38] *See* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998) ("To deal with limited brain power and time we use mental shortcuts and rules of thumb.").

[39] *See* Long, *supra* note 5, at 645 (2002) ("One strategy firms can use to convey information about attributes that are not easily discernible is signaling. A signal in this context is just a variable with low measurement costs that observers believe is not independently distributed relative to variables presenting high measurement costs."); *see also* F.H. Buckley, *When the Medium is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493, 526 (1990) ("Signaling strategies diminish information costs borne by the firm's investors, and reduce its cost of capital."); J.H. Verkerke, *Is the ADA Efficient?*, 50 UCLA L. REV. 903, 922 (2003) ("Relying on signals is a time-honored way to economize on information costs.").

[40] WILLIAM A. KLEIN, JOHN C. COFFEE, JR., & FRANK PARTNOY, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 443 (11th ed. 2010) ("Many familiar market institutions, such as the investment banking firm, can be understood as market mechanisms for reducing information costs."); Partnoy, *supra* note 34, at 773–74 ("To stem some investor concerns about their reputations, managers generally select one or more third-party intermediaries (typically investment banks and accounting firms) to assist with new issues. These intermediaries are willing to stake their reputational capital on their ability to evaluate a firm and its management, to ensure that managers are not appropriating (too much) shareholder wealth.") (citation omitted).

[41] *See* Buckley, *supra* note 39, at 537–40. Conversely, an equity *issuance* is usually seen as a negative signal. *See* Anton Miglo, *Trade-Off, Pecking Order, Signaling, and Market Timing Models*, *in* CAPITAL STRUCTURE AND CORPORATE FINANCING DECISIONS: THEORY, EVIDENCE, AND PRACTICE 171, 179 (2011) ("A negative share price reaction on the announcement of equity issues is usually consistent with empirical evidence"); *see also* Jeff Strnad, *Taxing Convertible Debt*, 56 SMU L. REV. 399, 412–18 (2003) (discussing the signaling function of convertible debt).

company quality; thus, they must be observable. Enhancing the salience of a signal increases its effectiveness.[42] But the signal must also be costly.[43] If a signal is cheap to send, a bad company can send it just as easily as a good company.[44] Therefore, good companies will attempt to send signals that are too costly for bad companies to mimic (e.g., hiring Goldman Sachs to underwrite their IPO).[45]

B. INFORMATION ASYMMETRY IN ENTREPRENEURIAL FINANCE

Information asymmetry is extremely high in entrepreneurial finance. Brand new companies have no track record or established product or service for investors to rely on; oftentimes, these companies are just an idea, prototype, or product in its infancy.[46] Barriers to entry may be low, meaning the entrepreneur's idea—even if proven—may be doomed by a competitor's first-mover advantage.[47] Scientific uncertainty and complexity in technology-based innovations adds to the information asymmetry between the startup's management and potential investors.[48] Angels and VCs must navigate this treacherous terrain to choose among the

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[42] Utset, *supra* note 35, at 668 ("Message magnification is one way to increase the salience of messages. The more salient a signal, the more likely that investors will incorporate it into their decision making.") (citations omitted).

[43] ERIC A. POSNER, LAW AND SOCIAL NORMS 19 (2000) ("Signals reveal type if only the good types, and not the bad types, can afford to send them, and everyone knows this.").

[44] Merritt B. Fox, *Regulating Public Offerings of Truly New Securities: First Principles*, 66 DUKE L.J. 673, 687 (2016) ("Signaling will fail to eliminate the information-asymmetry problem, however, if a seller's claim of high quality is not completely credible.").

[45] Utset, *supra* note 35, at 653 ("Good companies will. . . try to identify expensive signals—courses of action that are too costly for bad companies to undertake. If one exists, they will incur the cost of sending the signal, with the expectation that the bad companies will not follow suit. . . .") (citations omitted).

[46] *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076–77 (2003) ("Precisely because the portfolio company is at an early stage, uncertainty concerning future performance is magnified. Virtually all of the important decisions bearing on the company's success remain to be made, and most of the significant uncertainties concerning the outcome of the company's efforts remain unresolved."); *id*. at 1076 ("The special character of venture capital contracting is shaped by the fact that investing in early stage, high technology companies presents [information asymmetry] in an extreme form.").

[47] Roger A. Kerin, P. Rajan Varadarajan & Robert A. Peterson, *First-Mover Advantage: A Synthesis, Conceptual Framework, and Research Propositions*, 56 J. MARKETING 33, 33 (1992) (discussing the link between order of entry into market and market share).

[48] *See id*. at 1077 ("[T]he technology base of the portfolio company's business exacerbates the general uncertainty by adding scientific uncertainty.").

thousands of new companies seeking their funding.[49] Traditionally, these investors have decided which companies to invest through networks, contracts, and signals.[50]

Angels, and to a lesser extent VCs, rely on networks to sort among potential investments. Networks work in traditional angel/VC investing because of the tight geographic proximity between entrepreneur and investor.[51] Both angels and VCs have long preferred to invest locally, often within a short drive of themselves.[52] For their deal flow, angels rely on a "network of trusted" advisers including business associates, accountants, and lawyers.[53] VCs likewise prefer to invest in entrepreneurs with whom they know and feel comfortable.[54] Networks are therefore an effective tool for reducing information asymmetry.[55] However, as the Internet reduces the necessity of geographic proximity, networks diminish in their utility. Entrepreneurs no longer have to

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[49] For example, in 1997, leading Silicon Valley VC Benchmark Partners funded only nine of the 1500 business plans submitted to them. RANDALL E. STROSS, EBOYS: THE TRUE STORY OF THE SIX TALL MEN WHO BACKED EBAY, WEBVAN, AND OTHER BILLION-DOLLAR START-UPS 24 (2000).

[50] As discussed later, one of the main ways in which investors in public companies mitigate information asymmetries—disclosure—is not required in offerings to angels and VCs. *See infra* notes 113–114 and accompanying text.

[51] *See* Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 561 ("Venture capitalists (VCs) and angel investors have long valued close networks and personal relationships when selecting which entrepreneurs to fund, and they closely monitor their investments in person after they fund."). *See generally* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994) (describing intimate Silicon Valley culture).

[52] *See* Jeffrey E. Sohl, *The Early Stage Equity Market in the USA*, 1 VENTURE CAP. 101, 112 (1999) (explaining that angels live close to their investments); *see also Venture Support Systems Project: Angel Investors,* MIT ENTREPRENEURSHIP CTR. 32 table 3.2 (2000), http://nutsandbolts.mit.edu/resources/angelreport.pdf ("Most active angels will not invest in opportunities outside a 1-2 hour driving range.").

[53] Ibrahim, *Angel Investors*, *supra* note 11, at 1432; s*ee also* Stephen Prowse, *Angel Investors and the Market for Angel Investments*, 22 J. BANKING & FIN. 785, 789 (1998) ("The primary criterion that angels use to screen proposals is whether the entrepreneur is previously known and trusted by them or by an associate who they trust.").

[54] *See* Alex Iskold, *8 Things You Need to Know About Raising Venture Capital*, ENTREPRENEUR (July 15, 2015), http://www.entrepreneur.com/article/248377 [https://perma.cc/C7RA-MCSG] (explaining that VCs feel more comfortable considering investing in someone who is somehow connected to them).

[55] *See* Eugenia Macchiavello, *Peer-to-Peer Lending and the "Democratization" of Credit Markets: Another Financial Innovation Puzzling Regulators*, 21 COLUM. J. EUR. L. 521, 577 (2015) ("[T]he use of social networks backed by financial commitments in the form of early financing has appeared a determinant of a campaign success as well as a mechanism to reduce information asymmetries." (citation omitted)).

move to Silicon Valley to seek funding—they can do so over the Internet.[56]

The second way in which VCs, and to a lesser extent angels,[57] mitigate information asymmetry is through the use of detailed investment contracts. The typical VC investment contract includes many protective provisions. The most important of these for reducing information asymmetry is the practice of "staged financing,"[58] or financing the company in stages instead of all at once. By allowing investors to gather more concrete evidence about the company between each stage of financing, staged financing reduces information asymmetry directly. Importantly, if the evidence portends bad outcomes, VCs have the option to abandon the investment altogether.[59] As discussed in the next section, staged financing also reduces information asymmetry indirectly, through signals.

C. SIGNALS USED IN ENTREPRENEURIAL FINANCE PRE-CROWDFUNDING

Angels and VCs also rely on signals to mitigate information asymmetry when screening potential investments.[60] VCs and angels

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[56] *See* Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 564 ("As startups need less money to ramp up, and because it is cheaper and more efficient to raise money online than in person, startups will likely raise an increasingly large percentage of funds over the Internet.") (citations omitted).

