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## Over- And Under-Funding: Crowdfunding Concerns of the Parties Involved

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### Cover Page Footnote

Tanya M. Marcum is an Associate Professor of Business Law and Eden S. Blair is an Associate Professor of Entrepreneurship, both at the Foster College of Business at Bradley University in Peoria, Illinois. They would like to thank Andrea Nemcova for her research assistance.

# Over- And Under-Funding: Crowdfunding Concerns of the Parties Involved

By: Tanya M. Marcum, J.D. & Eden S. Blair, Ph.D.\*

## I. INTRODUCTION

Financial collaboration for new business ventures or the expansion of existing businesses utilizing the internet and social media is expanding. One area of growth is in the area of crowdfunding. Crowdfunding or crowdsourcing is known as collaborative funding using the internet to attract many investors to a new business venture.<sup>1</sup> As of February 12, 2017, “[o]n average 416 new projects each day”<sup>2</sup> and 456,875 projects are currently tracked.<sup>3</sup>

Crowdfunding platforms can be a great way for entrepreneurs to fund new ventures or projects. Funding for the project can be obtained utilizing crowdfunding platforms when traditional funding choices may not be available to the artist, entrepreneur, or small business owner.<sup>4</sup> Although there are many types of crowdfunding, this research will focus on crowdfunding utilizing a platform where rewards or thank you gifts are provided to those who invest in a campaign utilizing one of several popular platforms for such campaigns, sometimes known as patronage plus *ex ante* crowding<sup>5</sup> or rewards-based crowdfunding.<sup>6</sup> Entrepreneurs pitch their products on a fundraising platform looking for financial support.<sup>7</sup> Support is given when the like-minded contributor provides

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<sup>1</sup> Chance Barnett, *Top 10 Crowdfunding Sites for Fundraising*, FORBES (May 8, 2013) <http://www.forbes.com/sites/chancebarnett/2013/05/08/top-10-crowdfunding-sites-for-fundraising/#de9562a1cfbd>.

<sup>2</sup> *Project Stats and Analytics*, THE CROWD DATA CENTER, [thecrowdfundingcenter.com](http://thecrowdfundingcenter.com) (last visited Feb. 12, 2017).

<sup>3</sup> *Id.*

<sup>4</sup> Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 15 TRANSACTIONS: Tenn. J. Bus. L. 63, 64 (2011) (discussing securities regulation as it may or may not apply to patronage crowdfunding).

<sup>5</sup> Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENL. L. REV. 375, 376 (2009).

<sup>6</sup> See Uriel S. Carni, *Protecting the Crowd Through Escrow: Three Ways That the SEC Can Protect Crowdfunding Investors*, 19 FORDHAM J. CORP. & FIN. L. 681, 686 (2014) (defining the reward model of crowdfunding).

<sup>7</sup> Teachers are using an online platform called Funding4Learning to fund education based classroom projects. See, Eric Savitz, *Crowdfunding: Potential Legal Disaster Waiting to Happen*, FORBES, (Oct. 22, 2012), [www.forbes.com/sites/ericsavitz/2012/10/22/crowdfunding-potential-legal-disaster-waiting-to-happen/](http://www.forbes.com/sites/ericsavitz/2012/10/22/crowdfunding-potential-legal-disaster-waiting-to-happen/) (last visited Feb. 8, 2017).

funding for the project. When several like-minded contributors invest, the project becomes funded. Seems simple. However, properly budgeting, communicating and fulfilling the rewards while simultaneously finishing the project funded is fraught with risks and complications.

A typical reward-based crowdfunding campaign may offer to the backer a movie credit, an opportunity to meet the creators, a small token gift associated with the campaign's end result, or other such item.<sup>8</sup> In addition, some "reward-based crowdfunding treats funders as early customers, allowing them access to the products produced by funded projects at an earlier date, better price, or with some other special benefit."<sup>9</sup>

We will examine the short-term and long-term implications of both successful and unsuccessful crowdfunding campaigns. We will also discuss the implications of ethical, legal, and strategic business issues surrounding crowdfunding because entrepreneurs and those that advise entrepreneurs need to understand these implications.

## II. UNDERSTANDING CROWDFUNDING

### A. *Crowdfunding Basics: Terminology*

The term "crowdfunding" comes from the concept that many backers invest relatively small amounts of funding that add up to a larger amount. Most crowdfunded projects could not get funding from traditional sources, such as a bank, angel investor, or large donor. Crowdfunding campaigns involve three distinct parties, those that contribute funding for the campaign, often called backers or contributors, the platform itself, which enables the campaign to exist, and the campaign started by the creator seeking the funds.<sup>10</sup> As Christopher Moore explains: "Project creators" solicit "pledges" from backers, who then choose whether to pledge money to the project."<sup>11</sup> Creators often create a social media campaign in order to find a majority of these backers. Backers receive something for their contributions - either rewards, financial returns, or goodwill - depending on the type of crowdfunding used. Each platform

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<sup>8</sup> Jay H. Ganatra, *When a Kickstarter Stops: Exploring Failures and Regulatory Frameworks for the Rewards-Based Crowdfunding Industry*, 68 Rutg. U. L. Rev. 1425, 1434 (2016).

<sup>9</sup> Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. OF BUS. VENTURING 1, 3 (2014).

<sup>10</sup> Garry A. Gabison, *Equity Crowdfunding: All Regulated but Not Equal*, 13 DEPAUL BUS. & COMM. L.J. 359, 362-363 (2015).

<sup>11</sup> Christopher Moores, *Kickstart My Lawsuit: Fraud and Justice in Revenue-Based Crowdfunding*, 49 U.C. DAVIS L. REV. 383, 387 (2015).

has an internet page for interested parties to read with the relevant terms of use policy include within it.

### *B. Types of Crowdfunding*

There are four main types of crowdfunding: rewards-based crowdfunding, donation-based crowdfunding, equity crowdfunding, and debt crowdfunding.<sup>12</sup> Each of the four types of crowdfunding will be defined and compared, but the main focus of this article is rewards-based crowdfunding.

A reward-based crowdfunding campaign begins when the campaign creator has a project, product or idea they would like funded, they then establish different levels of rewards ranked by the amount of money a backer contributes on their campaign platform of choice.<sup>13</sup> The levels of rewards can have a wide range of choices; a simple thank you with a small financial contribution, to receiving the product before it is commercially released with a larger backer contribution to the project.<sup>14</sup> In Edan Burkett's recent article on this subject, he describes this relationship as "[t]he principal reason most promoters do not reward their online patrons with equity shares, or any other security, is the danger of getting entangled in complicated securities laws."<sup>15</sup> At this time, the main platforms used for rewards-based crowdfunding are Indiegogo and Kickstarter, and our discussion will largely be about these platforms.

Donors or contributors provide funding for donation-based charity crowdfunding instead of funding from backers. Donors contribute their chosen amount of money to a campaign. These donations are used to raise money for the campaign creator's cause. A creator's cause can be to donate to a specific charity of their choice or a charitable need of the creator, such as funding the payment of medical expenses.<sup>16</sup> There is typically no reward for their donations beyond knowing their money is going to their chosen good cause. The two examples of platforms for donation-based crowdfunding are Crowdrise and GoFundMe.

As an example, GiveForward<sup>17</sup> is an online donation based crowdfunding platform designed to set up a campaign to give and receive

<sup>12</sup> Garry A. Gibson, *Equity Crowdfunding: All Regulated but Not Equal*, 13 DePaul Bus. & Comm. L.J. 359, 361 (2015).

<sup>13</sup> Ganatra, *supra* note 8, at 1427-28.

<sup>14</sup> Mollick, *supra*, note 8, at 3.

<sup>15</sup> Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS 63, 64 (2011).

<sup>16</sup> Lex Mundi Pro Bono Foundation, *A Guide to Successful Donation-Based Crowdfunding* (2017), <http://www.lawforchange.org/NewsBot.asp?MODE=VIEW&ID=6348>.

<sup>17</sup> GIVEFORWARD, [www.giveforward.com](http://www.giveforward.com) (last visited March 3, 2017).

support usually to those suffering financially due to a medical problem.<sup>18</sup> As Lauren Button stated, “I never thought we would get above \$1,000, it seemed a pipe dream. This whole process has held the family up and given them so much through such a stressful time. The well wishes alone have been such a source of joy for Brandon and Cathy. Just the thought alone that so many really care is overwhelming to them all.”<sup>19</sup> Her campaign for her friend, A Kidney For Cathy, raised \$4,773.

