Regulation Crowdfunding: A Viable Option for the Franchising Industry?

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Since the advent of the Internet, small businesses have sought ways to raise capital by issuing securities to the public at large via Internet solicitations. However, they have typically run into issues with state and federal securities laws that prohibit offering securities unless the security is registered or an exemption applies. The answer that these businesses have traditionally tried to turn to was "crowdfunding," which generally means using the Internet to solicit potential investors to help fund any number of projects.[1] However, in its earliest iterations, to avoid potential securities law violations, most small businesses did not actually issue equity in their companies when seeking funds from the general public over the Internet, instead opting to use services like Kickstarter or Indiegogo to raise funds.[2] Congress finally adopted a new exemption that specifically provides for a crowdfunding exemption from federal securities laws, and the Securities and Exchange Commission (SEC) has recently adopted final rules related to crowdfunding, which went into effect on May 16, 2016.

This article examines what impact crowdfunding may have on the franchise industry. It will first provide a brief history of the federal laws governing securities offerings in the United States and Title III of the 2012 Jumpstart Our Business Startups Act (JOBS Act), which first exempted crowdfunded offerings from Section 5 of the Securities Act of 1933 (Securities Act). The article will then explore the actual Regulation Crowdfunding rules issued by the SEC for qualifying for the exemption. Next, the article

1. Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Permit Crowdfunding: Proposes Amendments to Existing Rules to Facilitate Intrastate and Regional Securities Offerings (Oct. 30, 2015), https://www.sec.gov/news/pressrelease/2015-249.html [hereinafter SEC Press Release].

2. Scott Martin & Yuka Hayashi, *SEC Opens Way for Wider Pool of Investors to Take Stakes in Startups*, WALL ST. J., Oct. 30, 2015 ("Crowdfunding campaigns on Kickstarter and Indiegogo, which don't accept equity, have helped countless small companies grow. Many have gone on to raise traditional venture funding.")

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will discuss crowdfunding as a method of raising capital for both franchisees and franchisors. The article will also discuss some issues that franchisors should consider before consenting to a franchisee implementing a crowd-funded securities offering. Finally, the article will conclude with some parting thoughts on crowdfunding and the franchise industry.

I. History of Securities Offering and JOBS Act

A. *Securities Act of 1933*

In the wake of the stock market crash of 1929 and the Great Depression, Congress passed the Securities Act of 1933 on May 27, 1933.[3] The Securities Act has two main objectives. First, it requires that investors receive financial and other important information concerning securities being offered for public sale. Second, it seeks to prohibit deceit, misrepresentations, and other fraud in the sale of securities.[4] At its most basic level, the Securities Act requires that all securities sold in the United States must be registered unless an exemption applies.[5] Some of these exemptions include private offerings to a limited number of persons or institutions; offerings of limited size; intrastate offerings; and securities of municipal, state, and federal governments.[6] With the advent of the Internet, companies and investors have sought ways to increase the ability of small investors to purchase securities in startup companies, while minimizing the regulatory burden and cost of compliance with the Securities Act. Congress sought to bridge this void by enacting an exemption for crowdfunded securities offerings.

B. *Title III of the JOBS Act*

On April 5, 2012, President Barack Obama signed into law the JOBS Act.[7] A major goal of the JOBS Act is to help provide startups and small businesses with investment capital from small investors by making relatively low dollar offerings of securities, featuring relatively low dollar investments by small investors, less costly and burdensome from a regulatory perspective.[8] To accomplish this goal, Title III of the JOBS Act added new Section 4(a)(6) to the Securities Act, which is the actual crowdfunding exemption. Title III of the JOBS Act further required the SEC to write rules and issue studies on capital formation, disclosure, and registration