[57] The more organized, "professional" angel groups may mirror the VC's investment contract, while "traditional" angel investors who operate more loosely rely primarily on networks to screen their investments. *See* Ibrahim, *Angel Investors*, *supra* note 11, at 1446 ("[A]ngel group investment contracts bear a closer resemblance to venture capital contracts than to traditional angel contracts, albeit without some of the venture capitalist's bells and whistles.").

[58] *See* Gilson, *supra* note 46, at 1073 ("The initial venture capital investment usually will be insufficient to fund the portfolio company's entire business plan. Accordingly, investment will be 'staged.' A particular investment round will provide only the capital the business plan projects as necessary to achieve specified milestones set out in the business plan.").

[59] *Id.* at 1081 ("By accepting a contractual structure that imposes significant penalties if the entrepreneur fails to [meet] specified milestones based on the business plan's projections—the venture capital fund's option to abandon then becomes exercisable—the entrepreneur makes those projections credible.").

[60] Note an important distinction: this Article is *not* discussing the signals that investors *in crowdfunding campaigns themselves* might use when selecting among startups seeking crowdfunding *funds*. *See* Gerrit K.C. Ahlers et al., *Signaling in Equity Crowdfunding*, 39 ENTREPRENEURSHIP THEORY & PRAC. 955, 959 (2015) (stating that information asymmetries between investors and entrepreneurs are "even more pronounced in an equity crowdfunding

generally have three signals to assess a potential investment: (1) the identity of the company's early investors, (2) the investment contracts the VCs inked with entrepreneurs, and (3) the company's patenting activity.[61] Unfortunately, there are problems with relying on these signals for *ex ante* investment selection.

The first signal, looking at who has already funded the company, can certainly be credible. Prominent individual angels, such as LinkedIn founder Reid Hoffman and professional angel groups like Silicon Valley's Band of Angels, are likely to have their choice of top investments. Therefore, companies funded by these angels send a credible signal of high quality to VCs who may follow.[62] However, not all companies can attract the attention of a prominent angel or investment group. Absent these investors, startups can rely on friends and family, but these investors do not send the same signal of quality as angels and VCs because they will support the startup for reasons other than an eventual return.[63]

Another pre-crowdfunding signifier of a high-quality company is said to be the entrepreneur's willingness to accept certain contract terms. Accepting staged financing from VCs, with more funding contingent on the next milestone, is thought to signal an entrepreneur's confidence in reaching that milestone.[64] "Bad"

context … because small investors are less likely to have experience evaluating investment opportunities"); *see also* Ethan Mollick & Alicia Robb, *Democratizing Innovation and Capital Access: The Role of Crowdfunding*, 58 CAL. MGMT. REV. 72, 74 (2016) ("While a lot is known about the signals VCs look for when funding a venture, we know much less about how the crowd decides what to fund.").

[61] *See* Darian Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 749–50 (2010) [hereinafter Ibrahim, *The Next Silicon Valley*] (noting that private VCs send signals regarding which start-ups they fund and that VCs look to the start-ups' patents and investment contract).

[62] *See* J.W. Verret, *Uber-ized Corporate Law: Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications*, 41 J. CORP. L. 927, 934 (2016) ("Information problems not resolved by intermediaries could be resolved by the signal of an initial anchor investor. For example, seed funding from a venture capital (VC) could be a vitally important initial signal for crowdfunded entities. This way crowdfunders could free ride on the initial investment of diligence by the VC.").

[63] JAMES JOYCE, A PORTRAIT OF THE ARTIST AS A YOUNG MAN 213 (John Paul Riquelme ed., W.W. Norton 2007) (1916) ("Whatever else is unsure in this stinking dunghill of a world a mother's love is not.").

[64] *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 56 (Ashgate ed., 2001) ("The prospect of an initially small investment keyed to a performance milestone will tend to deter an entrepreneur from approaching a VC with a low quality business and exaggerating its prospects.").

entrepreneurs will not be confident of their ability to reach the milestones and will want all funding upfront.[65] The same is true of granting VCs "preferred stock" as opposed to granting the entrepreneur common stock.[66] Because a VC's preferred stock will get paid on sale or liquidation before the common stock receives any payout, an entrepreneur who accepts "inferior" common stock is thought to signal their belief that the value of the startup will be more than the VC's preferences.[67]

The problem is that contract-based signals are not particularly credible.[68] Given how difficult it is to achieve VC financing, an entrepreneur who is offered several million dollars to grow their venture will probably agree to almost any contractual terms. This is certainly not true of all entrepreneurs. For instance, "serial" entrepreneurs on their third or fourth successful venture will have far more leverage[69] and likely have the financial resources to hire an attorney to negotiate.[70] But for the vast majority of first-time entrepreneurs seeking their first VC funding, agreeing to staged financing and preferred stock is simply the price of attracting a VC's investment.[71]

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[65] *See* Ibrahim, *The Next Silicon Valley*, *supra* note 61, at 751 ("When entrepreneurs agree to delay future funding until reaching certain benchmarks, it sends a signal that this is a high-quality entrepreneur who believes these benchmarks will be reached.").

[66] *See* Gilson, *supra* note 46, at 1072 ("The venture capital fund's equity investments in portfolio companies typically take the form of convertible preferred stock.").

[67] *See* Ibrahim, *The Next Silicon Valley, supra* note 61, at 751–52 (discussing the signals that entrepreneurs send by selling preferred stock to private VCs while holding common stocks themselves).

[68] *See id.* at 752 (stating that signals based on investment contracts have questionable credibility).

[69] *See* John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 315 n.130 (2013) ("[T]he culture of Silicon Valley lionizes the serial entrepreneur."); *see also* John F. Coyle & Joseph M. Green, *Startup Lawyering 2.0*, 95 N.C. L. REV. 1403, 1426 (2017) (quoting a lawyer as saying, "A lot of the work we do puts us at risk of not ever getting paid. Sometimes we'll assume that risk knowingly, as when a serial entrepreneur has a really hot startup. We'll run a tab and count on the funding to come through at some point.").

[70] *See* Paul Gompers et al., *Performance Persistence in Entrepreneurship*, 96 J. Fin. Econ. 18, 19 ("[E]ntrepreneurs with a track record of success can more easily attract suppliers of capital, labor, goods and services if suppliers believe there is performance persistence. A knack for choosing the right industry-year in which to start a company generates additional subsequent excess performance if, as a result, the entrepreneur can line up higher quality resources for his next venture.").

[71] *See* Ibrahim, *The Next Silicon Valley*, *supra* note 61, at 751–52 (noting that most entrepreneurs would not reject staged financing or preferred stock, as both are difficult to obtain).

VCs have also looked to a startup's patenting activity as a marker of potential success.[72] The argument is that new companies with more patents are, all other things equal, better investments. However, intellectual property experts have now seemed to coalesce around the idea that a startup's patents have, at best, limited signaling value. Patents *do* signal that an entrepreneur is "disciplined in [her] engineering approach"[73] and not lazy.[74] Patents also signal that a new company is of the rapid-growth variety, as opposed to a lifestyle firm.[75]

But patents do not necessarily signal market dominance in the patented technology. Ronald Mann has observed that software patents are often rendered obsolete by rapidly-changing technology,[76] and that it is difficult to patent an entire software product or understand what is exactly covered.[77] Consequently, in software at least, the very decision to obtain a patent—as opposed to continuing product development and consumer testing—reveals an entrepreneur who focuses on the wrong priorities.[78] Thus,

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[72] Long, s*upra* note 5, at 646 ("Intellectual property can serve as a signal of less readily measurable attributes . . . . The quantity and quality of the patents in the portfolio can serve as a signal of other firm attributes, as can the order in which the firm applies for the patents.").

[73] Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 TEX. L. REV. 961, 993 (2005) (internal quotation marks omitted). *See also* Long, *supra* note 5, at 654 ("Nobody associates obtaining patents with sloth and shiftlessness.").

[74] Mann, *supra* note 73, at 994 (patents "reflect[] something positive about the ability of the management team to focus and execute" and "nothing about the uniqueness of the technology or the firm's ability to ex[c]lude competitors").

[75] Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1191 (2010)(discussing interviews with venture lenders who revealed that "a start-up that has IP signals itself as a rapid-growth company as opposed to a lifestyle firm").

[76] *See* Mann, *supra* note 73, at 979 ("[T]echnology tends to develop so rapidly that by the time a patent is issued—and the formal right to exclusivity commences—the technology may be obsolete.").

