CROWDFUNDING TRAPS FOR THE UNWARY

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The advent of online crowdfunding has been a tremendous boon to entrepreneurs. Through Kickstarter, Indiegogo and an increasing number of other sites, entrepreneurs can easily reach out directly to the masses to help fund innovative new projects, rather than seeking institutional capital through banks, angel investors or venture capitalists. The recent passage of the JOBS Act promises to expand the use of crowdfunding even further by making it possible for entrepreneurs to sell ownership interests in their startups to supporters.

Because online crowdfunding is fairly new the legal risks are not well understood, but many issues that may arise from crowdfunding are the same as those that arise in other businesses. Here are five pitfalls to watch out for:

Exposing Yourself to Personal Liability. As with any business transaction, crowdfunding doesn’t always go as planned. If you aren’t able to deliver the rewards you promised, supporters may try to get their money back. Even worse, if your product turns out to be harmful you could face product liability lawsuits. Running your crowdfunding campaign through a company, if done correctly, protects you by preventing disgruntled supporters from making a successful claim against your personal assets to satisfy any damage they might suffer.

Violating Obligations to Your Employer. If you’re working a day job, there’s a decent chance you signed a document at the start of your employment agreeing to devote your full-time working efforts to your employer, and giving your employer rights in intellectual property you develop within the scope of your employment. Before launching a crowdfunding campaign, it’s a good idea to take a look at these documents to understand your obligations. In many cases the biggest risk may not be that you could lose your job, but rather that your employer could rightfully claim to own your product. These obligations often continue for some time after you leave a job, typically for 1-2 years, so it’s a good idea to look at documents you signed with recent employers as well.

Violating Site Rules. Each crowdfunding platform has a different set of rules governing not just the types of projects that can be posted and rewards that can be offered, but also the relationship between companies and their supporters and between companies and the site. When picking a platform for your project, look at the terms and conditions for using the site so you understand your obligations in advance.

Misrepresenting Your Project or Product. In creating your project pitch, be careful not to cross the line between legitimately touting your idea and misleading people by promising things you can’t deliver. Remember that in hindsight even innocent misrepresentations can look like fraud.

Forgetting About Taxes. In rewards-based crowdfunding, each supporter is paying you for goods or services you’ve promised to provide in return, which means you (or your company) has income subject to federal and possibly state and local taxes. Doing a little research on the applicable tax rules in advance will keep you out of trouble with the IRS and help you budget your project more accurately.

These pitfalls can have disastrous consequences for your business and for you personally. Fortunately, most are easy to avoid with a little preparation. So before you launch your project, do your homework and consider talking to a lawyer about things you can do to mitigate your risk.

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