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CROWDFUNDING

EXPLOIT THE POTENTIAL AND LIMIT YOUR RISK

Torben Waage
Partner

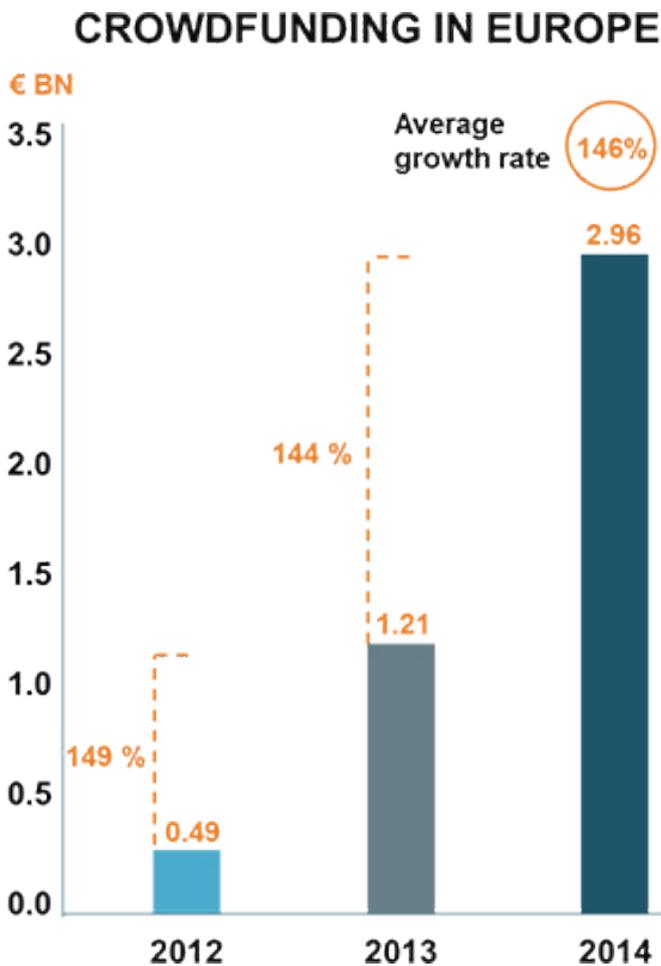
Jeppe Buskov
Partner

Michael Nørremark
Partner

CROWDFUNDING - EXPLOIT THE POTENTIAL AND LIMIT YOUR RISK

Crowdfunding is on the rise all over the world, and figures from Europe show that the amount of funds raised via crowdfunding grew by as much as 146% from 2012 to 2014. In Denmark, 339 projects were crowdfunded in 2014, and this number is expected to increase significantly in the coming years. Crowdfunding is part of the digital sharing economy concept, in which everybody can contribute funds to the entrepreneur projects that they wish to back. However, crowdfunding has developed into a professional funding method in line with the other methods of raising capital, with the consequent advantages and limitations.

At Kromann Reumert it is our impression that more and more start-up businesses consider crowdfunding to be one of their primary funding options and sales channels. We receive an increasing number of inquiries from investors requesting advice on how to handle potential investment objectives that either have been crowdfunded or operate a crowdfunding platform. In this KR Insight we will therefore focus on the clash between the sometimes informal crowdfunding and the established rules.



Torben Waage
Partner

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Mobile: +45 40 61 08 86
Direct: +45 38 77 45 60
tw@kromannreumert.com

Jeppe Buskov
Partner

Mobile: +45 24 86 00 18
Direct: +45 38 77 44 15
jbu@kromannreumert.com

Michael Nørremark
Partner

Mobile: +45 38 77 44 61
Direct: +45 24 86 00 53
mno@kromannreumert.com

In the European Union, crowdfunding grew by averagely 146 % a year from 2012 to 2014, which brought the total 2014 amount up to EUR 2.96 billion (approx. DKK 22 billion). Crowdfunding is still more widespread in the US; in 2014, crowdfunding in the US totalled USD 9.46 billion (approx. DKK 64 billion). The largest crowdfunding growth can be found in Asia, which saw a 320 % growth in 2014.