[77] *See Id.* ("[I]t is difficult to patent an entire product in the software industry because any particular product is likely to include dozens if not hundreds of separate technological ideas."); *id.* (observing "the difficulty of being sure that a competing product infringes a patent").

[78] *See* Mann, *supra* note 73, at 982 (emphasizing that "attention to patents can be damaging to a startup because it has the potential to divert limited time and resources from . . . a highly time-pressured effort to develop a product and convince customers and investors of its worth before the firm runs out of capital resources").

patents, if even available as a signal, may send mixed messages to potential investors.[79]

For the reasons above, the signals on which angels and VCs have traditionally relied turn out to be of limited use in *ex ante* investment selection. But information asymmetry between entrepreneurs and investors still exists in the extreme, and signaling will be as important as ever for new companies seeking investors. All of which leads to this Article's main argument: for new companies that plan to seek angel or VC funding down the road, completing a successful crowdfunding campaign is a new and positive signal an entrepreneur can send about her company's high quality.

III. CROWDFUNDING AS A NEW SIGNAL OF HIGH QUALITY

This Part will introduce the existence of a crowdfunding campaign as a new signal of firm quality. As previously discussed, effective signals must be both costly and observable.[80] Crowdfunding is costly not only because entrepreneurs are granting investors a piece of their company, but because undertaking a crowdfunding campaign requires significant disclosure and associated costs.[81] Further, crowdfunding is costly in the sense that failure may doom a nascent company from the outset.

Crowdfunding is also salient: a company that crowdfunds will be listed on a funding portal's website, file forms with the SEC, and may be featured in newspaper or online articles. Given that crowdfunding campaigns should send credible signals to the market, the question remains: *are these signals all bad, as currently intimated, or are they positive?*

[79] *See id.* at 980–81 ("The general theme . . . is that there are many factors that play into the ability of a startup firm to obtain funding and success and that intellectual property has a low place on the list of factors, if it appears on that list at all.").

[80] *See supra* notes 43–45 and accompanying text.

[81] *See* Houman B. Shadab, *Henry Manne and Nonpublic Company Disclosure*, 12 J.L. ECON. & POL'Y 361, 368 (2016) ("Crowdfunding companies must file Form C containing extensive disclosures, including about issuer's business, its capital structure, how its securities were valued, and a narrative of its financial condition."); Samuel G. Wieczorek, *Regulation Crowdfunding: A Viable Option for the Franchising Industry?*, 36 FRANCHISE L.J. 275, 283 (2016) (complying with Regulation CF "would, in all likelihood, entail hiring legal counsel to assist in completing the offering disclosure statement . . . and in many cases engage an independent accountant to prepare either reviewed or audited financial statements").

A. SUCCESSFUL VS. UNSUCCESSFUL CROWDFUNDING CAMPAIGNS

First, we must distinguish between crowdfunding campaigns that raise the desired funds and those that do not. A company's failure to raise the desired funds in a crowdfunding campaign sends a negative signal to follow-on investors because it demonstrates a lack of market interest in the company's product. Therefore, it will be important to empirically track what percentage of crowdfunding campaigns are successful. The rarer a successful crowdfunding campaign is, on average, the stronger a positive signal success would send. But that positive signal must be strong enough that it attracts follow-on investment; otherwise, companies will not accept the risk of an unsuccessful crowdfunding campaign.

The success of a campaign can be found by calculating the ratio, S, between the amount raised, a, and the amount desired, d. This formula is expressed below:

$$S = a/d$$

When $S \geq 1$, the campaign is successful. When $S < 1$, the campaign has not been successful.[82]

The success rate of a series of campaigns can be found by calculating the ratio, R, between the number of successful campaigns, S_n, and the total number of campaigns, n. This formula is expressed below:

$$R = S_n/n$$

When $R = 1$, all campaigns have been successful. There is an inverse correlation between R and the likelihood of a stronger positive signal from successful campaigns.

B. CROWDFUNDING AS A NEGATIVE SIGNAL

Early commentary has argued that a company who chooses to seek crowdfunding sends a *negative* signal. Some legal academics

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[82] This assumes an all-or-nothing campaign. It is also possible that, with greater experience, investors may require some multiple of the amount raised to the amount desired, in which case S may need to be higher than 1 to send a positive signal. Conversely, if a company fails to hit their fundraising target, they may be forced to return investor funds. *See* 17 C.F.R. §§ 227.304(d), 227.201(g) (2016).

that have addressed crowdfunding and its implementing law, Regulation CF, have suggested that raising money through crowdfunding is a path that only low-quality companies will take. Michael Dorff, for example, is a vocal critic of crowdfunding. Dorff observes "[t]he core issue has nothing to do with disclosure: it's that these investments are going to be *terrible*."[83] He goes on to opine that crowdfunding is beyond repair as an idea and should be killed through "excessive regulation."[84]

Others take a more nuanced approach, but remain negative or at least skeptical of crowdfunding as currently designed. Some call for more disclosure to combat potential fraud.[85] From the other end of the disclosure spectrum, some complain that what began as a promising idea has been made unworkable due to overregulation.[86] Crowdfunding disclosure is actually robust given the relatively small amounts of funds sought.[87] Disclosure, however, no matter

[83] Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 496 (2014).

[84] *Id.* at 523.

[85] *See* 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, 1767 (2012) ("[The] exemption for crowdfunding should include some affirmative disclosure requirements. Those disclosures could be less burdensome than those currently required under Regulation A, but they should still be sufficiently detailed to provide investors with sufficient information to enable them to make an informed investment decision."). Merritt Fox cautions against giving up on disclosure and relying on proxies including signaling, at least for public issuances of formerly privately held securities:

> First, the presence of these information asymmetries can lead to a severe adverse-selection problem. This problem will prevent a substantial portion of worthy offerings from being successfully marketed unless, as an antidote, investors are made confident that issuers are providing a certain level of credible disclosure at the time of the offering. A regime relying solely on market-based antidotes to these problems—signaling, underwriter reputation, and accountant or credit-rating certification—and backed only by liability for intentional affirmative misrepresentation is, in many circumstances, not a sufficient solution.

Fox, *supra* note 44, at 678. *See also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 935–37 (2011) (expressing concerns that crowdfunding will be vulnerable to some of the same abuses for fraud as under Rule 504).

[86] *See* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1604–05 (2013) (noting that compromises regarding Regulation CF turned a "regulation-free zone into a quite heavy and costly set of responsibilities on both issuers and any intermediaries that assist them— so much so that it is difficult for us to see why a rational start-up entrepreneur would find it appealing to use the [crowdfunding] exemption at all.") (citation omitted).

[87] *See* Coyle & Green, *The Not-So-Safe SAFE*, *infra* note 93, at 180 (arguing that Regulation CF "has largely been viewed as heavily favoring investor protection over capital

how robust, can only do so much when companies have limited track records and rely on unsophisticated investors to read and process the disclosures.[88]

Still there are other concerns that the crowd may not choose investments as wisely as angels with years of experience or as VCs who select investments as a profession.[89] By its very nature, the crowd cannot provide advice and connections (so-called "value-added services"[90]) *ex post* investment like angels and VCs.[91]

Others question whether the crowd will be skilled at judging new business ideas.[92] Or that crowdfunding can attract growth

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formation," especially regarding disclosure requirements"); Frank Vargas, Jennifer Dasari & Michael Vargas, *Understanding Crowdfunding: The SEC's New Crowdfunding Rules and the Universe of Public Fund-Raising*, BUS. L. TODAY 1, 7 (Dec. 14 2015) https://businesslawtoday.org/2015/12/understanding-crowdfunding-the-secs-new-crowdfunding-rules-and-the-universe-of-public-fund-raising/ (opining that crowdfunding requires "[private placement memorandum"-like disclosures, annual reports and better quality financials").

[88] *See* Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 594–95 (discussing OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014) in the crowdfunding context); *see also* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 109–110 (2012) [hereinafter Bradford, *Crowdfunding and Federal Securities Laws*] (giving statistics and noting that "[m]any Americans are not financially literate."); *id.* at 112 ("Since crowdfunding sites are usually open to the general public, at least some of the people investing in crowdfunding offerings will not have the basic financial knowledge required to understand the risks."); Vargas, Dasari & Vargas, *supra* note 87, at 8 (discussing how "[a] start-up simply would not be wise to take on an army of unsophisticated investors").

[89] Traditional entrepreneurial finance has succeeded in large part due to expert investors. *See* Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 10, at 1494–96 (explaining that passive startup investors rely on angel and VC investors to take the lead in screening, due diligence, and engaging *ex post* with entrepreneurs).