3. Securities Act of 1933, 15 U.S.C. §§ 77a et seq.
4. Sec. & Exch. Comm'n, *The Laws That Govern the Securities Industry*, https://www.sec.gov/about/laws.shtml (last visited Aug. 29, 2016) [hereinafter SEC].
5. 15 U.S.C. § 77e
6. SEC, *supra* note 4.
7. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 2016.
8. *See, e.g.*, Crowdfunding: Supplementary Information, 80 Fed. Reg. 71387, 71388 n.2 (Nov. 16, 2015) [hereinafter Supplementary Information] (citing statements by various U.S. Senators in support of allowing small investments in crowdfunded securities by "ordinary" and "average" investors, not just high net worth individuals).

requirements.[9] On October 23, 2013, the SEC proposed rules to implement the new exemption.[10] Nearly 500 professional and trade associations, investor organizations, law firms, investment companies and advisors, broker-dealers, potential funding portals, members of Congress, state securities regulators, government agencies, and other groups and individuals submitted comment letters on the proposed rules.[11] After consideration of these responses, the SEC adopted final crowdfunding rules on October 30, 2015.[12]

C. *Regulation Crowdfunding*

The final regulations, known as "Regulation Crowdfunding," which were scheduled to take effect 180 days after their publication in the Federal Register,[13] became effective on May 16, 2016. Regulation Crowdfunding covers five broad topics related to the crowdfunding exemption: (1) the requirements of the exemption itself, (2) the requirements governing issuers of securities in a crowdfunded placement, (3) the requirements of intermediaries to crowdfunded offerings, (4) additional funding portal requirements, and (5) other miscellaneous provisions.[14] The focus of this article will be on the actual requirements of the exemption itself.

II. Regulation Crowdfunding

A. *Amounts That Can Be Raised and Limits on Amounts That Investors Can Invest*

Subject to certain thresholds, Regulation Crowdfunding lets anyone, regardless of income or net worth, invest in securities-based crowdfunding transactions. This is important because, unlike some other exemptions under the Securities Act, an issuer is not limited to offering securities only to accredited investors. An issuer of securities is permitted to raise a maximum of $1 million in the aggregate through crowdfunded offerings in a twelve-month period.[15] Depending on their income and net worth, individuals can invest in crowdfunded offerings over the course of a twelve-month period as follows:

1) if an individual's annual income or net worth is less than $100,000, the greater of $2,000 or 5 percent of the lesser of his or her annual income or net worth;

9. Sec. & Exch. Comm'n, *Jumpstart Our Business Startups (JOBS) Act*, https://www.sec.gov/spotlight/jobs-act.shtml (last visited Aug. 29, 2016).
10. Sec. & Exch. Comm'n, Crowdfunding: Proposed Rules, 78 Fed. Reg. 66427 (Nov. 5, 2013).
11. Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71389.
12. SEC Press Release, *supra* note 1.
13. *Id.*
14. *See* Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71388 (table of contents).
15. 17 C.F.R. § 227.100(a)(1).

2) if both an individual's annual income and net worth are equal to or greater than $100,000, 10 percent of the lesser of his or her annual income or net worth.[16]

In addition, during the twelve-month period, the aggregate amount of securities sold to a single investor through all crowdfunded offerings cannot exceed $100,000.[17] An investor's net worth and annual income are determined in the same manner as determining an individual's status as an accredited investor under federal securities laws.[18] In general, holders of securities purchased through a crowdfunded offering cannot be resold for a period of one year.[19]

As an example of these limitations, an investor with an annual income of $50,000 a year and $105,000 in net worth would be limited to investing $2,500 in a twelve-month period. By contrast, an investor with an annual income of $1.2 million and net worth of $2 million would be limited to investing $100,000.[20] The obligation to determine whether an individual meets the annual income and net worth requirements generally falls on the intermediary that the issuer uses to oversee the offering.[21]

