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## Feature

BY DAVID MCGRAIL

### “Crowdfunding” a Chapter 11 Plan

Crowdfunding is an Internet-based approach to fundraising for a specific project or cause, where backers contribute through a website owned by an intermediary crowdfunding company. Kickstarter, one of the largest crowdfunding companies, describes the process as follows:

Every project creator sets their project's funding goal and deadline. If people like the project, they can pledge money to make it happen. If the project succeeds in reaching its funding goal, all backers' credit cards are charged when time expires. If the project falls short, no one is charged. Funding on Kickstarter is all-or-nothing.<sup>1</sup>

While Kickstarter charges a payment fee and a 5 percent “success fee” for a funded project,<sup>2</sup> other crowdfunding companies have adopted different fee structures, and not all require a project to reach a specific funding goal as a condition to funding/charging backers. Crowdfunding has exploded over the last few years, and various platforms raised \$530 million in 2009, \$854 million in 2010 and \$1.5 billion in 2011, and are expected to raise \$2.8 billion in 2012.<sup>3</sup>

Pebble, a company developing a “smart” wristwatch, raised \$10.3 million from 69,000 people through Kickstarter.<sup>4</sup> Oculus Rift, which is producing a “truly immersive virtual reality headset for video games,” raised about \$2.5 million.<sup>5</sup> There are now crowdfunding sites specifically geared toward mobile application developers, social entrepreneurs, musicians, and many other groups and industries.

While crowdfunding still has a distinctly “start-up” feel to it, some sites now offer crowdfunding for existing companies or groups (or individuals) with a wide variety of goals. For instance, hundreds of thousands of dollars have been raised through crowdfunding site Indiegogo to help the Lakota Sioux buy back part of their sacred land before it is sold for development,<sup>6</sup> and about \$410,000 was raised to rebuild a mosque in Joplin, Mo., that burned down in a suspicious fire.<sup>7</sup> On a smaller scale, individuals with crushing student loan debt and medical bills are now turning to crowdfunding sites to raise money.<sup>8</sup>

Crowdfunding is remarkable in that backers' “returns” could be in the form of a small thank-you gift such as a T-shirt, the opportunity to play a new board game, or a warm, fuzzy feeling such as when a 68-year-old bus monitor who is verbally harassed by a group of middle school kids is sent on the “vacation of a lifetime” (more than \$703,000 was raised in that case).<sup>9</sup> As it currently stands, backers cannot receive equity in a crowdfunded company. That, however, is going to change.

### Coming Soon: Equity-Based Crowdfunding

Under the Securities Act of 1933, securities offered in the U.S. must be registered with the Securities and Exchange Commission (SEC) unless they qualify for an exemption.<sup>10</sup> Because registration and the reporting requirements that follow can be time-consuming and expensive (not to mention revealing), companies are often eager to satisfy one (or more) of those exemptions, which are set forth in sections 3 and 4 of the Securities Act.



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1 See “Kickstarter Basics: Kickstarter 101,” [www.kickstarter.com/help/faq/kickstarter%20basics#Kick](http://www.kickstarter.com/help/faq/kickstarter%20basics#Kick) (last visited Jan. 4, 2013).

2 See *id.*

3 See “Crowdfunding Industry Report: Market Trends, Composition and Crowdfunding Platforms,” [Crowdsourcing.org](http://Crowdsourcing.org) (Oct. 1, 2012), [www.crowdfunding.nl/wp-content/uploads/2012/05/92834651-Massolution-abridged-Crowd-Funding-Industry-Report1.pdf](http://www.crowdfunding.nl/wp-content/uploads/2012/05/92834651-Massolution-abridged-Crowd-Funding-Industry-Report1.pdf); see also Harry McCracken, “The Kickstarter Economy,” *Time Magazine* (Oct. 1, 2012), [www.time.com/time/magazine/article/0,9171,2125023,00.html](http://www.time.com/time/magazine/article/0,9171,2125023,00.html).

4 See Connie Loizos, “Entrepreneurs Are Taking Kickstarter More Seriously; VCs Should, Too,” Sept. 6, 2012, [www.pehub.com/164952/entrepreneurs-taking-kickstarter-more-seriously-vc-should-too/](http://www.pehub.com/164952/entrepreneurs-taking-kickstarter-more-seriously-vc-should-too/).