As a caution, sometimes individuals create an account to raise funds for fictitious medical needs.<sup>20</sup> GiveForward has a mechanism where they can hide a campaign from the public while it attempts to investigate allegations of fraudulent campaigns.<sup>21</sup> As an example, a donation-based campaign was started by the father (a noncustodial parent) of a child known as KDH alleging that the minor child suffered from a heart condition and need surgery.<sup>22</sup> The child did not suffer from any health conditions.<sup>23</sup> The campaign raised funds in the amount of \$11,379.89.<sup>24</sup> GiveForward’s system generated an internal alert due to suspicious donations.<sup>25</sup> GiveForward hid the campaign due to the suspected fraud and returned the funds to donors.<sup>26</sup> In the suit, GiveForward sought a declaration that it was immune from suit.<sup>27</sup> The court determined that GiveForward was not an information content provider relative to the setup of the campaign.<sup>28</sup> Independent fraud claims could be filed by those affected by the potentially fraudulent campaign. The fraudulent father pled guilty in a related criminal case.<sup>29</sup>

A third type of crowdfunding is equity crowdfunding where investors in the campaign receive an equity stake in the business.<sup>30</sup> Campaign

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<sup>18</sup> See, *Success Stories*, GIVEFORWARD, <http://www.giveforward.com/success-stories> (last visited May 6, 2017).

<sup>19</sup> *Id.*

<sup>20</sup> See, *GiveForward, Inc. v. Hodges*, Civil No. JFM-13-1891 (Dist. Md 2015), <http://www.leagle.com/decision/In%20FDco%2020150806D39/GiveFORWARD,%20INC.%20v.%20HODGES> (last visited June 3, 2017).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> See, *GiveForward, Inc. v. Hodges*, Civil No. JFM-13-1891.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> Anne T. McKenna, *Letter to Honorable J. Frederick Motz*, (June 3, 2015), <http://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=2025&context=historical>.

<sup>30</sup> John S. Wroldsen, *The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 359 (2013).

business is conducted through a broker-dealer portal which are bound by less cumbersome regulations.<sup>31</sup>

With their investment, investors receive an ownership interest, or equity, in the company. Individuals here are not looking for a reward, to pre-purchase a product, or to fulfill goodwill; investors are looking to invest in a company that they believe will grow their money, leaving them a favorable return on their investment.<sup>32</sup>

Traditionally, equity fundraising for entrepreneurs involves giving equity shares of stock to the lender, usually common shares with or without voting rights.<sup>33</sup>

The fourth type of crowdfunding is debt crowdfunding, also referred to as crowdlending. This type of crowdfunding involves lenders or investors who loan funds with the expectation of full repayment of the principal loan amount plus interest.<sup>34</sup> Debt crowdfunding is a great alternative for entrepreneurial startups because of the lower interest rates as compared to a traditional bank loan, but with more flexibility and options to secure resources.<sup>35</sup>

The JOBS Act<sup>36</sup> was passed to regulate equity- and debt-based crowdfunding, but it does not apply to rewards-based crowdfunding.<sup>37</sup> Because an investor receives a token reward in turn for investing in a particular project, the investor should not expect a financial return on their investment.<sup>38</sup>

### C. Strategic Concepts

There are three phases to a rewards-based crowdfunding campaign: before the campaign, during the campaign, and after the campaign.

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<sup>31</sup> Jay H. Ganatra, *When a Kickstarter Stops: Exploring Failures and Regulatory Frameworks for the Rewards-Based Crowdfunding Industry*, 68 RUTGERS U. L. REV. 1425, 1435 (2016).

<sup>32</sup> *Id.*

<sup>33</sup> Garry A. Gabison, *Equity Crowdfunding: All Regulated but Not Equal*, 13 DEPAUL BUS. & COMM. L.J. 359, 366 (2015).

<sup>34</sup> Gantra, *supra* note 31 at 1434-1435.

<sup>35</sup> *What is Debt-Based Crowdfunding?*, CROWDFUND, <http://crowdfund.co/what-is-debt-crowdfunding/> (last visited May 20, 2017).

<sup>36</sup> Jumpstart Our Business Startups Act (JOBS Act), PUB. L. NO. 112-106, 126 STAT. 306 (2012) (to be codified in 15 U.S.C.).

<sup>37</sup> Garry A. Gabison, *Equity Crowdfunding: All Regulated but Not Equal*, 13 DEPAUL BUS. & COMM. L. J. 359, 386 (2015) (comparing equity crowdfunding in the U.S., Italy, United Kingdom, France, and Australia).

<sup>38</sup> David Groshoff, *Kickstarter My Heart: Extraordinary Popular Delusions and the Madness of Crowdfunding Constraints and Bitcoin Bubbles*, 5 WM. & MARY BUS. L. REV. 489, 538 (2014).

### 1. Before the Campaign

Prior to starting the campaign, the creator must carefully budget all aspects of the campaign: the cost of the completed the project, the cost of fulfilling the rewards, the percentage that goes to the crowdfunding platform, and any shipping costs not already included. Entrepreneurs often underestimate the costs of the project.<sup>39</sup> Therefore, it is very important to talk to others who have successfully completed a campaign in a similar area about the costs in terms of time and money to fulfill the rewards and complete the project. During the pre-campaign phase, creators should carefully determine the rewards and the level of funding for each rewards tier to match with the perceived value backers will receive for the money they will give, as well as an appropriate deadline.<sup>40</sup> Creators should also plan their pitch video for the project and their social media strategy to increase awareness of the campaign prior to launch.<sup>41</sup> It is important that all materials be professional in nature, with no typographical errors.<sup>42</sup>

### 2. During the Campaign

While the campaign is running, successful campaigns rely on social media to communicate to fans, friends and family, and those new to the work of the creator to make them aware of the campaign. Social media tends to be an effective way to market the project.<sup>43</sup> Writing press releases to help get the project mentioned in local papers can help, as well as contributing to podcasts for people with similar interests to the creator's project. Communicating with backers and potential backers by responding to emails and questions through the platform, showing appreciation for their help, and addressing any concerns is vital at this stage. Crowdfunding campaigns tend to receive their greatest funding at the beginning of the campaign and near the campaign deadline.<sup>44</sup>

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<sup>39</sup> Mathew L. A. Hayward, Dean A. Shepherd, & Dale Griffin, *A Hubris Theory of Entrepreneurship*, 52(2) MGT. SCI. 160–172 (2006), <https://doi.org/10.1287/mnsc.1050.0483>.

<sup>40</sup> Amy Yeh, *A Pre-Launch Guide for Successful Campaigns*, Indiegogo Blog, <https://go.indiegogo.com/blog/2015/12/crowdfunding-prep-calendar-checklist.html> (last visited May 20, 2017).

<sup>41</sup> Mollick, *supra* note 8, at 8.

<sup>42</sup> Mollick, *supra* note 8, at 7.

<sup>43</sup> Chun-Ta Lu, Sihong Xie, Xiangnan Kong, & Philip S. Yu, *Inferring the Impacts of Social Media on Crowdfunding*, PROCEED. OF THE 7TH ACM INT'L CONF. ON WEB SEARCH & DATA MINING 573, 582 (2014), <https://doi.org/10.1145/2556195.2556251>.

<sup>44</sup> Jacob Solomon, Wenjuan Ma, & Rick Wash, *Don't Wait!: How Timing Affects Coordination of Crowdfunding Donations*, PROCEED. OF THE 18TH ACM CONF. ON COMPUTER SUPPORTED



### 3. After the Campaign

Communication is essential after a campaign. If the campaign was not successfully funded, creators should communicate to their backers their appreciation and the next steps they have for the project. It is possible to restart a crowdfunding campaign with more realistic funding expectations, an improved product, a better marketing strategy, or better rewards for backers. For successfully funded campaigns, effective communication can manage the expectations of the backers, especially when things do not go as planned. Frequent and honest communication can often allay backers' concerns about delays.<sup>45</sup>

#### D. Examples of Successful Rewards-Based Campaigns

Successful campaigns not only receive or exceed their funding requests, but also deliver with the rewards to their backers in a timely manner. On Kickstarter, "Bring Back *MYSTERY SCIENCE THEATER 3000*"<sup>46</sup> was able to raise over \$5,700,000 to produce fourteen episodes while originally requesting \$2 million for three episodes. The successful campaign gave the producers the leverage to negotiate airing the episodes on the Netflix streaming video platform.<sup>47</sup> One highlight of this campaign is the frequent communication in terms of updates<sup>48</sup> from the show's creator and executive producer, Joel Hodgson, as well as other members of the production, to those that provided investment in the campaign.