B. *Offering Must Be Through a Broker-Dealer or Funding Portal*

Title III of the JOBS Act seeks to provide some protection to investors in crowdfunded securities by requiring that crowdfunded offerings take place through either a broker-dealer or a "funding portal."[22] A funding portal is a new type of SEC registrant that was created to serve as a crowdfunding intermediary. Funding portals are prohibited in engaging in certain activities, such as offering investment advice or making recommendations; soliciting purchases, sales, or offers to buy securities; compensating promoters; or holding investor funds or securities.[23] To find a funding portal, an entity that wishes to issue securities through a crowdfunded offering can visit the website of the Financial Industry Regulatory Authority (FINRA), which maintains a list of funding portals that have registered with FINRA.[24]

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16. 17 C.F.R. § 227.100(a)(2).
17. 15 U.S.C. § 77d(a)(6)(B)(ii).
18. 17 C.F.R. § 227.100(a)(2), Instr. 1. For an individual to be considered an "accredited investor," his or her individual net worth (or joint net worth with that person's spouse), excluding the value of his or her primary residence, must exceed $1 million. Alternatively, an "accredited investor" includes any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. 17 C.F.R. § 230.501(a)(5) and (6).
19. 17 C.F.R. § 227.501(a).
20. Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71394.
21. 17 C.F.R. § 227.303(b)(1).
22. *See* Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71390 (providing that use of an SEC-registered intermediary is one of the "key investor protections" of the JOBS Act).
23. *Id.*
24. Fin. Indust. Regulatory Auth., Funding Portals We Regulate, https://www.finra.org/about/funding-portals-we-regulate (last visited Sept. 19, 2016). According to this list, as of September 14, 2016, fifteen funding portals have registered with FINRA.

C. *Bad Actor Disqualification*

Regulation Crowdfunding includes a "bad actor" provision that disqualifies offerings if the issuer or the issuer's "covered persons" have experienced a disqualifying event, such as being convicted of, or subject to court or administrative sanctions for, securities fraud or violations of other specified laws.[25] For these purposes, a "covered person" includes the issuer itself and certain predecessors and affiliates; directors, officers, general partners, or managing members of the issuer; beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; promoters associated with the issuer; and persons compensated for soliciting investors, including the general partners, directors, officers, or managing members of any such solicitor. In particular, the issuer would be disqualified from selling securities under a crowdfunded offering if a covered person has been convicted of or found guilty of having violated several categories of crimes or regulatory orders, such as conviction of a felony or misdemeanor in connection with the issuance of securities; being subject to a final order of a state securities commission that found a violation of a state law that prohibits fraudulent, manipulative, or deceptive conduct; and SEC disciplinary actions. There is generally a five- or ten-year look-back period for these types of violations.[26] However, disqualification will not arise as a result of disqualifying events that occurred before May 16, 2016, the effective date of Regulation Crowdfunding. Matters that existed before the effective date that are within the relevant look-back period and that would otherwise be disqualifying, however, are required to be disclosed in the issuer's offering statement.[27]

D. *Disclosure Requirements*

Although Title III of the JOBS Act and Regulation Crowdfunding is meant to reduce the regulatory burden on issuers of securities through crowdfunded offerings, issuers must still comply with comprehensive disclosure obligations. These disclosures fall into five broad categories: director and officer information, principal shareholder information, the issuer's business plan and risk factors, a description of the offering, and financial disclosures. In addition, there are ongoing disclosure requirements.

25. 17 C.F.R. § 227.503.

26. *See* 17 C.F.R. § 227.503 (The disqualifying events include, but are not limited to, felony and misdemeanor convictions within the last five years in the case of issuers, their predecessors and affiliated issuers; and ten years in the case of other covered persons in connection with the purchase or sale of a security involving the making of a false filing with the SEC.)

27. Sec. & Exch. Comm'n, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#7 (last visited Aug. 29, 2016).

1. Form C

An issuer wishing to rely on the crowdfunding exemption afforded by Section 4(a)(6) must file with the SEC certain disclosures and provide these disclosures to prospective investors. The document that an issuer files with the SEC is known as Form C and consists of thirty-one questions covering a variety of topics.[28]

The issuer must first disclose background information on each of the issuer's directors and its officers. The issuer must also disclose background information on each person who is the beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.

