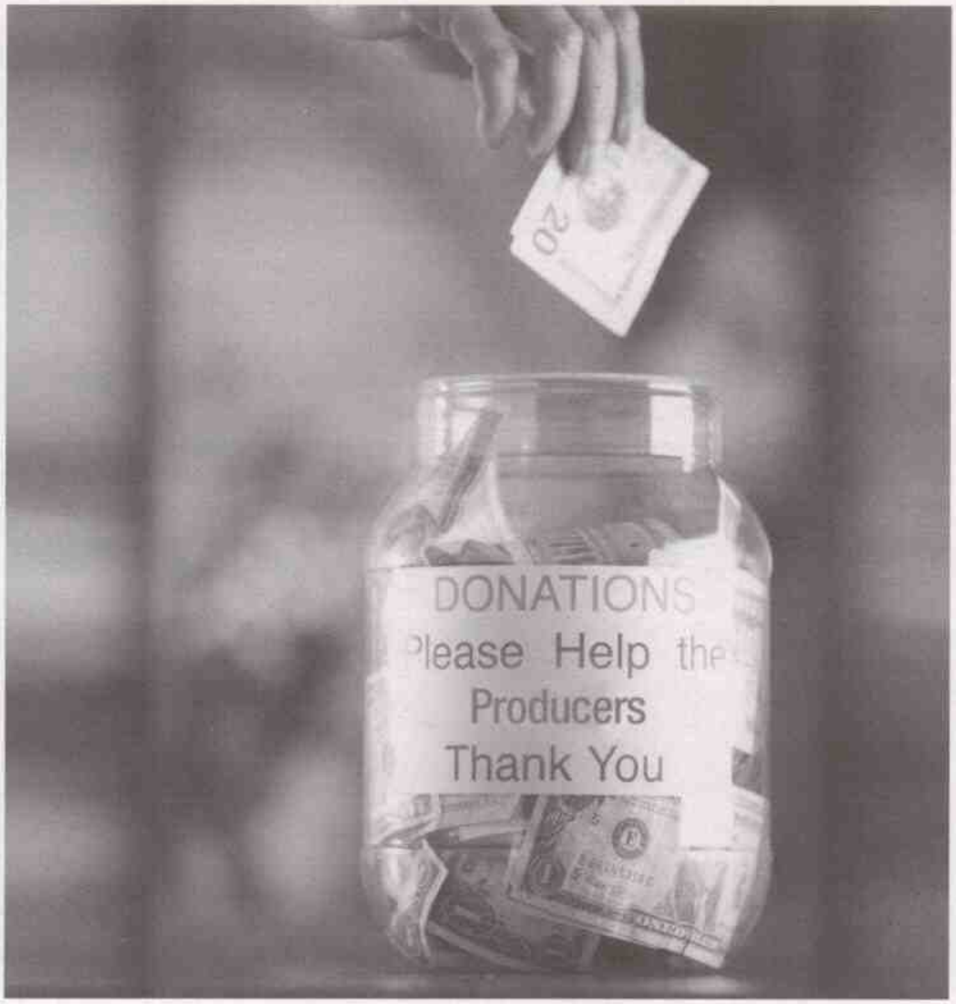

Crowd Funding

What Independent Producers Should Know About the Legal Pitfalls

BY DANIEL M. SATORIUS AND STU POLLARD

Independent film and television producers are innovative thinkers and resourceful problem solvers. As a new decade dawns, these attributes will prove more essential than ever—especially when it comes to financing projects.

The economic downturn has created scarcities in traditional sources of production capital such as equity, loans, and presales. Shifting patterns among consumers of video product—most notably online consumption of content and consumer expectation that content should be free—have negatively impacted the potential revenue upside for many films and TV projects. And while technological advances have lowered production costs and given independents unprecedented access to distribution, the resulting overabundance of projects (and producers) has led to an unprecedentedly large number of producers seeking funds and an ever dwindling pool of options. Traditional methods of financing are far harder for independent producers to access nowadays, even compared to just a few years ago. This has led many producers to seek alternative financing sources. These include soft money from state tax incentive programs (generally in the form of credits or rebates); deferral agreements with vendors, suppliers, and facilities; and product placement or sponsorship arrangements. This article focuses on another emerging alternative financing source: crowd funding.

WHAT IS CROWD FUNDING?