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COOPERATIVE WORK & SOCIAL COMPUTING 547–556 (2015),

<https://doi.org/10.1145/2675133.2675296> (last visited Mar. 20, 2017).

<sup>45</sup> Eden S. Blair & Tanya M. Marcum, *When Kickstarter Campaigns Don't Deliver: A Case Study of Phenom Fabrics*, ENTREPRENEURSHIP & INNOV. EXCH. (Apr. 12, 2016), <https://eiexchange.com/content/141-when-kickstarter-campaigns-dont-deliver-a-case-study-of-phenom-fabrics>.

<sup>46</sup> *Bring Back Mystery Science Theatre 3000 Campaign*, KICKSTARTER, [https://www.kickstarter.com/projects/mst3k/bringbackmst3k?ref=user\\_menu](https://www.kickstarter.com/projects/mst3k/bringbackmst3k?ref=user_menu). This project is currently in post-production and rewards that can be fulfilled prior to the final episodes have been completed. *The Complete Reward Update: What to Expect! When to Expect It! PLUS: How to Get Help!*, (Jan. 28, 2017),

<https://www.kickstarter.com/projects/mst3k/bringbackmst3k/posts/1794145>.

<sup>47</sup> Lesley Goldberg, *Comic-Con: Mystery Science Theatre 3000' Revival Set at Netflix With Felicia Day*, Patton Oswalt, THE HOLLYWOOD REPORTER, July 23, 2016

<http://www.hollywoodreporter.com/live-feed/comic-con-mystery-science-theater-91393>

<sup>48</sup> Joel Hodgson, *Bring Back MYSTERY SCIENCE THEATRE 3000*, KICKSTARTER, <https://www.kickstarter.com/projects/mst3k/bringbackmst3k/updates> (last visited Feb. 12, 2017).

On the Indiegogo platform, Flow Hive<sup>49</sup> is the most successful campaign on that platform to date in terms of fundraising, raised over \$13 million, 17,380 percent of its initial request.<sup>50</sup> The hives are now purchasable by the public and will arrive in 5 days.<sup>51</sup> The campaign was effective at explaining the problem they were trying to solve and the benefits to the consumer in their beehive solution.<sup>52</sup>

Successful campaigns not only receive or exceed their funding requests, but also deliver the rewards to their backers in a timely manner. As another example, Ouya raised almost \$8.6 million for a gaming console.<sup>53</sup> They were able to deliver their rewards within 10 months of launching their campaign.<sup>54</sup> The reward was a video game console.<sup>55</sup> While, their product has not been as successful as predicted by the creators, nor done well on the market,<sup>56</sup> the prompt delivery of the rewards helped the creators preserve their reputation for following through with their promises.

The Kickstarter campaign of Oliver's Apparel, LLC was deemed a success as the fundraising goal was \$10,000 and it raised a total amount of \$271,043 in 30 days from 3,307 investors to produce high end men's shorts.<sup>57</sup> The successful campaign received a high level of media coverage, as did the dispute that followed the campaign regarding the ownership of the venture.<sup>58</sup>

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<sup>49</sup> Cedar Anderson & Stuart Anderson, *Flow-Hive: Honey on Tap Directly From Your Behive*, INDIEGOGO, <https://www.indiegogo.com/projects/flow-hive-honey-on-tap-directly-from-your-beehive-environment--5#/> (last visited Feb. 12, 2017).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Flow Hive: A Case Study in "Bee" 2C Marketing on Indiegogo*, THE ART OF THE KICKSTARTER (Jan. 19, 2016) <http://artofthekickstart.com/flow-hive-a-case-study-in-bee2c-marketing-on-indiegogo/> (

<sup>53</sup> Ouya Campaign, *Ouya: A New Kind of Video Game Console*, KICKSTARTER, <https://www.kickstarter.com/projects/ouya/ouya-a-new-kind-of-video-game-console?ref=sidebar> (last visited May 12, 2017).

<sup>54</sup> Wil Schroter, *Top 10 Business Crowdfunding Campaigns of All Times*, FORBES (April 16, 2014), <http://www.forbes.com/sites/wilschroter/2014/04/16/top-10-business-crowdfunding-campaigns-of-all-time/#3e34f433203d> (last visited May 7, 2017).

<sup>55</sup> Moores, *supra* note 10 at 389.

<sup>56</sup> Erik Kain, *The Ouya Is Basically Dead*, FORBES (Mar. 7, 2014), <http://www.forbes.com/sites/erikkain/2014/03/07/hit-kickstarter-video-game-console-ouya-is-basically-dead/#6ab8032f178d>.

<sup>57</sup> *Purdem v. Wolfe*, No. C-13-04816, 2014 U.S. Dist. LEXIS 109643, (N.D. Cal., 2014) (order denying a preliminary injunction).

<sup>58</sup> *Id.*

### III. CAMPAIGN CONSEQUENCES

Crowdsourcing platforms can be an excellent financial resource for entrepreneurs seeking funding for new ventures or projects. Many of these campaigns are successful; many are not.<sup>59</sup> For example, an ownership dispute arose between founders of Oliver's Apparel, a high-end men's short venture, after a what appeared to be a successful Kickstarter campaign for production funds.<sup>60</sup> The negotiation of a final operating agreement was the cause of the dispute that led to the court case.<sup>61</sup> Purdem sought a preliminary order to enjoin Wolfe from selling shorts, to turn over social media and bank account passwords, stop the use of pictures, and stop the use of trademarks.<sup>62</sup> Purdem could not prove irreparable harm so the relief was denied.<sup>63</sup> One of the main measurements for success is funding. Campaigns seek a specific amount of money to launch their product or service. A successful crowdfunding campaign is measured by the campaign meeting or exceeding this financial goal. An unsuccessful campaign would fall short of this financial goal.

In measuring the success of meeting the financial goal of the crowdfunding campaign, the authors believe there are additional factors that must be considered. These items include the requirements of the crowdfunding platform, ability to fulfill promised rewards, fulfillment of the rewards on a timely basis, adherence to the budget, legal and ethical considerations, valuation of the idea, and strategic directions. These additional requirements must be strategically planned for by the creator before the crowdfunding campaign begins. May need add additional citations through these proceeding paragraphs as this is a lot of information.

There are several different rewards-based crowdfunding platforms, each with their own set of rules. A wealth of information can be obtained on the internet sites of each rewards-based crowdfunding platform regarding these rules and tips for success.

Most individuals can identify Kickstarter as a crowdfunding platform. Kickstarter has many on-going campaigns in the areas of "design, the arts, gaming, and technology",<sup>64</sup> further divided into 15 categories.<sup>65</sup> Its

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<sup>59</sup> Mollick, *supra* note 8.

<sup>60</sup> Purdem, *supra* note 57.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> Anjanette H. Raymond & Abbey Stemler, *Trusting Strangers: Dispute Resolution in the Crowd*, 16 CARDOZO J. CONFLICT RESOL. 357, 362 (2015).

<sup>65</sup> *Explore*, Kickstarter <https://www.kickstarter.com> (last visited June 12, 2017).

mission is to “help bring creative projects to life.”<sup>66</sup> Kickstarter is commonly known as an all or nothing fundraiser platform.<sup>67</sup> There is a five-percent fee for all successfully funded campaigns and Kickstarter indicates that there is no guarantee that the creators will deliver the rewards on their projects.<sup>68</sup> Indiegogo, its largest competitor, indicates that it is a “launchpad for entrepreneurial ideas”.<sup>69</sup>

### A. Testing the Market

Crowdfunding can be a fairly easy method for creators to test the market for the creator’s idea. Campaigns receive feedback from potential backers and actual backers that may be beneficial to the creators in terms of further product development.<sup>70</sup> By launching the campaign, even though it may not ultimately be successful, the creator can make a prediction about the project’s success before a formal launch is made.<sup>71</sup> By testing the market for the particular product on a crowdfunding platform, it becomes a relatively cheap way for the creator’s project to fail. “Crowdfunding has been used by founders to demonstrate demand for a proposed product, which can lead to funding from more traditional sources.”<sup>72</sup> Failure can be an effective tool for learning and should not be considered the final end to a project.<sup>73</sup> Thus, crowdfunding can test hypotheses related to the product’s value proposition, design, marketing strategy, and types of features.<sup>74</sup>

Creators of successful campaigns focus on their marketing communication as an essential strategy for the campaign process. In the early stage of the development of a project, the creator of the campaign may seek to create an interest in a new project.<sup>75</sup> The use of social media

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<sup>66</sup> Kickstarter, *About Us*, <https://www.kickstarter.com/about?ref=nav> (last visited June 12, 2017).