Following these disclosures, the issuer must describe its business plan and then set forth a standard set of risk factors informing potential investors that they can lose their entire investment, that the SEC has not passed on the merits of the securities being offered nor the information presented in Form C, and that the issuer is relying on an exemption from the Securities Act. There is also a section for the issuer to include its own set of risk factors that may be unique to the offering.

Next, the issuer must describe the offering itself, including the purpose of the offering, how the issuer intends to use the proceeds of the offering, the target offering amount and the deadline to meet it, and how the issuer plans to complete the transaction and deliver the securities to its investors. This section of Form C also describes an investor's forty-eight hour right to cancel, pursuant to which investors may cancel an investment commitment up to forty-eight hours prior to the deadline identified in the offering.

After this section, the issuer must make certain financial disclosures. The extent of the financial disclosures depend on the size of the offering. For issuers offering $100,000 or less, the issuer must disclose both its financial statements and the amount of total income, taxable income, and total tax as reflected in the issuer's federal income tax return.[29] These disclosures must be certified by the issuer's principal executive officer.[30] However, if the issuer has financial statements that have either been reviewed or audited by an independent public accountant, the issuer must disclose the reviewed or audited financial statements and is not required to disclose the tax return information described earlier or include the signed certification of the issuer's principal executive officer.[31]

If the issuer is offering more than $100,000, but not more than $500,000, the issuer must include financial statements that have been reviewed by an independent accountant. However, if the issuer has financial statements

28. 17 C.F.R. § 239.900.
29. 17 C.F.R. § 227.201(t)(1).
30. 17 C.F.R. § 227.201(t)(1).
31. 17 C.F.R. § 227.201(t)(1).

that have been audited by an independent accountant, it must disclose those audited financial statements instead.[32]

Finally, if the issuer is offering more than $500,000, and it is the issuer's first time selling securities in reliance on the crowdfunding exemption, the issuer may disclose financial statements that have been reviewed by an independent accountant. However, once again, if the issuer has audited financial statements, it must use those audited statements in lieu of the reviewed financial statements. If the issuer has previously sold securities in reliance on the crowdfunding exemption, it may only use audited financial statements in its disclosure.[33]

The instructions to Section 201(t) provide more details on the information that must be included in the required financial statements. In particular, the financial statements must cover the two most recently completed fiscal years or the period(s) since inception, if shorter.[34] For an offering conducted in the first 120 days of an issuer's fiscal year, the financial statements provided may be for the two fiscal years before the issuer's most recently completed fiscal year. However, if the issuer has prepared audited financial statements for the most recently completed fiscal year, it must include those, even if 120 days have not elapsed. If 120 days have elapsed since the end of the issuer's fiscal year, the audited financial statements must be for the issuer's two most recently concluded fiscal years.[35]

2. Ongoing Reporting Requirements

Regulation Crowdfunding requires that an issuer that has sold securities in reliance on the crowdfunding exemption must file an annual report with the SEC no later than 120 days after the close of the issuer's fiscal year.[36] In addition, the issuer must post a copy of the annual report on its website.[37] However, there is no requirement that issuers provide a physical copy to investors because the SEC felt that for an Internet-based offering under Regulation Crowdfunding, most investors should be familiar with obtaining information from the Internet.[38] Interestingly, issuers are not required to file any intermediate reports, for instance, to disclose material changes.[39]

With respect to annual financial disclosures, the issuer must provide updated financial statements. However, there is no requirement that the financial statements be audited or reviewed. Instead, it is sufficient if the issuer's