Crowd funding is the use of fans as financiers. Sums—generally in small increments—are collected from a wide breadth of people who generally have little to no prior experience in financing entertainment ventures. Crowd funding often implicates the use of Internet–based social media tools to raise awareness of opportunities for fans to contribute funds for a project. While mammoth sites such as Facebook, YouTube, Twitter, and MySpace can be utilized for this purpose, several specialty sites have gained notoriety as the leaders in the crowd funding arena, including Kickstarter (http://www.kickstarter.com) and IndieGoGo (http://www.indiegogo.com).

Backers support projects via electronic pledges that producers receive via PayPal or credit card. Funds pledged are almost always donations and are generally *not* tax deductible unless specific arrangements are made. If contributions to a project are indeed properly structured as donations—not loans or investments—there is no obligation to repay.

Producers entice potential backers by providing various levels of rewards in exchange for donations at escalating intervals. For example, $25 might get a backer a t-shirt and official "membership" in the film's fan club; $50, a signed DVD (upon release); $200, a screening invitation; $1,000 or more, the chance to meet the cast and crew over lunch. Such incentives are determined at the producer's discretion and vary from project to project.

The vast majority of projects raising money via crowd funding generate amounts of $25,000 or less. While there are examples of producers who have raised sums in excess of six figures, these instances are more the exception than the norm.

A FLASH IN THE PAN OR SUBSTANTIVE FUNDING SOURCE?

The jury is out on whether crowd funding is a short-lived aberration or a great new source of substantial amounts of production and distribution financing. In its present form it does not appear to be a viable method for completely financing most independent films—certainly not those with budgets in excess of $1 million.

But before writing off crowd funding completely, consider a couple of examples of successful crowd funding. In the final weeks and months leading up to the 2008 election, the Obama presidential campaign used crowd funding to raise about $1 million a day, all online, with more than a million sub-$1,000 contributions. In all, the campaign raised nearly three-quarters of a billion dollars over the Internet. Also consider the recent success of the new social network Diaspora—the open source alternative to Facebook that raised $200,000 via Kickstarter in May and June.

CROWD FUNDING ADVANTAGES

Although the amounts raised are small, almost anyone can do it. Sites such as Kickstarter and IndieGoGo make it simple to create a project page and start "passing the hat."

Also, there is considerable latitude as to what producers can do with the funds they raise. For example, donations can be used to complete a project, pay for deliverables, or pay for a marketing campaign. Donations can also be used to develop a project, i.e., pay the fees and costs of legal documents to put the company in a position to attract larger and more traditional sources of funding. But whatever is promised to the donor must be delivered; otherwise one becomes vulnerable to fraud claims.

Perhaps the biggest advantage is that if the arrangement is properly structured, the funds raised are untethered—there is no obligation for the producer to repay backers. Plus, when crowd funding is combined with a properly structured fiscal sponsor arrangement, the donor may be able to treat the donation as a tax-deductible charitable gift.

There are also valuable subjective benefits to crowd funding. Successful fundraising efforts can demonstrate a project's viability and potential following. By involving many people in the development stage, a producer can tap into "the wisdom of the crowd"—gleaning feedback and endorsements that build awareness and forward momentum. Those contributors who participate in crowd funding are vested in the project (not legally, but philosophically), and they may become proselytizers for the project, which may be many times more valuable to the project than their contribution.

The process of seeking the support of the crowd may also serve as the genesis of a project's promotional strategy. Encouraging existing fans to spread the word will undoubtedly grow the project's fan base, especially if it can involve communities with a particular interest in a hot topic or cause (e.g., climate change, the Gulf oil spill, and so forth). These communities may assist with a film's early development and later may be engaged to help with grassroots marketing efforts. Finally, if crowd funding involves the sale of tickets, copies of the film, or merchandise, the lack of middlemen in these transactions means the producers keep a larger percentage of the subsequent revenues.

CROWD FUNDING DISADVANTAGES

Crowd funding must be undertaken with planning and forethought.

From a decorum standpoint, producers need to be acutely aware of who they are soliciting, how often potential donors are approached, and how the funds will be utilized. A lack of sensitivity to these factors could spawn the adverse perception of a project's being perpetually on the take or crying wolf—feelings that will most certainly alienate even a project's most loyal friends and followers.

TRADITIONAL METHODS OF FINANCING ARE FAR HARDER FOR INDEPENDENT PRODUCERS TO ACCESS NOWADAYS, EVEN COMPARED TO JUST A FEW YEARS AGO.

Producers should also consider the risk of underselling certain high net worth fans by accepting smaller sums online from donors who might otherwise contribute larger amounts if approached in a more traditional and/or personal manner.

More importantly, if crowd funding raises are done haphazardly, producers run the risk of violating laws relating to the sale of securities, charitable fundraising, and consumer fraud.