<sup>67</sup> *Terms of Use*, KICKSTARTER, available at: <https://www.kickstarter.com/terms-of-use> (last visited May 6, 2017).

<sup>68</sup> *Id.*

<sup>69</sup> INDIEGOGO, <https://www.indiegogo.com/how-it-works?gclid=CLvc-fuIutlCFci1wAodKAAE2Q> (last visited May 3, 2017). (should be noted that Indiegogo has recently made equity based offerings available on its platform.)

<sup>70</sup> Jay H. Ganatra, *When a Kickstarter Stops: Exploring Failures and Regulatory Frameworks for the Rewards-Based Crowdfunding Industry*, 68 RUTGERS L. REV. 1425, 1426 (2016).

<sup>71</sup> *Id.*

<sup>72</sup> Mollick, *supra*, note 8 at 3.

<sup>73</sup> Dean A. Shepherd, *Educating Entrepreneurship Students about Emotion and Learning from Failure*, 3(3) ACAD. OF MANGT. LEARNING & EDU., 274–287 (2004).

<sup>74</sup> Paul Belleflamme & Thomas Lambert, *Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings*, SOCIAL SCIENCE RESEARCH NETWORK, SSRN ID 2437786, (2014), <https://papers.ssrn.com/abstract=2437786>.

<sup>75</sup> Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. OF BUS VENTURING 1, 3 (2014).

and crowdfunding platforms can create a buzz about a project. This is an inexpensive form of marketing where backers can spread the word about the campaign to a wide audience and potentially create product branding for the creators.<sup>76</sup>

Entrepreneurs who use crowdfunding are making a public disclosure of their ideas. These entrepreneurs may be at risk as others could take or infringe upon their ideas.<sup>77</sup> Outside of the crowdfunding platforms, entrepreneurs who seek investment can use non-disclosure agreements to protect their ideas and business plans.<sup>78</sup> The crowdfunding platforms do not provide for such an option for creators. Many creators of rewards-based crowdfunding campaigns usually lack the funds to pursue litigation against someone who takes their idea.<sup>79</sup> Despite the risks, it may be more beneficial to get the idea out into the marketplace to test it in its early stages than wait until the final product is made.<sup>80</sup> The 2013 Kickstarter project of Tom Joseph, the onE Puck project, was funded to develop a device that could charge a cell phone battery with a cup of coffee.<sup>81</sup> Joseph stated that after meeting with a patent attorney, “that publicly disclosing details about the onE Puck technology, which is based on the principles of an 1800s Stirling engine, could jeopardize his patent and intellectual property claims.”<sup>82</sup> After filing a provisional patent, Joseph has promised to issue refunds and more timely updates.<sup>83</sup> However, many of his backers have not received a refund nor has he updated them in 18 months.<sup>84</sup>

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<sup>76</sup> Jay H. Ganatra, *When a Kickstarter Stops: Exploring Failures and Regulatory Frameworks for the Rewards-Based Crowdfunding Industry*, 68 RUTGERS L. REV. 1425, 1432 (2016).

<sup>77</sup> Sean M. O'Connor, *Crowdfunding's Impact on Start-Up IP Strategy*, 21 Geo. Mason. L. Rev. 895, 896 (2014).

<sup>78</sup> Blake William Jackson, *Startups Seeking Crowdfunding: Avoiding Patent Pitfalls*, JD SUPRA BUS. ADVISOR (May 1, 2014), <http://www.jdsupra.com/legalnews/startups-seeking-crowdfunding-avoiding-42569/10>.

<sup>79</sup> *Supra*, note 77 at 898.

<sup>80</sup> Eric Ries, *THE LEAN STARTUP: HOW TODAY'S ENTREPRENEURS USE CONTINUOUS INNOVATION TO CREATE RADICALLY SUCCESSFUL BUSINESSES* (Crown Business 2011).

<sup>81</sup> Kim Lyons, *Crowdfunders, Such as Those for Epiphany's onE Puck, Grow Impatient*, PITTSBURGH POST-GAZETTE, (Apr. 13, 2015), <http://www.post-gazette.com/business/tech-news/2015/08/13/Crowdfunders-such-as-those-for-Epiphany-s-onE-Puck-grow-impatient/stories/201508130045>.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> Dan F., Comment to *Epiphany onE Puck*, KICKSTARTER, <https://www.kickstarter.com/projects/epiphanylabs/epiphany-one-puck/comments> (December 29, 2016). (“Its Dec. 2016. Its 1½ year since your last message, where you last apologized for not updating us and promised change. You lied. I respectfully ask for a refund.”)

### *B. Legal Concepts*

One of the most prevalent legal issues surrounding rewards-based crowdfunding is contractual in nature.<sup>85</sup> For example, the Terms of Use of Kickstarter states “when a creator posts a project on Kickstarter, they’re inviting other people to form a contract with them. Anyone who backs a project is accepting the creator’s offer, and forming that contract.”<sup>86</sup> The contract between Kickstarter and the creator is established when the creator accepts the terms of agreement and starts their campaign.<sup>87</sup> Part of that agreement with Kickstarter indicates that if the creator’s campaign fails in some way, perhaps due to an incomplete project or inability to fulfill the stated rewards promised to the backers, the creator “must make every reasonable effort to find another way of bringing the project to the best possible conclusion for backers.”<sup>88</sup> Backers also have responsibilities to the creator. Since in Kickstarter the funds are not taken from the backers until the end of the campaign, backers are required to meet their pledged amount and must contact the creator to change it.<sup>89</sup>

A basic principle of contract law is the legal capacity of the parties. Kickstarter indicates on its platform site that all users must be at least “18 years old, or old enough to form a binding contract.”<sup>90</sup> A basic definition of a contract is that it is an agreement with a set of promises that if breached the law will recognize a duty or provides a remedy.<sup>91</sup> Kickstarter, like many online platforms, requires both the creator and the backer to accept the Terms of Use by a prompted click-to-accept notice of acceptance.<sup>92</sup> Individuals that do not receive their funding back or the promised rewards may file a lawsuit with a breach of contract claim against the creator. The burden of proof will be on the plaintiff, usually the backer of a campaign, to establish that a contract exists and that it was breached. “Anything short of full performance [of a contract] is a breach, even if the party who failed to perform was not at fault.”<sup>93</sup>

The second legal issue surrounding crowdfunding is that of fraud. Many rewards-based crowdfunding platforms are at risk for fraud

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<sup>85</sup> See generally, Christopher Moores, *Kickstart My Lawsuit: Fraud and Justice in Rewards-Based Crowdfunding*, 49 U.C. DAVIS L. REV. 383 (2015).

<sup>86</sup> *Terms of Use*, KICKSTARTER, [www.kickstarter.com/terms-of-use](http://www.kickstarter.com/terms-of-use) (last visited May 3, 2017).

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Terms of Use*, Kickstarter, [www.kickstarter.com/terms-of-use](http://www.kickstarter.com/terms-of-use) (last visited Jan. 22, 2018).

<sup>91</sup> RESTATEMENT (SECOND) OF CONTRACTS §1 (AM. LAW INST.1981).

<sup>92</sup> *Terms of Use*, KICKSTARTER, [www.kickstarter.com/terms-of-use](http://www.kickstarter.com/terms-of-use) (last visited May 3, 2017).

<sup>93</sup> RESTATEMENT (SECOND) OF CONTRACTS §235(2) (AM. LAW INST.1981).

because crowdfunding is built on trust between strangers.<sup>94</sup> The Federal Trade Commission (“FTC”) is the federal agency that works on behalf of consumers to assist in the prevention of fraudulent, deceptive, and unfair business practices.<sup>95</sup> The FTC also provides information to the public to identify such practices in order to avoid engaging in them.