[90] *See* Reza Dibadj, *Crowdfunding Delusions*, 12 HASTINGS BUS. L.J. 15, 48 (2015) ("[C]rowdfunding broaches the topic of unbundling governance rights and value-added services from capital. Consider, for instance, that startup companies seeking funds from angel investors and venture capital firms typically also receive 'value-added' services in the form of strategic and management guidance, but crowdfunding essentially uncouples these services from the transfer of capital itself.").

[91] *See* Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 79 (1998) (talking not about crowdfunding but earlier efforts at Internet investing, "[i]nvestors may also view the absence of outside expert involvement in Internet offerings as a negative signal.").

[92] *See* Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 10, at 1493 (noting that "[w]hile crowd-based wisdom does not seem to be a good fit with startup investing, expert-based investing has a proven track record").

companies that make entrepreneurial legends, or only lifestyle companies with limited growth potential?[93]

Others question the tactics companies use in early crowdfunding efforts, particularly selling certain types of "deferred" securities to the crowd, when those securities work better in traditional angel/VC finance when follow-on financing is more certain.[94] For example, John Coyle and Joe Green have argued that the type of security sold in some crowdfunding campaigns—the Simple Agreement for Future Equity (or "SAFE")—is anything but safe.[95] The SAFE itself is neither debt nor equity, and converts to actual equity only if the issuing company either raises a follow-on round of financing or is sold.[96] Since many crowdfunding companies are predicted to be lifestyle companies that do not seek future funding or a quick sale, Coyle and Green fear that early investors (especially the unsophisticated crowd) who buy SAFEs will never see a return on their investment.[97]

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[93] *See* John F. Coyle & Joseph M. Green, *Crowdfunding and the Not-So-Safe SAFE*, 102 VA. L. REV. ONLINE 168, 175 (2016) [hereinafter Coyle & Green, *The Not-So-Safe SAFE*] ("[M]any of the startups that choose to pursue crowdfunding as a means of raising capital do so because they have no other options, and they may still struggle to raise traditional venture financing down the road."); Michael Lilly, *Exploring the Finer Details of Regulation CF Crowdfunding*, SQUARE 1 BANK 1, 2 (May 4, 2017), https://www.square1bank.com/insights/exploring-the-finer-details-of-regulation-cf-crowdfunding/ (noting that "[i]f you are launching a lifestyle business . . . then Reg. CF is a solid option"); *see also* Nicholas Herdrich, *Just Say No to Crowdfunding*, 6 U.P.R. BUS. L.J. 157, 177 (2015) (stating that equity crowdfunding may give a "[n]egative impression [that the] business [was not] able to secure traditional funding sources earlier"); Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 254 (2015) ("The end result would be that crowdfunding would be a signal, whether true or not, of poor quality.") (citation omitted). But as this Article has already noted, not all companies that crowdfund will be lifestyle companies. *See supra* notes 9–17 and accompanying text.

[94] *See infra* notes 118–129 and accompanying text.

[95] Coyle & Green, *The Not-So-Safe SAFE*, *supra* note **Error! Bookmark not defined.**, at 171–74 (arguing that SAFEs are appropriate for startups coming out of the famous Y-combinator accelerator who go on to raise additional sums of venture capital, but not well understood and potentially hazardous for inexperienced startups seeking crowdfunding).

[96] *See id.* at 171–72; *see also* Wroldsen, *supra* note 17, at 574 ("SAFEs do not include any provisions related to fiduciary duties or information rights and expressly state that SAFE investors are not shareholders of the company.").

[97] Coyle & Green, *The Not-So-Safe SAFE*, *supra* note **Error! Bookmark not defined.**, at 175–76 (explaining that non-tech startups selling SAFE securities "are less likely to be candidates for VC investment and more likely to evolve into either lifestyle businesses for the founders . . . or companies that rely on debt financings (such as bank loans) and reinvested profits to support additional growth").

Still others question whether crowdfunding, by adding numerous small, unsophisticated investors,[98] will scare off angels and VCs who might want to make a follow-on investment.[99] When prior investors complicate a company's voting or capitalization table, sophisticated investors may take a pass and invest in another startup.[100]

The arguments above are all reasons why conducting a crowdfunding campaign could be (and has been) viewed as a negative signal to follow-on investors. In sum, commenters argue if a company crowdfunds, the company signals to angels and VCs that it: a) cannot raise money anywhere else; b) lacks expert investors to guide it; c) takes advantage of early investors; and d) complicates the company's capitalization table. This paper will address these criticisms and demonstrate that, despite these concerns, crowdfunding can send positive signals and attract follow-up funding.

C. CROWDFUNDING AS A POSITIVE SIGNAL

Early commentators have not distinguished between successful and unsuccessful crowdfunding campaigns—that is the difference between companies that the crowd vets and companies that the crowd *approves*. Early commentary seems to assume that most attempts at crowdfunding will be unsuccessful due to unsatisfactory quality or fraudulent companies employing the medium. And if all crowdfunding campaigns fail, obviously these concerns have merit. But if some succeed, a divide—and indeed natural selection

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[98] *See* Hurt, *supra* note **Error! Bookmark not defined.**, at 242–43 (noting the existence of "amateur" and unsophisticated investors in crowdfunding).

[99] *See, e.g.,* Gregory D. Deschler, Comment, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries*, 58 ST. LOUIS U. L.J. 1145, 1184–85 (2014) ("[A] crowd of investors with voting power in securities crowdfunding emits a warning signal and professional investors who might otherwise have bought into a crowdfunded company (and thereby provided at least some crowd investors with liquidity) steer away from such investments."); *Risks*, WEFUNDER, https://wefunder.com/faq/investors (last visited Nov. 3, 2017) ("Venture capitalists are uncomfortable when startups have many small investors (they don't like collecting thousands of signatures)."); Vargas, Dasari & Vargas, *supra* note 87 (referring to horror stories of some startups' crowdfunding donors disrupting a company's operations, "[a] start-up simply would not be wise to take on an army of unsophisticated investors for the sake of a few thousand dollars."); Wieczorek, *supra* note 81, at 283 ("Another potential downside to issuing crowdfunded securities is the prospect of hundreds of small investors.").

[100] *See infra* note 122 and accompanying text.

experiment—ensues. Despite the arguments outlined above, this Article argues that a successful crowdfunding campaign sends a positive signal of firm quality to follow-on investors.

First, crowdfunding can be used skillfully to demonstrate a real-world demand for a company's product or service, and subsequently turn customers into brand advocates. Second, crowdfunding can "professionalize" a company in ways that traditional entrepreneurial finance does not. Third, issuing the SAFE security actually preserves follow-on investment because the SAFE is redeemable by the company, preventing VCs from having to deal with numerous small investors and a messy capitalization table. Finally, given the way that the SAFE functions, crowdfunding suggests a savvy entrepreneur—one who does not wish to dilute their own equity stake—rather than a desperate one. These arguments will now be discussed in turn.

1. *Crowdfunding can show real-world demand for a company's product or service.*

First, a successful crowdfunding campaign signals *real-world demand* for the company's product or service.[101] Conducting a successful crowdfunding campaign, especially if success becomes the exception rather than the rule, signals something positive about the company who successfully entices the crowd to buy in. As one commentator notes: "[c]rowdfunding platforms can . . . be used for effective product and service validation."[102] Who invests in crowdfunding campaigns? For companies selling consumer products or services, it is likely the company's customers.[103] These customers use the company's product or service, like it, and think others will too. They invest in the company to capture this potential upside. Anecdotally, I have been told the same is true for smartphone apps and video games. While the same brand-loyalty argument may not apply to a highly-technical innovation, some growth companies dependent on consumers exist in the technology space.[104]

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[101] *See* Mollick & Robb, *supra* note 62, at 75 ("Crowdfunding serves as an excellent tool for demonstrating demand, since it shows a willingness to pay for a product."). *See also* Fleming & Sorenson, *infra* note 137, at 14 ("Venture capitalists can also potentially benefit [from crowdfunding by] having entrepreneurs eliminate some of the questions around whether a market exists for their product or service. . . ."); Herdrich, *supra* note **Error! Bookmark not defined.**, at 169 n.96 (2015) ("[A] successful crowdsourcing round may be one way to prove to angel or venture funds that there is a market for a new product."); *cf.* Christian Catalin et al., *Can Equity Crowdfunding Democratize Access to Capital and Investment Opportunities?*, MIT INNOVATION INITIATIVE 12 (May 2016), https://innovation.mit.edu/assets/MIT_-Equity-Crowdfunding_Policy-Brief.5.16.2016.pdf ("Backers of wildly successful Kickstarter campaigns (like Oculus and Pebble) not only provide startups the money they need to build prototypes and scale, but also generate the demand signal that professional investors later rely on when choosing which ventures to fund.").