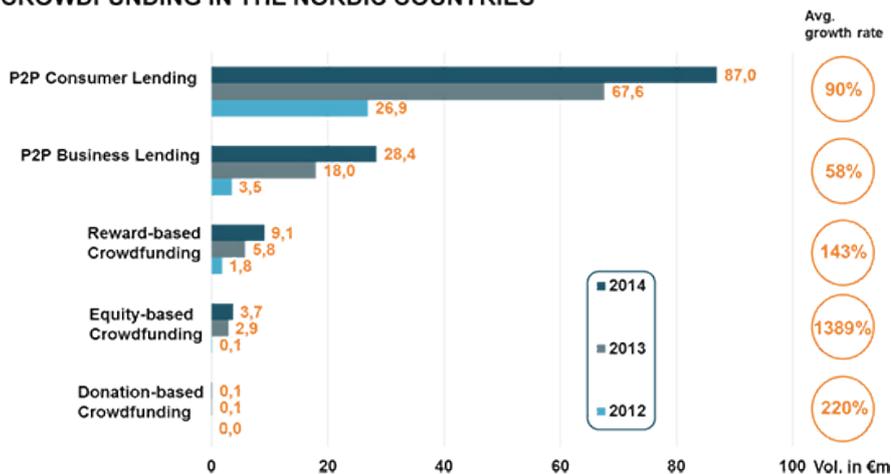
Moving Mainstream - The European Alternative Finance Benchmarking Report, February 2015, University of Cambridge and Ernst & Young.

THE FOUR TYPES OF CROWDFUNDING

There are four different types of crowdfunding:

- **Debt crowdfunding (P2P lending):** In debt crowdfunding the platform functions as a “marketplace” for loans where lenders can contribute to loans to businesses. The interest rate of the loan will normally be determined either by the platform based on a credit assessment of the borrower, or through an auction process among the interested lenders. Danish platforms include Lendino, Flex Funding and Kreditmatch.
- **Equity crowdfunding:** The idea behind equity crowdfunding is that the investor invests a cash amount in exchange for an equity interest in the business looking for funding. There are currently no Danish equity crowdfunding platforms, but the British Crowdcube and the Danish Bridgefunding are both trying to build up equity platforms in the Danish market.
- **Reward crowdfunding:** By using reward crowdfunding, the business will obtain a cash contribution to its project in exchange for a reward, for example in the form of the product developed by the business. Reward crowdfunding is the most widespread type of crowdfunding, and the most popular platforms in the Danish market include Kickstarter, Indiegogo and the Danish Boomerang.
- **Donation crowdfunding:** Donation crowdfunding is a pure donation (gift) to the business or organisation looking for funding. Various international platforms and the Danish Caremaker and Boomerang offer donation crowdfunding.

CROWDFUNDING IN THE NORDIC COUNTRIES



At a European Union level, debt crowdfunding (P2P lending) to consumers and reward crowdfunding rank first and second in terms of volume. In the Nordic countries, debt crowdfunding (P2P lending) to businesses has outpaced reward crowdfunding, which may be due to the limited number of reward crowdfunding platforms for Danish projects (by way of example, not until the end of 2014 did Kickstarter open up for Danish projects). Equity crowdfunding made its real entry into the Nordic countries in 2013, where the volume rose from practically nothing to EUR 2.9 million (approx. DKK 22 million) in 2013 and to EUR 3.7 million (approx. DKK 27 million) in 2014. Moving Mainstream - The European Alternative Finance Benchmarking Report, February 2015, University of Cambridge and Ernst & Young.

ARE YOU ALREADY A PARTICIPANT IN THE CROWDFUNDING MARKET?

Are you already a player, or are you planning on trying crowdfunding, then it is important for you to be aware of the issues that may result in dearly-bought experience and prevent a lucrative exit, and to know as an investor what you need to be particularly aware of in order to avoid buying a pig in a poke.

WHAT YOU NEED TO FOCUS ON

In Kromann Reumert's opinion, players in the crowdfunding market should particularly focus on the following:

- Businesses looking for crowdfunding: Check your obligations and protect your rights
- Investors in businesses that have used crowdfunding: Identify potential deal breakers
- Crowdfunding platform providers: Reduce your risks
- All players in the crowdfunding market: Avoid tax and VAT surprises

I AM LOOKING FOR FUNDING - WHAT DO I NEED TO TAKE INTO CONSIDERATION?