The FTC’s first fraud enforcement case involving crowdfunding was that of Erik Chevalier doing business as The Forking Path Co., which that sought funds from backers to create a board game.<sup>96</sup> Chevalier sought \$35,000 from backers for the board game and actually raised \$122,000.<sup>97</sup> Instead of providing the backers with copies of the game or pewter game figurines as promised, Chevalier used the funds for personal expenses.<sup>98</sup> Although Chevalier periodically communicated with the backers about the rewards, they were not produced.<sup>99</sup> In fact, he finally communicated with the backers that he was cancelling the campaign and would return the funds.<sup>100</sup> The funds were not returned, and backers contacted the FTC. This case was settled and Chevalier agreed to refrain from misrepresentations in the future and was ordered to pay \$111,793.71.<sup>101</sup> As a result of this case and others, the FTC has started a FinTech series bringing together industry specialists, researchers, participants, and others to examine consumer concerns.<sup>102</sup>

Another independent campaign with legal troubles was COIN, INC., which a self-fundraiser to fund their “Coin Device.” The Coin is a plastic card that consolidates a person’s credit and debit cards into one card in order to simplify the user’s life by being the only card the user would need to carry with them. A security feature was also included to alert users when their coin card was out of range of their cell phones.<sup>103</sup> A class action lawsuit was filed against COIN, INC. for material misrepresentation, breach of contract, unlawful business practices, violation of the California Consumer Legal Remedies Act, violation of

<sup>94</sup> Catherine Fredman, *Fund Me or Fraud Me? Crowdfunding Scams Are on the Rise*, CONSUMER REPORTS (Oct. 5, 2015) <http://www.consumerreports.org/cro/money/crowdfunding-scam>.

<sup>95</sup> Federal Trade Commission [www.ftc.gov](http://www.ftc.gov) (last visited Jan. 22, 2018).

<sup>96</sup> Jay Mayfield, *Crowdfunding Project Creator Settles FTC Charges of Deception*, FEDERAL TRADE COMMISSION, OFFICE OF PUBLIC AFFAIRS (June 11, 2015) <https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception>

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> Jay Mayfield, *Crowdfunding Project Creator Settles FTC Charges of Deception*, FEDERAL TRADE COMMISSION, OFFICE OF PUBLIC AFFAIRS (June 11, 2015) <https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception>

<sup>102</sup> Colleen Tressler, *FTC Examines Crowdfunding*, FEDERAL TRADE COMMISSION (Oct. 26, 2016) <https://www.consumer.ftc.gov/blog/2016/10/ftc-examines-crowdfunding>.

<sup>103</sup> *Kelly v. Coin*, No. 3:16-cv-00567, compl. at 6 (N.D. Cal. Feb. 2, 2016).

California Song Beverly Consumer Warranty Act, and breach of the implied warranty of merchantability.<sup>104</sup> The card delivery was delayed, and once delivered, the card was found to be reliable as advertised only 60% to 85% of the times used. Along with these issues, the security feature did not work as advertised. COIN, INC. was recently acquired by Fitbit, a wearable technology company, and all Coin related business activities stopped in February 2017.<sup>105</sup> This obviously will complicate the lawsuit and any subsequent collection processes.

A case of first impression in the state of Washington<sup>106</sup> involved the campaign of Asylum playing cards.<sup>107</sup> Although considered a successful campaign as it raised \$25,146, it did not provide backers with the promised items.<sup>108</sup> After two years, the attorney general for the state of Washington filed a lawsuit against Altius Management and Edward J. Polchlopek for misrepresentation and failure to deliver the rewards that were described in the campaign.<sup>109</sup> The court determined that the actions constituted unfair or deceptive acts or practices and the use of unfair methods of competition.<sup>110</sup>

Additionally, there are federal and state tax issues surrounding rewards-based crowdfunding. Creators can mistake the crowdfunding donations as a gift and not taxable income. Many platforms refer to the money backers give as a donation. It is highly unlikely that the crowdfunding campaign is an actual tax-exempt charity for purposes of claiming a charitable donation by the backer on his or her tax returns. As stated by Thomas D. Selz, partner in the law firm of Frankfurt, Kurnit, Klein & Selz:

The taxes are an issue. From an IRS perspective, if you're doing a rewards-based crowdfunding where you're supplying a product or a service, that is a pre-sale of the product or service, which is taxable. The state tax authorities view that, as well. There was one situation in Washington where the person raising the money on a rewards-based

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<sup>104</sup> *Id.* at 1.

<sup>105</sup> Joshua Jamerson, *Fitbit Buys Coin's Digital-Wallet Technology*, WALL STREET J. (May 18, 2016), <https://www.wsj.com/articles/fitbit-buys-coins-digital-wallet-technology-1463587687>.

<sup>106</sup> *State v. Altius Mgmt., LLC.*, No. 14-2-12425-SEA, compl. (Apr. 30, 2014).

<sup>107</sup> Taylor Soper, *Kickstarter Fraud: Washington Files First Consumer Protection Lawsuit Involving Crowdfunding*, GEEKWIRE (May 1, 2014), <https://www.geekwire.com/2014/attorney-general-asylum-playing-cards-crowdfunded-project/>

<sup>108</sup> *Id.*

<sup>109</sup> Bob Ferguson, *Attorney General Files Lawsuit Against Company Behind Asylum Playing Cards Crowdfunded Project*, OFFICE OF THE ATTORNEY GENERAL (May 1, 2014), <http://www.atg.wa.gov/news/news-releases/attorney-general-files-lawsuit-against-company-behind-asylum-playing-cards>.

<sup>110</sup> Dawn Brotherton, *Kickstarter Project Sued in Landmark Case Randomly Begins Delivering*, THE AM. GENIUS (Sept. 4, 2015), <https://theamericangenius.com/business-news/kickstarter-project-sued-in-landmark-case-for-not-delivering-begins-delivering/>.



model basically had people in multiple 8 counties within the state and had to figure out what the local sales tax was in each of the counties. And the amount of money that they raised wasn't worth the effort that had to go into figuring that out. So you have to be aware of the tax consequences of what you're doing for rewards-based crowdfunding.<sup>111</sup>

Depending on the entity formation for the particular business associated with the campaign, these tax issues can also include personal income tax to the creators.

#### IV. CONSEQUENCES OF FUNDING

There are both legal and strategic consequences to both underfunded and overfunded campaigns. These issues and the risks involved must be considered prior to starting the “Before the Campaign” phase.

##### *A. Financial Result: The Campaign Has Met its Goal*

At the conclusion of a successful campaign, one that has either reached its financial goal or exceeded it, the creator then has many tasks to complete. The timeline for completion of these tasks will vary. Creators have many issues that may be faced if an incorrect decision is made in the performance of these tasks. A recent report indicates that between 69 and 89 percent of all crowdfunding campaigns do not meet their goals.<sup>112</sup> The reverse indicates that about one-third of the campaigns actually do meet their goals.

In 2015, Kickstarter 31-percent of its campaigns reached their goals.<sup>113</sup> In projects created utilizing the Kickstarter platform, the creator whose project is fully funded must fulfill the rewards promised to his or her backers. According to the current Terms of Use for Kickstarter,

When a project is successfully funded, the creator must complete the project and fulfill each reward. Once a creator has done so, they've satisfied their obligation to their backers. Throughout the process, creators owe their backers a high standard of effort, honest communication, and a dedication to bringing the project to life.<sup>114</sup>

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<sup>111</sup> *FTC FinTech Series: Crowdfunding & Peer-to-Peer Payments*, FEDERAL TRADE COMMISSION, p. 7-8 (Oct. 26, 2016), [https://www.ftc.gov/system/files/documents/videos/fintech-series-crowdfunding-peer-peer-payments-part-2/ftc\\_fintech\\_series\\_crowdfunding\\_p2p\\_-\\_transcript\\_segment\\_2.pdf](https://www.ftc.gov/system/files/documents/videos/fintech-series-crowdfunding-peer-peer-payments-part-2/ftc_fintech_series_crowdfunding_p2p_-_transcript_segment_2.pdf).

<sup>112</sup> Catherine Clifford, *Less than a Third of Crowdfunding Campaigns Reach Their Goals*, ENTREPRENEUR (Jan. 18, 2016) <https://www.entrepreneur.com/article/269663>.