5 See “Oculus Rift: Step Into the Game,” [www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game](http://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game) (last visited Jan. 4, 2013).

6 See “Pe ‘Sla: Help Save Lakota Sioux Sacred Land,” [www.indiegogo.com/PeSla-LakotaHeartland](http://www.indiegogo.com/PeSla-LakotaHeartland) (last visited Jan. 4, 2013).

7 See “Rebuild the Joplin Mosque,” [www.indiegogo.com/joplinmosqueofficial](http://www.indiegogo.com/joplinmosqueofficial) (last visited Jan. 4, 2013).

8 See Alice Park, “Crowdfunding a Cure,” *Time Magazine* (Dec. 2, 2013), [www.time.com/time/magazine/article/0,9171,2129795,00.html](http://www.time.com/time/magazine/article/0,9171,2129795,00.html).

9 See “Let’s Give Karen—The Bus Monitor—H Klein a Vacation,” [www.indiegogo.com/loveforkarenhklein](http://www.indiegogo.com/loveforkarenhklein) (last visited Jan. 4, 2013).

10 See Registration under the Securities Act of 1933, Sec. & Exch. Comm’n, sec.gov/answers/regs33.htm (last visited Jan. 4, 2013).

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups (JOBS) Act, which adds a section 4 exemption for issuers that raise money through crowdfunding.<sup>11</sup> There are certain limitations to this new exemption.

To qualify for the exemption, issuers may only access funds when they have reached the targeted offering amount (as with Kickstarter).<sup>12</sup> In addition, investors with less than \$100,000 in net worth or annual income may only invest the greater of \$2,000 or 5 percent of their annual income or net worth, while investors with greater than \$100,000 in annual income or net worth may only invest 10 percent of their annual income or net worth, not to exceed \$100,000.<sup>13</sup> Moreover, the exemption is not available for offerings exceeding \$1 million in the aggregate during any 12-month period.<sup>14</sup> With the SEC (and possibly other regulatory agencies) scheduled to adopt certain rules and regulations implementing the JOBS Act by January 2013, equity-based crowdfunding is coming.<sup>15</sup>

## Crowdfunding in Small Business Bankruptcy Cases

As a result of amendments to the Bankruptcy Code, changes to companies' capital structures and various other factors, a company that enters chapter 11 is increasingly more likely to conduct a Bankruptcy Code § 363 sale than it is to successfully reorganize.<sup>16</sup> In particular, successfully restructuring a small business through chapter 11 is no easy feat.

Chapter 11 imposes additional reporting requirements and time limitations on a small business debtor, which is defined as a company with \$2,343,300 million or less in debts, with certain exceptions.<sup>17</sup> For instance, unless it successfully moves the court for an extension, a small business debtor's exclusive period to file a plan only lasts 180 days, and it must file a plan and disclosure statement within 300 days of the order for relief.<sup>18</sup> Section 1116 of the Bankruptcy Code, which was added in 2005 and is entitled "Duties of Trustee or Debtor in Possession in Small Business Case," is a laundry list of additional filing and other requirements (including financial statements and income tax returns) imposed specifically on small business debtors.<sup>19</sup>

Against this backdrop, many small business debtors also face the question of how and when they will raise the funds necessary to emerge from chapter 11. Are they even able to propose a reorganization plan that is "feasible" under § 1129(a)(11) of the Bankruptcy Code?

Crowdfunding may offer a new funding alternative and potential exit strategy for small business debtors for at least three reasons. First, the recent explosion in crowdfunding has

demonstrated that people will support a business they believe in, and there are signs that such support need not be limited to startup businesses. A small business, such as a local restaurant, may be able to raise \$250,000 from loyal patrons through crowdfunding, especially if it can offer those patrons an equity stake in the business, as will soon be the case.