[102] Judd Hollas, *Why Venture Capitalists Are Turning to Crowdfunding*, ENTREPRENEUR (Jan. 20, 2015), https://www.entrepreneur.com/article/240984. *See also* Epi Ludvik Nekaj, *Five Reasons Why Equity Crowdfunding Beats Venture Capital*, VIRGIN (Dec. 3, 2015), https://www.virgin.com/entrepreneur/five-reasons-why-equity-crowdfunding-beats-venture-capital ("The beauty of crowdfunding is that a community can show support through their wallets and put their weight behind [an] entrepreneur and an idea.").

[103] *See* Sunghan Ryu & Young-Gul Kim, *A Typology of Crowdfunding Sponsors: Birds of a Feather Flock Together?*, 16 ELEC.COMMERCE RESEARCH & APPLICATIONS 43, 48 (2016) (noting that the "avid fan" of the product or service being crowdfunded is one of the largest groups of investors (emphasis removed)); *see also* Ricarda B. Bouncken et al., *Crowdfunding: The Current State of Research*, 14 INT'L BUS. & ECON. RES. J. 407, 411 (2015) (noting that with a crowdfunding campaign, the company's "base of potential customers is increased").

[104] For example, Angry Birds started as an iPhone app. *See generally* Paul Kendall, *Angry Birds: The Story Behind iPhone's Gaming Phenomenon*, THE TELEGRAPH (Feb. 7, 2011, 5:30 PM), http://www.telegraph.co.uk/technology/video-games/8303173/Angry-Birds-the-story-

Thus, in the right context, crowdfunding shows follow-on investors that the company has a real customer base and that there is demand for its product or service.[105] When selecting their investments, angels and VCs consider whether the company (i) demonstrates a market for a product or service; and (ii) shows that it is fulfilling that market demand.[106]

Further, having individuals not only as customers but as investors can help to increase the company's market reach. Those customers or users, now investors, can become brand advocates for the company.[107] One article noted the "[s]ignificant number of

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behind-iPhones-gaming-phenomenon.html. Since 2009, Angry Birds has enjoyed substantial periods of valuation and growth. Jussi Rosendahl & Tuomas Forsell, *'Angry Birds' Maker Rovio Plans IPO to Spur Growth, M&A*, REUTERS (Sept. 5, 2017, 1:22 AM), https://www.reuters.com/article/us-rovio-ipo/angry-birds-maker-rovio-plans-ipo-to-spur-growth-ma-idUSKCN1BG0HY ("Rovio saw rapid growth after the 2009 launch of the original 'Angry Birds' game ....". *See also* Ibrahim, *supra* note 1, at 578 and (discussing consumer product growth companies raising funds on Title II site CircleUp).

[105] *See* CROWDFUND CAPITAL ADVISORS, HOW DOES CROWDFUNDING IMPACT JOB CREATION, COMPANY REVENUE AND PROFESSIONAL INVESTOR INTEREST? 4, 10 (2014), http://crowdfundcapitaladvisors.com/research/ (explaining that crowdfunding has a marketing benefit that translates into sales); Ajay Agrawal et al., *Some Simple Economics of Crowdfunding*, INNOVATION POL'Y & ECON. 63, 72–73 (2014) (discussing how equity crowdfunding can benefit the company as a form of market research to predict product demand); Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 3 (2014) ("[F]unding need not be the only goal of a crowdfunding effort . . . crowdfunding has been used by founders to demonstrate demand for a proposed project, which can lead to funding from more traditional sources."); John Beckwith, *Predicting Success in Equity Crowdfunding* (Apr. 27, 2016) (unpublished manuscript) (on file with the University of Pennsylvania ScholarlyCommons), http://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=joseph_wharton_scholars ("[E]quity crowdfunding can serve as a validation tool to ensure that there is substantial demand for the product, providing a particularly informative type of market research.").

[106] *See* Mann, *supra* note 73, at 976 ("The key is 'sustainable differentiation': something special about the particular firm that will enable it to do something that its competitors will not be able to do for the immediate future." (citation omitted)); *id.* ("[E]ven before investors consider whether a firm can protect a market leader position, they will want to know whether the product is one that customers need so desperately that the firm could earn significant revenues from sales of the product."); Ron Miller, *Can Crowdfunding and Venture Capital Coexist*?, CROWDFUND INSIDER (Mar. 2, 2016, 9:42 PM) https://www.crowdfundinsider.com/2016/03/82466-can-crowdfunding-and-venture-capital-coexist/ ("Equity crowdfunding provides a level of feedback that can't be easily replicated; there is no greater validation than people investing their hard-earned money into a company's future. The early market validation this provides is absolutely critical, a fact that venture capitalists are sure to appreciate.").

[107] Brett Relander, *With the Right Incentives Loyal Customers Will Become Brand Advocates*, ENTREPRENEUR (June 2, 2015), https://www.entrepreneur.com/article/246579 (discussing that loyal customers can grow a company through referral programs).

owners/brand advocates" as a positive reason to use equity crowdfunding.[108] Funding portals likewise indicate that crowdfunding can be used to convert customers into brand advocates.[109]

In sum, a successful crowdfunding campaign signals both a demand for a company's product or service and a company's capacity to meet that demand. By turning customers into owners, a crowdfunding campaign can elevate a company by creating brand advocates out of users.[110] A successful crowdfunding campaign can advertise or market the company to new users.[111]

2. Can "Professionalize" the Company.

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108 Herdrich, *supra* note 93, at 177.

109 *See Risks*, WEFUNDER, https://wefunder.com/faq/investors (last visited Nov. 4, 2017) ("Most of the fun from investing in startups comes from how you can help them! You can offer product feedback, introduce founders to relevant people in your network, or evangelize product launches."); *Title III Equity Crowdfunding on SeedInvest*, SEEDINVEST: RAISING CAPITAL, https://www.seedinvest.com/blog/raising-capital/title-iii-equity-crowdfunding (last visited Sept. 12, 2018) ("By inviting its early adopters to participate in a Reg CF [Regulation Crowdfunding] offering, a company can help turn users into brand evangelists. Customers who own stock in a business are more likely to recommend that company to others and increase the amount they spend with that company. Reg CF gives startups a way to build deep brand loyalty with their customers, a key driver of growth for early stage companies . . . Reg CF is about more than just fundraising. It is an opportunity for a company to make a marketing splash and create an army of brand ambassadors."); *Why Wefunder?*, WEFUNDER, https://wefunder.com/faq/founders (last visited Nov. 4, 2017) ("A crowd of investors can help in ways traditional investors can't. They are often your most passionate evangelists."). Non-U.S. equity crowdfunding portals make the same indication. *See* Steven Male, *Ultimate Guide to Marketing Your Equity Crowdfunding Offer*, SNOWBALL EFFECT (May 21, 2015), https://www.snowballeffect.co.nz/blog/ultimate-guide-to-marketing-your-equity-crowdfunding-offer ("Besides the inevitable value in having a whole new bunch of people invested in and buying your products, the crowd can also be harnessed to promote products, leverage skillsets and capabilities that are missing in the company, and provide a credible source of market feedback and ideas."); *Quarterly Company Progress Report*, SNOWBALL EFFECT (Dec. 2015), https://www.snowballeffect.co.nz/companies-update-december-2015 ("[C]ompanies can unlock significant value from shareholders who act as advocates for their products if they're mobilised by engaging and regular information.").

110 *See* Relander, *supra* note 107.

111 Victor Fleischer has argued that deal structures, such as Google's IPO, can advertise or have a "branding effect" in addition to transmitting information. Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1582 (2006); *see also* D. Gordon Smith, *The "Branding Effect" of Contracts*, 12 HARV. NEGOT. L. REV. 189, 196 (2007) ("Though Fleischer refers to this form of advertising as 'consumer signaling,' it is not signaling in the conventional economic sense because it is not aimed at mitigating information asymmetries") (citation omitted); *id.* ("This marketing component of deal structures is not focused on the transmission of information, but instead on the creation of meaning.") (citation omitted).

Conducting a crowdfunding campaign can force an entrepreneur to "professionalize" the company. The entrepreneur must put together disclosure, deal terms, and other information in a professional format, viewable on the Internet. This may not lead to a stronger product or service, but having to work with attorneys and accountants and describe what the company *is* doing can help the entrepreneur sharpen her strategy and explain it to others.[112] A company willing to bear these costs at an early stage signals to investors that it is willing to "do it right."