<sup>113</sup> *Id.*

<sup>114</sup> *Terms of Use: How Projects Work*, KICKSTARTER, <https://www.kickstarter.com/terms-of-use> (last visited May 25, 2017), *see also*, *Crowdfunding Project Creator Settles FTC Chargees of*

*B. Financial Result: The Underfunded Crowdfunding*

Presently There is a high probability that a crowdfunding campaign will not reach its financial goal. One source indicates that between 69 and 89 percent of all campaigns fail to reach the financial goal set in the campaign.<sup>115</sup>

Kickstarter does not provide the funding to the creator if the funding goals are not met within a given set time period.<sup>116</sup> This is referred to as an all-or-nothing approach to crowdfunding.<sup>117</sup> Kickstarter's site states that this approach "protects creators from being stuck with a fraction of the funds they need and an audience expecting fully funded results. By minimizing risk, it also makes backers more likely to pledge."<sup>118</sup>

Indiegogo, however, offers a Flexible Funding<sup>119</sup> option. Even if the campaign does not reach its funding goal, the creator will still receive the raised funds.<sup>120</sup> This may not be a good option for all creators. Under this option, it is possible to be underfunded and still have to give backers their expected perks without the funds to create them.<sup>121</sup> This may also make the creator look greedy or be willing to take what they can get.<sup>122</sup> (for example, they request \$20,000 but accept \$4000, which a backer may infer that either they asked for more than they needed or just want the funds with no intention of finishing the project).

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*Deception*, FED. TRADE COMM'N (June 11, 2015) <https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception> .

<sup>115</sup> Catherine Clifford, *Less Than a Third of Crowdfunding Campaigns Reach Their Goals*, ENTREPRENEUR, (Jan. 18, 2016), <https://www.entrepreneur.com/article/269663> (discussing various crowdfunding platforms and the success/failure rates of campaigns).

<sup>116</sup> *Creator Questions*, KICKSTARTER, [https://www.kickstarter.com/help/faq/creator+questions#faq\\_49541](https://www.kickstarter.com/help/faq/creator+questions#faq_49541) (last visited Mar. 20, 2017).

<sup>117</sup> Robert Hoskins, *How to Pick the Best Crowdfunding Sites for Successful Fundraising Campaigns*, CROWDFUNDING PR., SOC. MEDIA & MKTG. CAMPAIGNS (Feb. 17, 2013), <http://crowdfundingpr.wordpress.com/2013/02/17/kickstarter-vs-indiegogo-which-is-the-best-crowdfunding-site-and-why/> (comparing Kickstarter and Indiegogo crowdfunding campaigns).

<sup>118</sup> KICKSTARTER, *supra* note 56.

<sup>119</sup> *Choose Your Funding Type: Can I Keep My Money?*, INDIEGOGO, <https://support.indiegogo.com/hc/en-us/articles/205138007-Choose-Your-Funding-Type-Can-I-Keep-My-Money-> (last visited May 20, 2017).

<sup>120</sup> Ian Anderson, *Crowdfunding Tips & Tricks for Artists*, INDIEGOGO, <https://launchandrelease.com/7-ways-indiegogos-flex-funding-hurts-music-crowdfunding/> (last visited May 20, 2017).

<sup>121</sup> Charles Luzar, *Flexible Funding on Indiegogo Defined And Applied*, CROWDFUND INSIDER, <https://www.crowfundinsider.com/2013/03/11242-indiegogo-flexible-funding/> (last visited May 20, 2017).

<sup>122</sup> Anderson, *supra*, note 44.

### *C. Financial Result: The Over-Funded Crowdfunding Campaign*

Generally, rewards are provided to the backers. However, in some instances, the rewards are not provided. For example, projects that are overfunded are more likely to fail at delivering their rewards compared to those that were able to meet their goal.<sup>123</sup> We believe two main reasons exist as to why this does not happen: (1) either creators did not correctly budget the time and resources needed to fulfill the rewards, or (2) a deliberate intent of the creator to commit fraud or deception. A possible third option is less clear. Some creators fail to communicate effectively with their backers after the project has been funded, and the backers perceive they have been defrauded because they cannot identify what went wrong.<sup>124</sup> Many backers vent their frustrations on social media sites.<sup>125</sup> This negative publicity can cause long-term financial devastation to the livelihood of the creator. Still, all legal claims exist and are available to the backers as previously discussed.

#### *1. Fulfillment of Promises*

First, the campaign backers are expecting fulfillment of promises made by the creator. These promises may have been the inducement for the backers to make the investment in the campaign. Many backers have the mistaken belief that they are purchasing items rather than making an investment. This perception of backers that they are customers, and not investors, can cause problems for the creator. In 2012, creator Andy Muldowney's portable thermal printer, the mPrinter, received \$88,018 from 706 backers with only a \$10,000 goal.<sup>126</sup> Backers had expected to receive the printer as their reward for backing the project. However,

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<sup>123</sup> Mollick, *supra*, note 8, at 12-13.

<sup>124</sup> Eden S. Blair and Tanya M. Marcum, *When Kickstarter Campaigns Don't Deliver: A Case Study of Phenom Fabrics*, ENTREPRENEURSHIP & INNOVATION EXCH. (Apr. 12, 2016) <https://eiexchange.com/content/141-when-kickstarter-campaigns-dont-deliver-a-case-study-of-phenom-fabrics>. (A backer stated, "Two more months have passed and still no word from you on the progress of our orders. When you created this campaign you entered into a contract with your backers, who gave you their hard-earned money to support your project. You have been ignoring people's inquiries and conducting yourself in a manner that is very unprofessional. You have betrayed our trust and have damaged the faith we have in Kickstarter. Please start fulfilling your orders as we are all waiting and we deserve a resolution.")

<sup>125</sup> Indigoace, Comment to *FibroFibers Kickstarter Thread*, RAVELRY, (Aug 14, 2015) <http://www.ravelry.com/discuss/demon-trolls/3259456/>. (Ravelry is a social media site for knitters and crocheters. This thread was started on a forum to discuss consumer complaints after numerous threads on the FibroFibers Ravelry forum were deleted.)

<sup>126</sup> Andy Muldowney, *mPrinter-An Analog Printer for a Digital World*, KICKSTARTER, <https://www.kickstarter.com/projects/1953425088/mprinter-an-analog-printer-for-a-digital-world> (last visited May 21, 2017).

Muldowney did not deliver and canceled the project in 2015, nor did not offer a refund.<sup>127</sup> Many of his backers have filed claims with the FTC.<sup>128</sup>

## 2. *Time Spent Fulfilling Rewards vs. Starting the Project*

One of the biggest risks in overfunding a campaign is that the time spent in fulfilling the rewards prevents the creator from being able to pursue the project or venture funded by the campaign. In fact, receiving too much funding may make it harder to pursue the project than getting just the right amount. This is especially true for something that is not easily replicable or does not benefit from economies of scale.<sup>129</sup> Jennifer Hintz' FibroFibers Kickstarter campaign received \$26,068 while originally requesting \$15,000.<sup>130</sup> Most of her rewards involved hand-dyed skeins of yarn.<sup>131</sup> This benefitted little from economies of scale, as they could not be mass-produced.<sup>132</sup> She stated in her updates to backers:

Many people are frustrated that I'm stocking the shop, yet perks are still going out very slowly. The thing is, if I don't keep the shop going and the business running, then it would be impossible to fulfill any perks at all. Keeping the business running and myself fed and housed is a necessary basic prerequisite to fulfilling perks. Suspending normal business to put sole focus on perk fulfillment is impossible, and even if possible it would be a terrible idea for the business. This campaign was conducted to help the business, and out of respect for that the business will always come first.<sup>133</sup>

Hintz eventually failed to send out any of her rewards beyond digital patterns.<sup>134</sup> After shutting down all means of communication, her business now appears to be closed.<sup>135</sup>

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<sup>127</sup> Andy Muldowney, *mPrinter-An Analog Printer for a Digital World: Final Project Update*, KICKSTARTER, <https://www.kickstarter.com/projects/1953425088/mprinter-an-analog-printer-for-a-digital-world/posts/1311061> (last visited Mar. 21, 2017). ("After a long road and lots of hurdles, I regret to inform everyone that we will be unable to complete fulfillment of the mPrinter project.")

<sup>128</sup> Abigail Tracy, *These Could Be the Kickstarters the Feds Go After Next*, FORBES (June 30, 2015), <https://www.forbes.com/sites/abigailtracy/2015/06/30/kickstarter-campaigns-ftc-consumer-complaints/#4688be3d2866>. (A Freedom of Information Act request showed that this project had multiple complaints with the FTC.)