It is important for you to have a clear overview of your obligations to the platform and to the project backers (the funding contributors) in order that you can budget and organise the day-to-day operation of your business - but also in order to have documentation and answers ready explaining why you have been using crowdfunding, if you wish to sell the business some day. We know from experience that if you can prove and explain that your business is based on well-considered transactions, this will render a subsequent sales or investment process much smoother and considerably increase the chances of success. You should therefore particularly take the following into consideration:

GLOBAL CHALLENGES

Crowdfunding involves the same practical and legal challenges and advantages as any global sale, share offer or loan finance. So no matter whether your crowdfunding is based on lending, equity or rewards, you must be aware that you are launching a service that is offered to potential backers all over the world. The global dimension of crowdfunding has many related effects and latent cost drivers that you ought to be consider.

Reward crowdfunding

The following examples of global challenges may have significant financial consequences to your business in the event of reward crowdfunding:

- Are you logistically and financially prepared to deliver a product to a backer in the US, Kenya or China?
- Have you taken into consideration customs duty and VAT in the US, Kenya or China?
- Which national law will apply in the event of disputes with foreign consumers?

Kromann Reumert recommends in the event of reward crowdfunding that you prepare sales and delivery terms and conditions that are almost similar to those used in internet sales. We also recommend that you create a link to the terms and conditions on the contents page of your crowdfunding platform.

Equity crowdfunding

The global dimension also plays a role in equity crowdfunding and the other types of crowdfunding. There has not been any disputes within this area yet, but there are quite a few latent questions that need to be answered, including:

- how do we handle the owners of the business after having sold a share of the business to a broad and indefinable group of new owners?
- how do we handle the general company law requirements as to registration of owners, summoning of general meetings, etc.?
- how can the new owners enforce their rights as shareholders?

At Kromann Reumert we recommend that you consider these questions thoroughly before you embark on equity crowdfunding. If you choose an equity crowdfunding model, the process needs to be more regulated than the reward crowdfunding process. For example, it may make sense to direct your crowdfunding campaign at a specific target group such as selected A-round private equity funds with special ownership terms and conditions.

Accordingly, equity crowdfunding makes higher demands on the businesses looking for funding and on the platform than reward crowdfunding does.

Donation crowdfunding

If you are engaged in donation crowdfunding, the above issues will not be directly relevant to you. However, you must not forget that your crowdfunding will be considered a fundraising campaign, and that generally you will be required to notify the Danish Fundraising Board (Indsamlingsnævnet) of your campaign. Furthermore, you must present financial statements substantiating that you have spent the fundraising proceeds in compliance with the object reported.

CONSIDER YOUR MARKETING WHEN SEARCHING FOR FUNDING

It is decisive for a business searching for funding that they can create the required hype about their project in order to attract investors. Marketing may require large resources in the period up to and during the crowdfunding process. You should therefore clarify what is needed to market your project, whether you have the required resources at your disposal, and whether the efforts compare with the amount of the expected funding.

It is often seen that businesses indirectly contribute the first amounts in order to attract attention for their projects. Also, during the campaign period it is normal for businesses to market their projects by e.g. linking to the projects from social media without explicitly pointing out that it is a crowdfunding project campaign. Such activities may involve risks of liability, prosecution or a penalty for having misled businesses and consumers into investing in the project.

TAKE CARE THAT YOUR IDEA OR RIGHTS DO NOT GET STOLEN

Presenting your idea or project on a crowdfunding platform will disclose your idea to the general public and expose it to the risk of being stolen. Crowdfunding distinguishes itself from other funding methods by not being a risk control process in the same way as for example a

seed or A-round where the risk is reduced by the limited number of persons involved and, not least, by the exchange of non-disclosure statements. You must therefore particularly consider the risk of getting your idea stolen if you use crowdfunding.

Consequently, if your idea depends on trademarks, designs, patents, etc., you should examine whether you need to register your rights or whether they are sufficiently protected in some other manner. We also encourage you to ensure that the crowdfunding platform used by you does not reserve the rights to your intellectual property to an extent exceeding what is necessary for the promotion of the project.