Selling to friends and family, or even angels and VCs, will not force the company to do the same legwork. Friends and family likely invest under Rule 504 (if they are unaccredited) or Rule 506 (if they are accredited), and neither rule requires disclosure.[113] When angels and VCs invest, they do so under Rule 506, which does not require disclosure.[114] Thus, Regulation CF forces companies to present themselves professionally in ways that the prior securities law exemptions do not.[115]

As with patenting activity, doing the legwork to run a crowdfunding campaign signals entrepreneurial discipline and competence.[116] Crowdfunding also enables angels and VCs to

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[112] By analogy, Lynn Stout has argued that in large corporations, forcing directors to go through procedural hurdles (hiring lawyers, bankers, etc.) to meet their duty of care can actually lead to better substantive decisions. *See* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 693 (2002).

[113] *See* 17 C.F.R. §§ 230.504, 230.506 (2017) (exempting transactions from federal registration under regulation D); *see also* 17 C.F.R. § 230.502(b)(1) (2017) (stipulating under Rule 506, no disclosure is required as long as the investors are accredited); *cf.* Exempted transactions, 15 U.S.C. § 77d(a)(6)(A) (2012).

[114] *See* C.F.R. § 230.506 (2017) (exempting transactions such as limited offers and sales from disclosure); Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 7 OHIO ST. ENTREPRENEUR BUS. L. J. 287, 295 (2012) ("Regulation D offerings overwhelmingly are made under Rule 506. Even offerings of one million dollars or less—offerings that are suited for Rule 504—are overwhelmingly made under Rule 506. Similarly, the data show offerings of one million to five million dollars—offerings that are suited for Rule 505—are also overwhelmingly made under Rule 506."); Cable, *supra* note 9, at 132 ("[t]he exemption from registration that most startup companies rely on is Rule 506 of Regulation D . . . .").

[115] Additionally, as investors gain more experience with crowdfunding campaigns, the disclosure requirements could be revised to better address information asymmetry concerns. *See infra* Part IV.B.

[116] *See* Mollick & Robb, *supra* note 62, at 75 ("[V]enture capitalists look for preparation as a signal that entrepreneurs understand the risks and pitfalls of a new business, and have a plan to overcome obstacles that present themselves."); *see also* Younkin & Kashkooli, *infra*

conduct their due diligence more easily than they could on a startup that has not crowdfunded.[117] Thus, crowdfunding helps a company directly, by making it easier for VCs and angels to invest, and indirectly, by signaling that the entrepreneur is willing to put in the work to run a real company.

3. In Defense of SAFEs.

The SAFE security is "a deferred equity investment that will prove valuable to the holder if, and only if, the company that issues it raises a subsequent round of financing, is sold, or goes public."[118] Due to its binary nature (converting to common stock upon a major event or remaining a SAFE),[119] the SAFE is likely to result in a complete loss of investment for the less successful crowdfunding companies, and possibly for even moderately successful lifestyle companies. However, this paper has two responses in defense of SAFEs.

First, with no resale market for crowdfunding securities on the horizon,[120] common stock or other equity in these same companies may in practice prove to be equally worthless. In order for crowdfunding investors to have liquidity in their investment, a company that crowdfunds will need to attract follow-on investors, and will need to find an acquirer or undertake an IPO to achieve liquidity.[121] But companies would need to follow these steps with or without SAFE.

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note 134, at 32 (discussing how crowdfunding sites can "help founders develop a business plan, practice their pitch, and set appropriate benchmarks for success").

[117] *See* Hollas, *supra* note 102 ("Crowdfunding platforms inherently leverage technology to categorize multiple aspects of the companies seeking capital and present them in a standardized format that can quickly be reviewed by any potential investor. This allows for a much quicker due-diligence process than traditional means."); *cf*. Mollick & Robb, *supra* note 62, at 76 ("[T]he crowd also does a good job performing due diligence on projects . . . because the crowd, collectively, is wise in spotting fraud.").

[118] Coyle & Green, *The Not-So-Safe SAFE*, *supra* note **Error! Bookmark not defined.**, at 172.

[119] *See id.*

[120] *See* Scott Shane, *Will Equity Crowdfunding Buyers Be Able to Sell Their Shares?*, ENTREPRENEUR (June 30, 2015) https://www.entrepreneur.com/article/247832# (exhibiting skepticism of a resale market for crowdfunding securities); *cf*. Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 580 n. 106 (explaining the high minimum value VCs require to invest, which was around $5.2 million in 2003 (citation omitted)).

[121] *See* Shane, *supra* note 120(identifying the different methods for start-up companies to achieve liquidity).

Second, and perhaps more importantly, the way SAFEs are written now encourages angels and VCs to follow a crowdfunding round. VCs do not like a messy capitalization table, or to "share" their traditional equity stake with earlier investors.[122] Because SAFEs are not technically equity—and therefore do not add shareholders to the company whose votes must be procured—nor debt with looming interest payment obligations, the investments do not, before conversion, complicate later VC investments.[123]

At the time of a SAFE's conversion to equity, two saving graces help the attractiveness of the investment. First, SAFEs typically convert into non-voting stock, thus eliminating the voting concerns that typically come with a number of small investors.[124] Even more importantly, SAFE provisions typically include redemption clauses.[125] These redemption clauses allow companies to "repurchase the SAFEs of non-accredited investors for the fair market value of the instrument, as determined by an independent appraiser of the company's choosing."[126] Therefore, a VC preferring a clean capitalization table could simply buy out the SAFE holders before their SAFEs convert to equity.

Coyle & Green rightly observe that crowdfunding investors "can be prevented from seeing the bulk of the returns from the most successful companies they fund."[127] VCs can buy crowdfunding investors out if larger gains loom for the company. In short, the huge payoff from correctly picking the next Facebook is no longer there for the crowdfunding investors; instead, it all belongs to the entrepreneurs and VCs. If crowdfunding investors become wise to this practice, then perhaps crowdfunding falls apart.

Perhaps SAFE securities should be rewritten to give crowdfunding investors a premium on buyout, or factored into the

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[122] *See* Ibrahim, *Angel Investors supra* note 11, at 1429 ("A start-up marred by a complicated angel round is unattractive to venture capitalists because it requires them to 'unwind' the non-standard angel preferences in order to strike the venture capitalists' standard deal.").

[123] *See id.*

[124] Coyle & Green, *The Note-So-Safe SAFE*, *supra* note **Error! Bookmark not defined.**, at 179 (critiquing the non-voting nature as leaving crowdfunding investors with SAFEs that convert "at the mercy of the founders and more sophisticated investors" but observing that these investors "would at least be owed fiduciary duties by the company's board of directors").

[125] *See id.* at 178–79.

[126] *Id.*

[127] *Id.* at 179.

appraiser's initial valuation.[128] Companies giving redeemed crowdfunding investors a premium would soften the blow of redemption. While the investors may lose if a startup does go on to a public offering, they would win on the other startups that VCs fund but then ultimately flounder or fail. VCs, of course, may choose to be generous with SAFE redemptions out of litigation fears and not concern for crowdfunding's long-term viability as a matter of game theory.[129]

4. Crowdfunding Can Reveal a Savvy Entrepreneur.

Crowdfunding can be a savvy move for entrepreneurs for social and financial reasons. An entrepreneur seeking initial capital to get her venture off the ground has a few potential choices: bootstrapping, asking friends and family, or seeking money from angels, VCs—and now the crowd. Not all of these choices will be available to all entrepreneurs.

Bootstrapping is using an entrepreneur's personal resources to fund the startup, for example, by putting company expenses on a credit card.[130] As most growth startups fail, bootstrapping these types of companies is a significant financial risk to an entrepreneur.[131] A Kauffman Foundation study found that the more credit card debt a new company incurs, the more likely it is to fail.[132] And as explored more below, not all entrepreneurs have access to personal funds.

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[128] There is precedent for this. *See* Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 466 (1977) (affirming a circuit court determination that a plaintiff stated a cause of action for breach of fiduciary duty when Morgan Stanley valued a company at a $125 per share for minority shareholders and $150 per share for the majority shareholder).

[129] *But see* Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 415–16 (2012) (discussing the collective action problem of a number of small shareholders each with a small financial stake having the motivation or coordination to sue for crowdfunding fraud or other violations).

[130] *See* Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 821–22 (2004) (discussing bootstrapping methods).

[131] RANDALL STROSS, THE LAUNCH PAD: INSIDE Y COMBINATOR, SILICON VALLEY'S MOST EXCLUSIVE SCHOOL FOR STARTUPS 14 (2012) (quoting well-known entrepreneur Paul Graham as stating, "If you start a startup, you'll probably fail. Most startups fail. It's the nature of the business.").