<sup>129</sup> Jennifer Hintz, *FibroFibers Expansion-More Nightfall for Everyone!*, KICKSTARTER, <https://www.kickstarter.com/projects/1882887336/fibrofibers-expansion-more-nightfall-for-everyone/posts/1151860> (last visited May 20, 2017)

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> Candice Fitch Rinehart, Comment to *FibroFibers Expansion Fraud*, KICKSCAMMED, [http://kickscammed.com/project/fibrofibers-expansion-more-nightfall-for-everyone/#.WMqz3BC\\_mnc](http://kickscammed.com/project/fibrofibers-expansion-more-nightfall-for-everyone/#.WMqz3BC_mnc) (last visited May 20, 2017).

The Coolest Cooler was so successful that it led to supply shortages and delays.<sup>136</sup> While it did eventually get all of its promised rewards out, they were well behind the deadline.<sup>137</sup> The creators did, however, communicate about their delays in a timely manner and when the numbers of rewards they did send out.<sup>138</sup>

When setting up a campaign, it is important to have scalable rewards, where it is inexpensive and simple to replicate the rewards for larger numbers of backers than expected. Keeping work-intensive rewards, like hand-made projects, to a minimum number of backers and at a premium pledge amount can help make sure the rewards are distributed in a timely manner. Now there are separate companies that can help distribute rewards for the creators,<sup>139</sup> although this again eats into the money raised from the campaign and should be taken into consideration when determining the funding amount requested. Some creators have sent out digital copies of their product (such as a comic book)<sup>140</sup> until the final printed version one is finished.

### 3. Underestimating Costs

It is also possible to successfully fund a campaign but to have underestimated the costs of fulfilling the promised rewards. Creators tend to be overly optimistic<sup>141</sup> and downplay the costs in terms of money and time of fulfilling the rewards while simultaneously trying to start and manage the project funded. The time it takes to fulfill the rewards can prevent the creator from actually getting the project completed. This, in turn, decreases the opportunity for additional revenue from the completed project. Gordon Alan Stewart got his 2013 gStick project funded on Kickstarter in less than 24 hours and received \$130,463 after only a

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<sup>135</sup> FIBROFIBERS, <http://fibrofibers.com/> (last visited May 20, 2017). (The website domain appears to be up for sale by the owner.)

<sup>136</sup> Ryan Grepper, *Coolest Cooler: 21st Century Cooler That's Actually Cooler, Shipping Timeline*, KICKSTARTER, <https://www.kickstarter.com/projects/ryangrepper/coolest-cooler-21st-century-cooler-thats-actually/posts/1330897> (last visited Mar. 20, 2017).

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> Salvador Briggman, *22 Websites to Help Post-Kickstarter with Reward Fulfillment and Product Sales*, CROWD CRUX, <http://www.crowdcru.com/22-websites-to-help-post-kickstarter-with-reward-fulfillment-and-product-sales/> (last visited May 20, 2017).

<sup>140</sup> Steve Bryant, *Athena Voltaire and the Volcano Goddess: A Comic Book Project*, KICKSTARTER, <https://www.kickstarter.com/projects/389994459/athena-voltaire-and-the-volcano-goddess-a-comic/description> (last visited May 20, 2017).

<sup>141</sup> Daniel P. Forbes, *Are Some Entrepreneurs More Overconfident Than Others?* 20(5) J. OF BUS. VENTURING 623–640 (2005).

\$40,000 goal.<sup>142</sup> However, he is yet to send out his rewards.<sup>143</sup> In December 2016 he provided an update that manufacturing and personal issues have prevented the project from being completed on time, but he does plan to still get the mouse out to his backers and future customers.<sup>144</sup>

#### 4. Perception of Backers as Customer, Not Investors

Perhaps the largest risk in crowdfunding is the backers' perception of their role. While the crowdfunding sites and most creators treat these backers as investors with an at-risk investment, it appears that many backers perceive themselves as customers who are pre-purchasing a product, perhaps at a slight premium to support the project.<sup>145</sup> One of Hintz' backers stated, "[o]n the risk scale, this one was as risky as taking a walk on a cool fall evening and getting hit by a meteor."<sup>146</sup> This difference in perception of backers and creators can mean that backers are far more risk averse than they should be when backing a new crowdfunded project. Of Kickstarter projects that are successfully funded, nine percent fail to deliver on their rewards.<sup>147</sup> However, the failure rate of new ventures is at nineteen percent in the first year and thirty-five percent in the second.<sup>148</sup> Thus, Kickstarter campaigns, tested by the market in terms of reaching their funding goal, have a better chance of success than overall new ventures. But, despite the stated risks, the backers' frustration at the creator and the crowdfunding platforms can be great when projects do not go as planned. Many show frustration that, in a dispute, Kickstarter does nothing to assist them nor do they issue a

<sup>142</sup> Gordon Alan Stewart, *gStick: The Mouse You Hold Like a Pen, for PC's and Macs*, KICKSTARTER, <https://www.kickstarter.com/projects/529738175/gstick-the-mouse-you-hold-like-a-pen-for-pcs-and-m> (last visited May 21, 2017).

<sup>143</sup> Abigail Tracy, *These Could Be The Kickstarters The Feds Go After Next*, FORBES, (June 30, 2015) <https://www.forbes.com/sites/abigailtracy/2015/06/30/kickstarter-campaigns-ftc-consumer-complaints/#1fd76b332866> (last visited January 26, 2018)

<sup>144</sup> Gordon Alan Stewart, *gStick: The Mouse You Hold Like a Pen, for PC's and Macs, Massive delays Ordering New Samples*, KICKSTARTER <https://www.kickstarter.com/projects/529738175/gstick-the-mouse-you-hold-like-a-pen-for-pcs-and-m/posts/1767253> (last visited May 21, 2017). ("Thanks to several China factories, my Kick project was knocked of (*sic*) the tracks several times. And a few months ago personal issues knocked it off the tracks again.")

<sup>145</sup> Bb55bb, Comment to *FibroFibers Kickstarter Thread*, RAVELRY, (August 25, 2015) <http://www.ravelry.com/discuss/demon-trolls/3259456/226-250#232>.

<sup>146</sup> AbbyNormal, Comment to *FibroFibers Kickstarter Thread*, RAVELRY, (August 24, 2015) <http://www.ravelry.com/discuss/demon-trolls/3259456/176-200#197>.

<sup>147</sup> Ethan R. Mollick, *Delivery Rates on Kickstarter*, SSRN WORKING PAPER SERIES (2016), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2699251](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699251).

<sup>148</sup> Bruce A. Kirchoff, *ENTREPRENEURSHIP AND DYNAMIC CAPITALISM: THE ECONOMICS OF BUSINESS FIRM FORMATION AND GROWTH* 6 (Praeger. 1994).

refund.<sup>149</sup> Since rewards are not expected until many months if not years after the campaign ends, backers cannot dispute this through their credit cards or the payment platform they used.

## V. ANOTHER CROWDFUNDING CONCERN: THE EFFECT OF SOCIAL MEDIA

Using social media effectively is vital for a successful crowdfunding campaign. Social media can help creators and backers inform their networks about the campaign, which provides legitimacy for the project and increases the chances of additional backers by network members sharing on their social media feeds.<sup>150</sup> However, if problems arise after the campaign ends, there is a great risk of negative comments going viral. In all phases of crowdfunding, creators should monitor various social media sites for comments about the campaign by others. It is common for investors to make either positive or negative comments about the campaign, and both should be noted by the creator.

### A. Reputation

One of the greatest risks is a loss of reputation to the business and the creator due to not fulfilling the rewards as promised. New ventures are confronted with the liabilities of newness.<sup>151</sup> This states that, because the venture is new, certain problems are inevitable. One common problem is a lack of reputation. Reputation is a third party's opinion about a particular social entity or venture.<sup>152</sup> Even creators with a reputation built on past projects are likely to need to attract new backers to get their new project fully funded. Reputation must be built over time with good work and reliable delivery. However it can easily be destroyed by not meeting the expectations of the backers and customers. "A firm's reputation affects both consumers' intentions to purchase and customer loyalty, and as a result, increases brand equity and performance."<sup>153</sup> Entrepreneurs

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<sup>149</sup> Susanri, Comment to *FibroFibers Kickstarter Thread*, RAVELRY,(August 21, 2015) <http://www.ravelry.com/discuss/demon-trolls/3259456/151-175#175>.