KNOW YOUR PLATFORM

We encourage you to do your homework carefully before deciding which platform to use. Partly because it is decisive for you that the platform can procure contributions from the investors interested in your project, and partly because you must ensure that the consideration charged by the platform is reasonable. There may be large differences in the consideration charged by the various platforms, and whether consideration to the payment service provider is included or needs to be added; also, some platforms are entitled to consideration even if your funding target is not achieved. It should not come as an unpleasant surprise to a business searching for capital that the funding amount actually obtained gets reduced because the platform provider needs a slice of the pie.

We also recommend that your business makes sure to have a clear and proper privacy policy and that you are always able to prove that your processing of personal data is lawful. The reason is that investors focus immensely on compliance with privacy legislation. This is often regulated by the platform setup and is therefore a significant element in your choice of platform.

Finally, you should bear in mind that your interests and those of the platform are not necessarily identical in terms of risk control. The platform will typically be interested in reaching as many persons as possible in the simplest possible way, while you may be interested in steering the process towards a limited group and with restrictions on the contents and consequences of the funding.

Note that the choice of crowdfunding model will have an impact on your exit opportunities and, not least, on the pricing of your business.

I AM AN INVESTOR

- WHAT DO I NEED TO TAKE INTO CONSIDERATION?

In connection with business investments it is today a quite ordinary part of the due diligence process to examine whether the business has made use of crowdfunding. In this connection investors need to examine whether the business in which they intend to invest has addressed the problems described above.

Below we will emphasize some of the problems that are cost drivers and risk elements both in relation to investments in businesses that have been using crowdfunding, and in relation to crowdfunding platforms.

HAS THE BUSINESS THAT I INTEND TO INVEST IN PAID VAT AND OTHER TAXES CORRECTLY?

You need to investigate whether the tax issues of the business are under control, and whether VAT has been paid correctly. If a business has not been paying VAT and other taxes, this will result in large subsequent tax collections and probably fines, which may considerably reduce the value of your investment.

HAS THE BUSINESS THAT I INTEND TO INVEST IN BEEN COMPLYING WITH ITS DISCLOSURE OBLIGATIONS?

A business funded through equity crowdfunding must comply with various obligations in connection with share offerings. If the shares offered by a business are worth more than EUR 1 million, the business must draw up a prospectus that will be subject to approval by the Danish Financial Supervisory Authority. In the event of non-compliance with this obligation, the business faces a risk of being reported to the police and may face a claim for compensation from the persons that have invested in the business. You should therefore examine whether the business has been complying with the prospectus rules in connection with its funding.

IS THE OWNERSHIP STRUCTURE UNDER CONTROL?

It may be a large challenge for a business using equity crowdfunding to form an overview of, and control, its owners. In this connection it is important quite basically to make sure that the shares have been offered to identifiable owners whom the business can contact and register as owners. Also, it is of course quite decisive that the share offering has been a controlled process so that the business is in control of the ownership structure.

I AM A CROWDFUNDING PLATFORM PROVIDER - WHAT DO I NEED TO TAKE INTO CONSIDERATION?

As a crowdfunding platform provider it is your main role to facilitate contact between the backers and the businesses searching for funding, and you must ensure that this role is communicated clearly to all your users. In your position as a facilitator of a crowdfunding platform, you may be subject to mandatory statutory requirements, and you will most probably come into possession of sensitive personal data about the persons that register on your platform. You should therefore particularly take the following into consideration:

YOU WILL NEED TO CHECK YOUR PERMISSIONS

If you have not already done that, you must as soon as possible examine whether your platform requires special permissions. Debt and equity crowdfunding may both require permission from the Danish Financial Supervisory Authority. The business model of the platform and the relationship between the platform, the backers and the businesses searching for funding are decisive for the type of permission required. Failure to obtain permission may result in a number of sanctions against your business in the form of fines and/or the risk of being prohibited from carrying out your business. There is also a risk that you will be met with a claim for damages from backers alleging to have suffered a loss due to non-compliance with the rules.

DRAW UP A PROPER PRIVACY POLICY FOR YOUR PLATFORM

Some crowdfunding platforms may need to obtain various information about the users of the platform. The information may pertain to both legal persons (businesses, associations, foundations, etc.) and natural persons. If the platform collects data on natural persons, it is of particular importance that you inform those data subjects of the purpose of such collection. Also, it is important that you obtain the required consents from the relevant data subjects if, for example, you need to transfer the data to third parties such as group companies or your hosting provider. Furthermore, for the purposes of credit ratings and administration, you must as a platform provider bear in mind that in connection with debt crowdfunding you will come into possession of personal data, the use of which will require the borrower's consent.