32. 17 C.F.R. § 227.201(t)(2).
33. 17 C.F.R. § 227.201(t)(3).
34. 17 C.F.R. § 227.201(t), instr. 3.
35. 17 C.F.R. § 227.201(t), instr. 4.
36. 17 C.F.R. § 227.202(a).
37. 17 C.F.R. § 227.202(a).
38. Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71420.
39. *See id.* (contending that requiring issuers to submit filings more frequently than annually "would require an allocation of resources to the reporting function of Regulation Crowdfunding issuers that we do not believe is justified in light of the smaller amounts that will be raised pursuant to the exemption").

principal executive officer signs a statement certifying that the financial statements are true and complete in all material respects. But, if the issuer has had prepared audited or reviewed financial statements, it must disclose those financial statements and cannot rely on the certification of the issuer's principal executive officer.[40]

The obligation to prepare and file annual reports continues until the earliest to occur of the following: (1) the issuer is required to file reports under Sections 13(a)[41] or 15(d)[42] of the Securities Exchange Act of 1934, (2) the issuer has filed at least one annual report and has fewer than 300 holders of record, (3) the issuer has filed at least three annual reports and has total assets that do not exceed $10 million, (4) the issuer or another party purchases or repurchases all of the securities that were issued in reliance on the crowdfunding exemption, or (5) the issuer liquidates or dissolves in accordance with applicable state law.[43]

III. Franchisee and Franchisor Use of Crowdfunding

A. *Franchisees*

In the context of the franchise model, a crowdfunded securities offering could work well for franchisees with careful planning. This section explores some ideas for structuring a crowdfunded offering from a franchisee's perspective.

1. Possible Scenarios for Franchisee Use

The scenarios in which a franchisee could use a crowdfunded offering as a means of raising capital are limitless, but in general would most likely fall within one of several categories. The first category would be for the purchase of a unit franchise, particularly for a franchise that requires a large initial capital outlay, such as a large gym facility or a large restaurant concept with substantial build out costs. Another obvious category would be as a means to avoid taking on debt to finance the purchase of a franchise. A third category would be as a method to expand from one franchise to multiple franchises.

Indeed, for a few reasons, this third category seems to be the most logical place for a franchisee to employ a crowdfunded offering. First, if a franchisee has already operated a single unit successfully and now wants to expand, investors may be more willing to purchase securities from the franchisee that has previously demonstrated its success. Recall that franchisees must make certain financial disclosures with respect to their offering[44] so prospective in-

40. 17 C.F.R. § 227.202(a).
41. *See* Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m(a) (describing periodic reports that must be filed by issuers of securities).
42. Securities Exchange Act of 1934 § 78o(d) (describing periodic and supplementary information that must be filed by brokers and dealers).
43. 17 C.F.R. § 227.202(b).
44. *See* Part II.D.1.

vestors will be able to examine those financial statements to help them determine a franchisee's prior level of financial success.[45]

2. Downsides to Offering Securities

Although there are definite positive aspects to seeking funding via a crowdfunded offering, there are also potential downsides. The most obvious is the cost and expense of compliance with the Securities Act and the crowdfunding exemption. Although the purpose of Regulation Crowdfunding is to reduce the regulatory burden,[46] the issuer must still comply with some regulations. And compliance with these regulations would, in all likelihood, entail hiring legal counsel to assist in completing the offering disclosure statement.[47] At a minimum, the issuer must engage a funding portal or broker-dealer and in many cases engage an independent accountant to prepare either reviewed or audited financial statements.

Another potential downside to issuing crowdfunded securities is the prospect of hundreds of small investors. This is likely to cause operating burdens with respect to holding shareholder meetings, obtaining quorum for shareholder votes, and incurring expenses involved with keeping shareholders apprised of corporate matters.

The burden of complying with the financial disclosure requirements of Regulation Crowdfunding is another potential downside to seeking capital through a crowdfunded securities offering. As described earlier, any offering above $100,000 requires, at a minimum, reviewed financial statements, and in some cases, fully audited financial statements—an expense that is not typically incurred by a standard franchisee.