SECURITIES LAWS ISSUES

A security is any contract, transaction, or scheme whereby a person invests money in a business and is led to expect profits from the efforts of the company in which the money is placed and that person is not actively involved in the management of the company.[1]

It is illegal to offer or sell securities without filing a registration statement with the Securities and Exchange Commission ("SEC") and the appropriate state authorities unless the securities or the transaction qualify for an exemption from registration. Failure to comply with securities laws can result in severe penalties. A violation of the Securities Act of 1933 is a felony punishable by up to five years in prison and a $10,000 fine for each violation. The SEC may also seek civil penalties up to $500,000 per violation. The Securities Act also permits injured parties to bring civil actions seeking rescission of the transaction and also damages, penalties, and other remedies. States have similar penalties.

Crowd funding becomes the sale of a security when fans who give money to support a production have expectations that they will share in the project's profits and they do not participate in the management of the business. Therefore it is imperative that producers make no such assurances and create no such expectations. Sites such as Kickstarter and IndieGoGo have templates that provide the necessary language to clearly make these distinctions. But securities laws are complex, vary from state to state, and are best handled with the assistance of a knowledgeable and experienced attorney.

THE PROCESS OF SEEKING THE SUPPORT OF THE CROWD MAY ALSO SERVE AS THE GENESIS OF A PROJECT'S PROMOTIONAL STRATEGY.

To avoid a claim that your crowd funding activities involve the sale of securities, producers should not promise any return of any money in any way, or imply that fans will profit in any way from the film or its related activities. The arrangement should be strictly a donation or sale (tickets, merchandise, DVDs, and so forth). The arrangement should be clearly spelled out in writing on the project's information page, preferably in proximity to the "donate here" button.

FISCAL SPONSORS

As mentioned above, crowd funding can be combined with a fiscal sponsor arrangement that may allow donors to receive a charitable tax deduction. The fiscal sponsor must be a 501(c)(3) nonprofit organization. The fiscal sponsor accepts contributions and provides support for the project in the amount of the contribution, less a sponsorship fee (usually 5 to 10 percent).

The benefits of this arrangement are many. Donors' contributions may be eligible for a tax benefit in the form of a tax deduction on funds contributed. The project receives the bulk of these contributions, has no obligation for repayment, and may receive increased credibility by the association with the fiscal sponsor. The benefits to the sponsor include its ability to advance its mission, collect a commission, receive publicity from its association with the project, and meet new potential donors.

There are risks, however. The Internal Revenue Service ("IRS") is becoming more concerned with these transactions and will likely take a more active role in examining fiscal sponsorship arrangements. For example, the IRS could determine that the nonprofit fiscal sponsor is merely providing the sponsorship service to benefit from the deductibility for donations that would not otherwise qualify for such favorable tax treatment. In this case, the IRS could disregard the role of the nonprofit fiscal sponsor and declare the donation was made directly from the donor to the producer. As a result, the donor would not get the tax deduction for a charitable contribution. Further, if the IRS were to find that the fiscal sponsor abused its tax-exempt status, the entity could be stripped of its nonprofit status.

Additionally, in some instances the fiscal sponsor may be legally responsible for the operations and activities of the project and its use of funds. Again, this reinforces the importance of carefully structuring these types of arrangements with the assistance of an experienced legal advisor.

CONSUMER FRAUD

If a project has promised its donors items such as tickets, copies of film, merchandise, posters, or even a credit in the finished film, and fails to deliver these in a timely manner, then the producer may become liable for consumer fraud. To guard against fraud claims, the producer should clearly state what the donor will receive in exchange for a contribution and faithfully deliver on those expectations. If the producer is unable to deliver, funds must be promptly returned to donors. The producer should have a well-thought-out procedure for fulfilling such commitments. If a fiscal sponsor is involved, the fiscal sponsor should monitor this process.

THE BOTTOM LINE

If utilized properly, crowd funding can be a very useful and versatile financing tool for independent producers. Strategically, it can be deployed to develop, launch, partially fund, or complete a project. But with crowd funding still in its nascent stages, there are—and will be—numerous legal pitfalls to navigate. As this model becomes more widely used, it will most certainly draw increased legal scrutiny. ❖

Daniel M. Satorius' firm is Satorius Law Firm, PLLC, in Minneapolis. He can be reached at dan@SatoriusLawFirm.com.

Stu Pollard is an independent filmmaker whose credits include Nice Guys Sleep Alone, Bass Ackwards, *and* Ira & Abby. *He can be reached at stu@pollardfilm.com.*

ENDNOTES

1. Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L.Ed. 1244 (1946).