[132] Robert H. Scott III, *The Use of Credit Card Debt by New Firms*, KAUFFMAN FOUNDATION 1 (Aug. 2009) ("[C]redit card debt reduces the likelihood that a new business will survive in the first three years of operation. The results, which were statistically significant, found that every $1,000 increase in credit card debt increases the probability a firm will close by 2.2 percent.").

Asking friends and family to invest in an entrepreneur's new company is a time-honored tradition, but it requires the entrepreneur to have wealthier friends and family.[133] It also comes with social and financial costs. Socially, there is a risk that the entrepreneur's requests are rejected, or that successful requests for capital put added pressure on the entrepreneur to succeed.[134] Financially, selling off common stock to friends and family at a low valuation, which is typical for a nascent company, dilutes the entrepreneur's ownership share.[135] If the entrepreneur can hold off on selling equity until the company is more proven, she can sell stock at a higher price and suffer less dilution (i.e., retain a greater ownership stake).

As discussed, crowdfunding campaigns may entail selling SAFE securities, which do not dilute the entrepreneur at all at the time of issuance. Thus, crowdfunding can "extend the runway" before the first actual equity round.[136] This enables the entrepreneur to sell higher-priced equity later, which dilutes her ownership stake less than an early equity round would. Even with non-SAFE issuances, crowdfunding allows the entrepreneur to separate the traditional bundling of funds and value-added services. As I have observed, "the inherent passivity of [Regulation CF] investors—a seeming negative—would actually appeal to entrepreneurs who wish to unbundle the cash and value-added service components of traditional entrepreneurial finance. In obtaining only cash from

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[133] *See infra* Part IV.A. for a discussion of how crowdfunding can reduce inequality between well-heeled, well-connected entrepreneurs and entrepreneurs who do not enjoy those benefits.

[134] Peter Younkin & Keyvan Kashkooli, *What Problems Does Crowdfunding Solve?*, 58 CAL. MGMT. REV. 20, 28 (2016) (suggesting that crowdfunding is a preferable alternative to friends and family because "[f]ounders may be reluctant to ask those most willing to give for the fear of the social cost of being denied or of the project failing").

[135] *See* WILLIAM J. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 74 (1965) (discussing how new issuances dilute existing shareholders). Sometimes friends and family receive convertible notes or SAFEs instead of common stock. In such cases, the dilution argument that follows is inapplicable.

[136] This is what venture debt does for venture capital. *See* Ibrahim, *Debt as Venture Capital*, *supra* note 75, at 1196 ("A start-up that can continue to grow and achieve milestones using debt receives a higher valuation when more equity is eventually sold. A higher valuation means that existing shareholders do not have to sell as much of the firm to raise the needed funds. Therefore, venture debt 'enables the company to buy an additional six-to-twelve months of time so that they are able to get a much better valuation in their next financing round.'") (citations omitted).

investors, these startups could also obtain a better price for their shares. . . ."[137]

IV. NORMATIVE AND LEGAL IMPLICATIONS

This Article has argued that, for many reasons, companies completing a successful crowdfunding campaign send a positive signal of firm quality to follow-on investors. This final Part addresses some normative and legal implications that flow from this argument.

A. NORMATIVE IMPLICATIONS: OPENING OPPORTUNITIES TO MORE ENTREPRENEURS

First, not all entrepreneurs have access to other sources of initial capital.[138] This may be especially true for women and minority entrepreneurs, who have been historically underrepresented.[139] Perhaps they do not have well-heeled friends and family who can fund their business venture.[140] Maybe they do not have the assets or income necessary to obtain a credit card with a high limit, and

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[137] Ibrahim, *Equity Crowdfunding*, *supra* note 1, at 590 (citation omitted); *see also* Lee Fleming & Olav Sorenson, *Financing by and for the Masses: An Introduction to the Special Issue on Crowdfunding*, 58 CAL. MGMT. REV. 5, 13 (2016) (noting that "[f]rom the perspective of the entrepreneur . . . large allocations of equity to the venture capitalist often represent a cost that they would rather avoid[,]" making crowdfunding an attractive first step).

[138] *See* Andrew Schwartz, *The Digital Shareholder*, 100 MINN. L. REV. 609, 621 (2015) ("The traditional first source for entrepreneurial financing is from the entrepreneur's friends and family, as well as their own personal savings. Most people, however, have negligible personal savings, and the same can be said of their friends, so it comes down to whether the entrepreneur has a wealthy relative.") (citation omitted); Thomas Murphy, Note, *Playing to a New Crowd: How Congress Could Break the Startup Status Quo by Raising the Cap on the Jobs Act's Crowdfunding Exemption*, 58 B.C. L. REV. 775, 779 (2017) (lamenting "the exclusive social dynamics in the venture capital market, where the strength of an entrepreneur's network is often as important as the strength of his or her idea").

[139] *See* Murphy, *supra* note 138, at 787 ("Evidence further suggests that women and minorities are disproportionately ignored by traditional forms of startup financing."); Susan R. Jones, Jacqueline Lainez, & Debbie Lovinsky, *Viewing Value Creation by Business Lawyers Through the Lens of Transactional Legal Clinics*, 15 U.C. DAVIS BUS. L.J. 49, 95 (2014) ("In addition to limited access to capital, minority entrepreneurs may not meet bank credit approval criteria.").

[140] *See* Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347, 356 (2016) ("'[C]rowdfunding' enables entrepreneurs who traditionally face financing constraints to obtain capital from anyone in the world via the Internet.") (citation omitted).

therefore cannot bootstrap.[141] Crowdfunding shows signs of being more ethnically and gender diverse than traditional entrepreneurship. One commentator notes that over twenty percent of crowdfunded companies have "at least one female founder" compared to only eight percent of VC funded companies with "female founders."[142] Thus, crowdfunding may be a necessity for some entrepreneurs seeking early-stage capital.

Even for those entrepreneurs that can obtain friends-and- family money, a "capital gap" may persist in terms of next funds needed, but it still being too early for professional investors to consider coming in.[143] And the capital gap may be substantial.[144]

Angels can fill this capital gap to some extent, as angels invest smaller amounts and are active in more geographic regions than VCs.[145] But geographic discrepancy exists even in the angel community. If an entrepreneur is not proximate to angels or VCs in Silicon Valley, Austin, or New York, for example, she is unlikely to get funded.[146] Crowdfunding, while not the panacea of freeing "the geographic constraint that has long hindered entrepreneurship in

[141] Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV. 885, 948–49 (2018).

[142] *See* Bradford, *Crowdfunding and Federal Securities Laws*, *supra* note 88**Error! Bookmark not defined.**, at 103–04 ("Crowdfunding makes new sources of capital available to small businesses. It opens business investment to smaller investors who have not traditionally participated in private securities offerings. Those investors have less money to invest, so they would be willing to fund smaller business opportunities that the venture capitalists and angel investors would not touch. Crowdfunding also gives poorer entrepreneurs whose friends and family lack the wealth to provide seed capital somewhere else to turn.").

[143] *See* Cable, *supra* note 4, at 108 (describing the "funding gap" that exists after an entrepreneur's personal/family resources run out and before VCs will invest).

[144] *See* William K. Sjostrom, Jr., *Relaxing the Ban: It's Time To Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 3 (2004) ("Estimates indicate, however, that financial markets fall short by some $60 billion annually in meeting the demand of small companies for early-stage private equity financing. This unmet need is referred to as the funding gap.") (citations omitted).

[145] Ibrahim, *Angel Investors*, *supra* note 11, at 1418 ("Angels fill the funding gap as to both time and capital, functioning as a 'conveyor belt' that moves young start-ups toward waiting venture capitalists.") (citation omitted).

[146] *See* Schwartz, *supra* note 143, at 622 ("[T]here is tremendous competition for [angel and VC] investments and such investors are interested in certain types of companies, often in limited geographic areas. Importantly, angels and VCs rely heavily on connections, making it difficult to get funded in the absence of pre-existing relationships with such investors or their acquaintances.") (citation omitted); Ibrahim, *The Next Silicon Valley*, *supra* note 61, at 731 (discussing instances of entrepreneurs moving to Silicon Valley because they could not obtain funding in their prior locations).

rural areas," has shown "modest" success in funding companies in "states that are largely off the radar of traditional VCs and angel investors, such as Idaho, New Mexico and South Carolina."[147]

If a successful crowdfunding campaign serves as a positive signal to follow-on investors, then traditionally disadvantaged entrepreneurs will be on par with—or even above—the well-heeled entrepreneurs who raised initial capital from friends and family. In other words, if angels and VCs view successful crowdfunding campaigns as a positive signal, then a successful crowdfunding campaign will not disadvantage an entrepreneur who cannot avail herself of bootstrapping or friends-and-family capital. This argument supports crowdfunding proponents' initial plan to "democratize" startup investing.[148]

B. NORMATIVE IMPLICATIONS: CROWDFUNDING CAN REDUCE INFORMATIONAL LOCK-IN

A successful crowdfunding campaign (as opposed to investment from friends, family, early angels or seed-stage VCs) can also mitigate "informational lock-in."[149] Informational lock-in occurs when early investors enjoy informational advantages about the company when it comes to pricing and participating in its follow-on rounds.[150] Early investors can use this informational advantage to sell themselves cheap equity in follow-rounds and thereby dilute the founder's share of the company more than it would otherwise be diluted through arms-length fundraising.[151]

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[147] Schwartz, *supra* note 141, at 947–48; *see also id.* at 948 ("In the end, although it obviously has not transformed Bismarck into Boston, or Pine Bluff into Palo Alto, crowdfunding has in fact achieved some real amount of geographic inclusivity.").