As with all public offerings of securities, the would-be issuer needs to consider the possibility of liability for material misstatements and omissions in its offering documents. Section 11 of the Securities Act provides that if a registration statement contains an untrue statement of material fact or if a material fact is omitted, an aggrieved investor can recover the difference between the purchase price and the price at which it is able to dispose of the security.[48] The investor is entitled to sue any of a number of individuals involved with the registration statement, including every person who has signed the registration statement; the issuer's principal officers; each member of the issuer's board of directors; every person who has consented to being named in the registration statement as a prospective director of the issuer; professionals, such as accountants, engineers, and appraisers, who have consented to being named as having prepared or certified a portion

45. However, see Part IV, which discusses whether disclosing financial statements to prospective investors may violate a franchisee's confidentiality obligations.

46. Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71488 n.2.

47. The Office of Management and Budget estimates that the "average burden hours per response" in completing Form C is nearly forty-nine hours. 17 C.F.R. § 239.900.

48. 15 U.S.C. § 77k(e).

of the registration statement; and every underwriter.[49] The liability of these individuals is joint and several.[50] These potential extra costs arising from a securities violation are particularly risky for franchisees, which not only have standard overhead costs, but which also have to pay ongoing fees to a franchisor that may be unlikely to grant any forbearance arising from a default resulting from cash flow problems that may arise during such a securities dispute. By contrast, a franchisor would need to consider such cash flow problems arising from a securities dispute as potentially triggering a violation of a loan covenant if it relies on lender funding for its operations.

3. Tips for Issuers

If, despite the risks and possible downsides, a franchisee still wishes to offer securities through a crowdfunded offering, the issuer should bear in mind a few tips. First, Regulation Crowdfunding specifically allows oversubscriptions as long as the issuer does not exceed the $1 million annual limit.[51] There is no maximum oversubscription amount. Allowing for an oversubscription is a good practice because of the ability of investors to rescind their investment within forty-eight hours prior to the deadline identified in the offering.[52] If the issuer allows for an oversubscription, it will need to describe how oversubscribed securities will be allocated.[53]

Issuers also need to be aware of the restriction on their ability to advertise the terms of the offering. In particular, an issuer can issue an advertising notice as long as it directs prospective investors to the intermediary's platform and includes no more information than: (1) a statement that the offering is being conducted under the crowdfunding exemption of Section 4(a)(6) and the identity of the intermediary through which the offering is being conducted; (2) the terms of the offering; and (3) factual information about the issuer, which is limited to the issuer's name, address, phone number, and website, an email address for a representative of the issuer, and a brief description of the issuer's business.[54] The SEC has clarified that brief, informal social media communications about the offering would theoretically be allowed.[55] As an example, the SEC cites a social media post by an issuer that notes that the issuer is conducting an offering and that directs prospective investors to the issuer's registration materials on the intermediary's website as likely to be acceptable.[56] Advertising notices do not need to be filed with the SEC.[57]

49. 15 U.S.C. § 77k(a).
50. 15 U.S.C. § 77k(f).
51. 17 C.F.R. § 227.201(h).
52. *See* Part II.D.1.
53. 17 C.F.R. § 227.201(h).
54. 17 C.F.R. § 227.204(b).
55. Supplementary Information, 80 Fed. Reg., *supra* note 8, at 71425.
56. *Id.*
57. *Id.*

The final tip to keep in mind in seeking to raise capital from a crowdfunded securities offering is the restrictions on promoter compensation.[58] Regulation Crowdfunding permits compensation to, or a commitment to compensate, directly or indirectly, any person to promote the issuer's offering through communication channels provided by the intermediary as long as the issuer, or the person acting on the issuer's behalf, takes reasonable steps to ensure that the person promoting the offering discloses the receipt, or anticipated receipt, of any compensation in connection with the communication.[59] Other than compensation described in the previous sentence, no issuer may compensate any person to promote the issuer's offering unless the promotion is limited to advertising notices permitted by Rule 204 of Regulation Crowdfunding.[60]