<sup>150</sup> Steve Mariotti, *Crowdfunding 101 for Entrepreneurs*, Huffington Post (Jan. 15, 2014)

<sup>151</sup> Arthur L. Stinchcombe, Chapter 4, SOCIAL STRUCTURE AND ORGANIZATIONS, HANDBOOK OF ORGANIZATIONS 142–193 (J.G. March Ed., 1965).

<sup>152</sup> Keith MacMillan, Kevin Money, Steve Downing, & Carola Hillenbrand, *Reputation in Relationships: Measuring Experiences, Emotions and Behaviours*, 8(3) CORP. REPUTATION REV. 214-32 (2005).

<sup>153</sup> Robert Steinbauer, Nicholas D. Rhew, Eric Kinnamon, & Frances Fabian, *The Conflicting Drivers of Entrepreneurial Ethics*, 4(1) J. ETHICS & ENTREPRENEURSHIP 57, 64 (2014).

often do not have the financial ability or time to repair their reputations when faced with negative reputational type of comments.<sup>154</sup>

If backers make factual social media claims that are untrue, there may be a defamation cause of action by the creator against the backer. “Defamation law exists to protect an individual's reputation from injury due to false or defamatory attacks. Actions for defamation are based on written or oral statements, which can constitute libel and slander respectively.”<sup>155</sup> A civil case of defamation can be made if the plaintiff can prove: “(1) a false statement made against the plaintiff (2) that was published and (3) caused harm (4) due to the publisher's wrongful action or inaction at least amounting to negligence.”<sup>156</sup> Lawsuits for defamation can be strategically used to quiet or threaten a party.<sup>157</sup> An anonymous speaker on an internet forum raises additional legal concerns for a creator attempting to bring a lawsuit against that speaker.<sup>158</sup> However, unmasking anonymous commentators can prove difficult in court, rendering many defamation lawsuits unsuccessful.

### *B. Close Artistic Communities*

Many crowdfunding projects attract a niche market of devoted followers (e.g., knitting, comic book, film, or role-playing enthusiasts). This attraction can be very useful in terms of building up an audience willing to back an at-risk project. Additionally, the followers are likely to tell their network in and out of the community to support the creator as well. Unfortunately, this can increase the chance that the community will speak about a campaign negatively if something goes wrong. In the knitter and crocheter social media site Ravelry.com, Hintz was removed from a “Reliable Dyers” list after concerns about her lack of follow-through in her promised Kickstarter campaign.<sup>159</sup> When she deleted threads on her own forum on the site, users created one she could not

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<sup>154</sup> *Id.*

<sup>155</sup> Lauren Guicheteau, *What is the Media in the Age of the Internet? Defamation Law and the Blogosphere*, 8 WASH. J.L. TECH. & ARTS 573, 577 (2013).

<sup>156</sup> *Id.*

<sup>157</sup> David Orozco, *The Use of Legal Crowdsourcing (“Lawsourcing”) to Achieve Legal, Regulatory, and Policy Objectives*, 53 AM. BUS. L.J. 145, 187 (2016).

<sup>158</sup> See Sandra J. Perry & Tanya M. Marcum, *Unmasking the Anonymous Online Speaker: Balancing Free Speech and Defamation*, LABOR L.J. 529 (2016); see also Miriam A. Cherry, *Cyber Commodification*, 72 MD. L. REV. 381 (2013) (discussing the anonymous speaker and legal problems related to such speakers).

<sup>159</sup> RAVELRY, <http://www.ravelry.com/discuss/demon-trolls/2694993/1-25#2> (last visited May 20, 2017).



control.<sup>160</sup> Many commenters started seeking information about the delays in fulfillment, and Hintz failed to communicate effectively. The commenters started working together to determine the best ways to get their money refunded. This included reporting her to the FTC and state Attorney General's office. Hintz removed all of her personal and business social media sites so that she could not be contacted, which did nothing to regain her reputation among that community.

### *C. Inaccurate Information and Lack of Communication*

It is not uncommon for creators to miss their deadline for delivering rewards. However, with clear information about why and how this has happened, they tend to meet backers' expectations. Without clear communication from the creator, the backers may start seeking information themselves. This lack of communication can lead to a greater negative perception of the creator and venture, while furthering misinformation about what went wrong. Thus, a key factor for all reward-based crowdfunding campaigns is to communicate timely and often with the backers.

Despite some projects being designated as a "Staff Pick" some campaigns were still unable to gain success.<sup>161</sup> Backers of projects that failed to fulfill their promised rewards often felt insulted, but Kickstarter does not re-label projects, or report when a project has been repeatedly failed to deliver on its promised rewards. Kickstarter may suspend accounts for suspicious activity, but may not include all activities that backers may expect.<sup>162</sup>

According to research, over seventy-five percent of creators deliver their product later than expected.<sup>163</sup> Project delays are common with the complexity of the products and the overall campaigns.<sup>164</sup> However, most backers are comfortable with delays if the creator communicates effectively. Communication is a key to managing these risks and backers' expectations.

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<sup>160</sup> RAVELRY, <http://www.ravelry.com/discuss/demon-trolls/3259456/501-525> (last visited May 20, 2017).

<sup>161</sup> *Projects We Love*, KICKSTARTER, <https://www.kickstarter.com/discover/recommended> (last visited May 20, 2017) (wherein the staff of Kickstarter selects campaigns that are handpicked by the staff due partially due to their innovativeness. Projects included in these can add a "Staff Pick" logo to their campaign.)

<sup>162</sup> *Trust and Safety*, KICKSTARTER, <https://www.kickstarter.com/trust> (last visited May 20, 2017).

<sup>163</sup> Mollick, *supra*, note 8 at 11.

<sup>164</sup> *Id.*

## VI. ORGANIZATIONAL RISKS

Failing to deliver on rewards has implications beyond the legal ramifications. Creators risk losing their whole business based on the loss of their professional reputation. Backers may see the lack of fulfillment of the rewards as the inability to follow through with what was promised. For example, Hintz's FibroFibers' online store was closed and her social media sites removed after her backers complained.<sup>165</sup> Funds earmarked for the project may have to be diverted to legal fees. Backers are likely to tell others about their experiences with the creator. Negative experiences with the campaign will be communicated to others as negative experiences with the creator or his or her business, and could impact others' decisions to support the business by purchasing products. Any strategic partnerships will likely be impaired or lost.

Another organizational risk which is also a legal concern deals with entity formation. The legal form of the entity that the creators have set their entity is important. As an example, if the creators have not done any formal paperwork with a state governmental authority, the entity will be considered a partnership or a sole proprietorship, depending on how many creators are involved. This creates a high risk of personal liability for all debts and legal implications for potential fraud by the creator.<sup>166</sup> If the creators organized a limited liability company for their campaign, then the personal liability will only exist if the creators have not observed the legal formalities of the limited liability company.<sup>167</sup> As an example, if the creators have co-mingled personal and entity funds or spend the funds received from the campaign on personal expenses, there will be a high likelihood that the corporate veil will be pierced and personal liability will be extended to the creators.<sup>168</sup>

## V. CONCLUSION

While crowdfunding can be a relatively easy and effective way to receive funding when other options are unavailable, careful strategy and an understanding of the legal should be considered before pursuing. Fulfilling the campaign promises can take an enormous amount of time

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<sup>165</sup> *FibroFibers Expansion Fraud*, KICKSCAMMED, [http://kickscammed.com/project/fibrofibers-expansion-more-nightfall-for-everyone/#.WM\\_b0hC\\_mnc](http://kickscammed.com/project/fibrofibers-expansion-more-nightfall-for-everyone/#.WM_b0hC_mnc) (last visited May 20, 2017).

<sup>166</sup> Tanya M. Marcum & Eden S. Blair, *Entrepreneurial Decisions and Legal Issues in Early Venture Stages: Advice that Shouldn't be Ignored*, 54 Bus. Hor. 143, 146 (2011).

<sup>167</sup> *Id.*

<sup>168</sup> *See*, 18 Am. Jur. 2d Corporations §48 (2017).

and effort away from the project or business itself, and must be considered and budgeted for early in the process.

The creator of the crowdfunding campaign holds the key to its long-term future. The creator must act ethically, be honest, be prompt with communications, be innovative and think through the entire campaign before the campaign even begins. Even the overconfident creator must take the time to put forth a campaign that will not tarnish its reputation. To avoid these issues, the campaign should be broken down into three segments: before the campaign, during the campaign, and after the campaign. During each segment of the campaign, the creator must prepare early the marketing strategy, communication plans, and the management of backers' expectations.