[148] *See* Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (2011); *see also* Andrew A. Schwartz, *Inclusive Crowdfunding*, 2016 UTAH L. REV. 661, 662 (2016) ("Inclusivity is core to the nature of crowdfunding as a distinct form of capital raising.").

[149] Brian J. Broughman & Jesse M. Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some Evidence from Silicon Valley*, 18 J. CORP. FIN. 1104, 1105 (2012).

[150] *See id.* (noting that informational lock-in occurs "when information asymmetry between a firm's existing investors and potential outside investors make it difficult to obtain competitive financing"). Although this informational lock-in is typically an issue in the banking context, Broughman & Fried observed it may occur in subsequent VC financing rounds. *Id.* at 1107.

[151] *See id.* (discussing that informational lock-in "enable[s] the existing investors to extract rents in subsequent financings").

A successful crowdfunding campaign combats the informational lock-in problem by substituting the crowd for the early investor with the informational advantage. The crowd, by definition, as a large and dispersed group, will not be able to employ informational lock-in to its advantage due to collective action problems. Thus, by turning to the crowd instead of other early investors, founders can prevent dilution of their shares of the company not only by issuing SAFEs, but also by obtaining better pricing in follow-on rounds.

C. LEGAL IMPLICATIONS: CROWDFUNDING SIGNALS CAN REDUCE NEED FOR DISCLOSURE

If the costs of raising capital through Regulation CF are high,[152] due in part to legal costs,[153] then perhaps we can determine what types of disclosures actually are useful in reducing information asymmetry and hone Regulation CF's requirements accordingly. As it currently stands, Regulation CF requires significant disclosure for small companies.[154] Is it the risk factors that potential investors care about? The company-specific business plan descriptions? The financials?[155] We must also distinguish here between disclosure that is useful to investors in the crowdfunding campaign itself and those disclosures that are useful to follow-on investors. Perhaps the disclosures overlap, but maybe they do not.

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[152] *See* Lou Bevilacqua, *How Much Does It Cost to Raise Money Through Equity Crowdfunding?*, BEVILACQUA PLLC (Sept. 26, 2016), http://bevilacquapllc.com/much-cost-raise-money-equity-crowdfunding/ (estimating an "all-in" cost from $60,000 to $150,000 for a $1,000,000 equity crowdfunding offering).

[153] *See id.* (estimating these legal costs between $3,000 and $20,000); *see also* Thompson & Langevoort, *supra* note 86, at 1605 (noting that Title III imposes "a quite heavy and costly set of responsibilities on . . .issuers").

[154] *See* 15 U.S.C. § 77d-1(b)(1) (2016) (requiring disclosure of, among other things, the issuer's name and physical address; the website of the issuer; the names of directors and officers; a description of the issuer's business plan; a description of the issuer's financial situation; and a description of the issuer's ownership and capital structure).

[155] *See generally* 17 C.F.R. § 227.201(t)(2) (2017) (requiring that an issuer must have an independent public accountant review the financial statements for target offering amounts that total between $107,000 and $535,000 based on sales for the preceding twelve months); § 227.201(t)(3) (requiring that an independent public accountant audit financial statements for offerings exceeding $535,000 in sales for the previous twelve months, unless dealing with a first-time issuer, who need only provide financial statements previously audited by an independent public accountant if available or statements previously reviewed by such accountant).

One new study examines the signaling effect of "hard" and "soft" information disclosed by a company attempting to raise capital from the crowd.[156] Hard information includes items such as "age, financial condition of the issuer" and "executive team size."[157] Soft information, on the other hand, includes an "issuer's social capital" and "responsiveness to prospective investors on the crowdfunding platform."[158] The study finds that hard information has no or limited value to potential investors,[159] while soft information (particularly a strong social media following) sends a strong positive signal of company quality.[160]

I am not aware of any studies examining angels' or VCs' use of crowdfunding disclosures in making their own investment decisions.[161] Should mandatory disclosures of hard information prove of limited value to professional investors, as perhaps they are to the crowd, then the SEC may be able to limit disclosures of hard information in crowdfunding campaigns without negative effects. This would make crowdfunding a cheaper option to more entrepreneurs seeking funding.

The signaling/disclosure relationship is complicated. Angels and VCs use contracts, networks, and signals when sorting among potential investments.[162] Angels and VCs may or may not get any formal disclosure, as the law does not require it.[163] Thus, with disclosure historically playing a smaller role in angel/VC selection, contracts being of limited sorting utility, and networks diminishing in importance with the pervasiveness of the Internet, signals take

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[156] Anzhela Knyazeva & Vladimir I. Ivanov, Soft and Hard Information and Signal Extraction in Securities Crowdfunding (Nov. 17, 2017) (unpublished paper) (on file with author), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3051380.

[157] *Id.* at 12.

[158] *Id.* at 16–17.

[159] *Id.* at 26 ("Hard information about issuer quality based on current accounting characteristics and past track record has limited relation to offering success.").

[160] *Id.* at 28 ("[S]ocial media following is significantly positively related to both offering success and offering proceeds.").

[161] *But see* Part III.C.3. (arguing that forcing companies to put together the disclosure serves another purpose—professionalizing the company).

[162] *See supra* Part II.B. (showing angels and VCs use contracts, networks, and signal when sorting potential investors).

[163] *See supra* note 114 and accompanying text. *But see* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 587 (Foundation Press, 4th ed.., 2015) ("The requirements of the securities laws aside, most sophisticated investors in the private placement market will simply avoid offerings that lack a private placement memorandum").

on added importance. The signal sent by a successful crowdfunding campaign should top the list of signals that angels and VCs rely on going forward.

Although signaling cannot completely replace disclosure in combating information asymmetry,[164] perhaps it can play a larger role in the relative balance in further amendments to Regulation CF. Crowdfunding must be affordable for entrepreneurs to be able to use it, and current estimates suggest its costs can be excessive.[165] Crowdfunding signals may reduce the need for some disclosure, and should the SEC reduce the amount of disclosure required, the cost of conducting a crowdfunding campaign would likewise drop.

V. CONCLUSION

There is evidence that angels and VCs are using crowdfunding as a new source of deal flow.[166] As one commentator states: "Given the fact that more startups and small businesses are launching crowdfunding campaigns, it's no wonder that many venture capital firms are turning to crowdfunding platforms to access new deal flow."[167] Angels and VCs' increased reliance on crowdfunded companies suggests that early predictions about crowdfunding as a fund-raising tool of last resort are incorrect. Indeed, as this Article has argued, a successful crowdfunding campaign signals a company's high quality to follow-on investors. Through its signaling function, crowdfunding can democratize entrepreneurship and

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[164] *See generally* Fox, *supra* note 44, at 687.

[165] *See* Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1444 (2012) ("Can this new regulatory-laden exemption be useful to small entrepreneurs? It is difficult to imagine that for offerings under $250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities."); Seth A. Orangeburg, *Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 CORNELL J.L. & PUB. POL'Y 397, 437 (2015) ("Raising money by selling stock costs at least $25,000 in legal fees. Therefore, it would be irrational to raise less than $25,000 by selling stock in all instances.") (citation omitted).

[166] *See* CROWDFUND CAPITAL ADVISORS, *supra* note 105, at 11 ("There is a consistent refrain that professional investors will not want to work with companies that have received crowdfunding investments. The data from this study suggest the exact opposite . . . . Several founders remarked that they received calls from angel groups that had not even allowed them to pitch, and were receiving term sheets from [the angel groups]. These findings indicate that angels and venture capital groups may look to entrepreneurs to prove their ability to execute and fundraise from the crowd prior to investing. Doing so may [de-risk] their investment if they can see an entrepreneur has traction from the crowd.").

[167] Hollas, *supra* note 102.

make it more affordable. Meaning there is hope, still, that Regulation CF may live up to its initial promise.