TARGET THE PLATFORM CAMPAIGNS

Platforms, particularly debt platforms, have to a greater extent started to select and segment the backers and enterprises that are allowed onto the platform. The purpose thereof is to target the platform at a specific industry or a specific investor segment. Targeting the platform at a specific segment may at the same time contribute to paving the way for e.g. equity platforms in Denmark, as this will make it easier to define the group of investors that the project is offered to. It may also attract attention to your platform if it is considered attractive to join the platform, particularly if prospective investors automatically recognise businesses that have been crowdfunded through your platform.

CROWDFUNDING IN DENMARK 2014



Source: thecrowdfundingcentre.com

DO NOT FORGET TAXES

Irrespective of whether you are a business looking for capital, an investor or a crowdfunding platform provider, you should take into consideration all the tax and VAT aspects of crowdfunding. The obligations depend on the relevant set-up, and the tax and VAT obligations vary depending on the relevant situation. However, generally you must be aware of the following:

- **Debt crowdfunding:** (P2P lending): Interest on the debt is taxable for the lender and tax-deductible for the borrower.
- **Equity crowdfunding:** If the funding is achieved through the investors' subscription for new shares, the business searching for funding will not be liable to pay tax. As for the investors, according to the Danish Act on Taxation of Capital Gains on Sale of Shares, the investment will not trigger any taxation until the investors sell the shares or receive dividend.
- **Reward crowdfunding:** For tax purposes, reward crowdfunding is comparable to a purchase/sale of goods or services. This means that the business must pay tax on the profit, if relevant, and that VAT must be added to the contributions if the sale of the relevant goods or services is subject to VAT. For the avoidance of doubt, however, any contribution that significantly exceeds the value of the "reward" achieved may be treated as a donation, which implies that the amount will be taxed as a gift or a contribution.
- **Donation crowdfunding:** If you achieve funding in the form of donations, you will generally be required to pay taxes on all contributions. The contributors will not be granted any deduction rights in respect of their donations.
- **VAT:** No matter whether you are a business searching for funding, or a platform provider, the services that you supply may be subject to VAT. When to pay VAT depends on the relevant situation. If, for example, the recipient of your service is located in another country, then the situation is more complex. It is therefore necessary always to clarify whether your service is subject to VAT.
- **Foreign tax issues:** Finally, you will need to consider whether to pay foreign taxes and VAT.

WHAT TO DO NEXT?

By taking simple precautionary measures, you will be able to focus primarily on the most important crowdfunding issues. Kromann Reumert recommends that, as a minimum, you take the following measures:

General advice for all players

- Obtain an opinion addressing any particular tax and VAT rules that may apply to your activity.
- Seek advice as early as possible. This may save you a lot of money in the end.

Advice particularly for businesses looking for funding:

- Crowdfunding involves the same practical and legal challenges and advantages as any global sale. Address the risks involved.
- Crowdfunding has a quite extraordinary global dimension and consequent challenges.
- Crowdfunding may require marketing. What do you need, and what is legally permitted in that connection?
- Is your idea protected at the time when you submit it to the crowdfunding market?
- Examine your platform carefully. It is the platform that controls your funding.
- Crowdfunding will have an impact on the valuation of your business and on your exit opportunities.

Advice particularly for prospective investors:

- Has the business been paying VAT and other taxes correctly?
- Has the business been complying with its special disclosure obligations in connection with equity crowdfunding?
- Is the ownership structure of the business under control after the business' use of equity crowdfunding?
- Has the business' use of crowdfunding been appropriate all in all?

Advice particularly for crowdfunding platform providers:

- Do you have the necessary permissions?
- Be sure to have an adequate and clear privacy policy.
- Consider whether to target your platform at a specific segment.

KROMANN REUMERT'S ADVICE

Kromann Reumert has considerable experience in advising on crowdfunding. We can prepare you for crowdfunding and focus our advice on your particular interests, no matter whether you are a business searching for funding, an investor, or a platform provider.