Second, crowdfunding can lay the groundwork for a "soft landing" in chapter 11. A small business debtor that is not under immediate pressure from its creditors (*e.g.*, at risk of losing its lease) may be able gauge whether it can reach its targeted crowdfunding goal before filing for chapter 11, increasing its chances of a smooth, expeditious bankruptcy case (or even a prepackaged bankruptcy) or avoiding an otherwise costly and fruitless bankruptcy filing, as the case may be.

Third, some of the information that the JOBS Act requires issuers to provide to investors overlaps with the information that a debtor is required to include in its disclosure statement under § 1125 of the Bankruptcy Code. Specifically, the JOBS Act states that investors are entitled to the following information:

- name, legal status, website and physical address;
- names of officers, directors and 20 percent shareholders;
- description of its business and anticipated business plan;
- description of its financial condition and certain financial statements depending on the amount of the equity raised;
- description of the intended use of proceeds of offering;
- target offering amount, deadline to reach that amount, and regular updates regarding progress;
- price of securities or method to determine that price; and
- description of ownership and capital structure of the issuer, including:
  - terms of securities offered and each other class of securities of the issuer (and the differences between them), including how those terms might be limited, diluted or qualified by the rights of other classes of security;
  - a description of how exercise of rights of controlling shareholders could affect the rights of crowdfunding shareholders;
  - identification of holdings of 20 percent security-holders of any class of securities;
  - how securities offered are valued and how they may be valued in the future, including during corporate actions; and
  - risks of minority ownership, risks associated with future corporate actions, including additional issuances of shares, sale of issuer's assets and related party transactions.<sup>20</sup>

Debtors are already required to include, or at least it is good practice for them to include, much of this information in their disclosure statements.<sup>21</sup> Crowdfunding has the potential to create new options for small business debtors planning to enter, and seeking to emerge from, chapter 11.

## New Options in Large Chapter 11 Cases

Although the crowdfunding exemption is limited to offerings of \$1 million during any 12-month period, the JOBS Act also changes existing securities laws in a manner that could

11 See 15 U.S.C. § 77d(a)(6); H.R. 3606-10, § 302(a).

12 See 15 U.S.C. § 77d-1(a)(7); H.R. 3606-10, 11, § 302(b).

13 See 15 U.S.C. § 77d(a)(6); H.R. 3606-10, § 302(a).

14 See *id.*

15 See H.R. 3606-10, 11, § 302(c); see also "Crowdfunding 101," Nat'l Crowdfunding Assoc., [nlcfa.org/crowdfund-101.html](http://nlcfa.org/crowdfund-101.html) (last visited Jan. 4, 2013). The process of implementing the JOBS Act has been delayed, however, and it is unclear when these provisions will actually be implemented. See Robb Mandelbaum, "'Crowdfunding' Rules Unlikely to Meet Deadline," *N.Y. Times* (Dec. 26, 2012), [www.nytimes.com/2012/12/27/business/smallbusiness/why-the-sec-is-likely-to-miss-its-deadline-to-write-crowdfunding-rules.html?pagewanted=all&\\_r=1&\\_r=1&\\_r=1](http://www.nytimes.com/2012/12/27/business/smallbusiness/why-the-sec-is-likely-to-miss-its-deadline-to-write-crowdfunding-rules.html?pagewanted=all&_r=1&_r=1&_r=1).

16 See 363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies, as a Percentage of All Cases Disposed, by Year of Case Disposition, UCLA-LoPucki Bankruptcy Research Database, [lopucki.law.ucla.edu/tables\\_and\\_graphs/363\\_sale\\_percentage\\_graph\\_1\\_19\\_2012.pdf](http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage_graph_1_19_2012.pdf) (last visited Jan 4, 2013).

17 See 11 U.S.C. § 101(51D).

18 See 11 U.S.C. § 1121(e).

19 See 11 U.S.C. § 1116.

20 See 15 U.S.C. § 77d-1(b); H.R. 3606-12-13, § 302(b).

21 See 11 U.S.C. § 1125(a); see also *In re Oxford Homes Inc.*, 204 B.R. 264 (Bankr. D. Me. 1997).

impact large companies in distress (and healthy companies, for that matter). Rule 506 of Regulation D, an often-used “safe harbor” for the private offering exemption of section 4(2) of the Securities Act, provides that a company may sell its securities to an unlimited number of “accredited investors” and up to 35 other purchasers without registering those securities or, for the most part, filing reports with the SEC.<sup>22</sup>

Prior to the JOBS Act, however, issuers were not able to take advantage of this safe harbor if they engaged in any form of general solicitation with respect to the new securities, as prohibited by Rule 502(c) of Regulation D.<sup>23</sup> The JOBS Act amends that rule to lift the prohibition against general solicitation and advertising, provided that the seller takes reasonable steps to verify that purchasers of the securities are accredited investors.<sup>24</sup> There are similar amendments to Rule 144A of the Securities Act, which addresses the resale of securities.<sup>25</sup>

These changes, which are in the process of being implemented, open up a world of possibilities for companies attempting to raise capital and the investment bankers that assist them, not to mention investors and the manner in which they locate investment opportunities (or those opportunities locate them).<sup>26</sup> Enterprising online platforms such as AngelList are already setting the stage for this democratization of the investment process, bringing startups and investors together.<sup>27</sup> It may just be a matter of time before the larger investment banking firms, or new competitors, follow suit. Although such an open process is uncharted territory, large companies, both healthy and distressed, that avail themselves of these changes to the law may be able to raise capital in an entirely new manner.

## Conclusion

With the codification of crowdfunding and the amendments to Rule 506 of Regulation D and Rule 144A, there are about to be new financing options for companies. Of course, if and when these new options arise in the context of bankruptcy cases, they will inevitably raise a host of questions.

- Are the crowdfunding or other companies providing the online funding portals considered “professionals” under § 327(a) of the Bankruptcy Code?<sup>28</sup>
- Must a debtor/issuer reach its targeted crowdfunding goal before its plan is feasible under § 1129(a)(11)?
- What happens (mechanically and otherwise) if that goal is reached but the plan is not confirmed under the absolute-priority rule or for some other reason?
- To what extent do the Securities Act’s and SEC’s disclosure requirements overlap with those set forth in the Bankruptcy Code?

<sup>22</sup> See Rule 506 of Regulation D, Sec. & Exch. Comm’n, [www.sec.gov/answers/rule506.htm](http://www.sec.gov/answers/rule506.htm) (last visited Jan. 4, 2013).

<sup>23</sup> See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464 (proposed Aug. 29, 2012) (to be codified at 17 C.F.R. pts. 230, 239), available at [www.sec.gov/rules/proposed/2012/33-9354.pdf](http://www.sec.gov/rules/proposed/2012/33-9354.pdf).

<sup>24</sup> See *id.*

<sup>25</sup> See *id.*; see also Securities Act Rule 144, Sec. & Exch. Comm’n, [www.sec.gov/answers/rule144.htm](http://www.sec.gov/answers/rule144.htm) (last visited Jan. 4, 2013).

<sup>26</sup> Public Comments on SEC Regulatory Initiatives under the JOBS Act, Sec. & Exch. Comm’n, [sec.gov/spotlight/jobsectcomments.shtml](http://sec.gov/spotlight/jobsectcomments.shtml) (last visited Jan. 4, 2013).

<sup>27</sup> See generally AngelList, [www.angel.co/](http://www.angel.co/).

<sup>28</sup> 11 U.S.C. § 1125(a). There is also some question about whether, and to what extent, the SEC has placed limits on funding portals’ compensation. See 15 U.S.C. § 78c(a)(80); H.R. 3606-17, § 304(b); see also Paul Bork and Dean F. Hanley, “SEC Proposes JOBS Act Amendments to Rule 506 and Rule 144A to Remove Ban on General Solicitation,” Foley Hoag LLP (Sept. 11, 2012), [www.foleyhoag.com/NewsCenter/Publications/Alerts/Securities/Securities\\_Alert\\_091112.aspx](http://www.foleyhoag.com/NewsCenter/Publications/Alerts/Securities/Securities_Alert_091112.aspx).

- Can this new method of raising capital co-exist with a rights offering in a larger case?
- What is the applicability of § 1145’s exemption from securities laws?

Stay tuned for answers to these and other questions when the democratization of finance encounters chapter 11. **abi**

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