B. *Franchisors*

Subject to the same drawbacks as a franchisee-initiated crowdfunded offering, a securities offering by a franchisor could make sense in the right circumstances. However, it may not work as well as it would for franchisees. In particular, as described earlier, an issuer of securities is permitted to raise a maximum of $1 million in the aggregate through crowdfunded offerings in a twelve-month period.[61] Depending on the size of the franchise system, this $1 million limitation may be an insufficient amount of capital to make a crowdfunded offering worthwhile.

On the positive side, because a franchisor must already prepare audited financial statements in connection with its FDD, there would be little extra cost involved in using the audited financial statements in a registration statement. In addition, much of the information required in Form C for a crowdfunded offering overlaps with information that must be disclosed in a franchisor's FDD. As such, the burden of assembling this information may be less onerous than for a franchisee that wishes to offer securities via a crowdfunded offering.

However, franchisors should bear in mind that there is not perfect overlap between the information required by the FDD and Form C and that Form C in some cases requires more information be disclosed than the FDD. As an example, Form C requires the disclosure of all principal shareholders (defined as each person who is the beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities).[62] Form C also requires disclosure of the material terms of all indebtedness, including the identity of the creditor, outstanding amount, interest rate, maturity date, and other material terms.[63] Some franchisors may be unwilling to disclose this information. In

58. *See generally* 17 C.F.R. § 227.205 (describing restrictions on promoter compensation).
59. 17 C.F.R. § 227.205(a).
60. 17 C.F.R. § 227.205(b).
61. 17 C.F.R. § 227.100(a)(1).
62. 17 C.F.R. § 239.900, at question 6.
63. 17 C.F.R. § 239.900, at question 24.

addition, some franchisees may argue that this is material information that should have been disclosed in the franchisor's FDD.[64]

In structuring a franchise offering, a franchisor would likely want to create a general holding company to issue the shares. The actual franchisor entity would be a subsidiary of the holding company. Other subsidiaries of the holding company could include entities in charge of overseeing operations and employee matters, operating company-owned units, holding intellectual property assets, and overseeing global operations.

IV. Franchisor Considerations in Consenting to Franchisee Crowdfunded Offerings

Assuming a franchisee wishes to raise capital through a crowdfunded securities offering, at a threshold level, it will almost certainly need to obtain the consent of its franchisor pursuant to the "restriction on transfer" provisions of the franchisee's franchise agreement. In contemplating whether to grant its consent, a franchisor needs to consider several factors.

The first factor that a franchisor will want to consider is any potential liabilities that it could be responsible for in connection with a franchisee's issuance of securities. The biggest concern in this area surrounds potential secondary liability for a franchisee's violation of securities law. As discussed earlier, the universe of potential defendants in a Section 11 claim involves all individuals involved with the registration statement, including every person who has signed the registration statement; the issuer's principal officers; each member of the issuer's board of directors; every person who has consented to being named in the registration statement as a prospective director of the issuer; every professional, such as accountants, engineers, and appraisers, who has consented to being named as having prepared or certified a portion of the registration statement; and every underwriter.[65] For this reason, the franchisor needs to take a careful approach that it does not participate in the franchisee's preparation of its registration statement. In addition, the standard warnings against exercising too much control over a franchisee's operations would apply to avoid the possibility of liability under a vicarious liability basis. In fact, an especially cautious franchisor may not want to risk reviewing the registration statement at all even though there may be good reasons to do so, as described below.

Another factor that a franchisor may wish to consider is whether it is worth the risk to the franchise system to allow franchisees to raise capital via a crowdfunded securities offering when there is a risk of purchasers of such securities losing their entire investment if the franchise does not succeed. In other words, will the negative publicity generated by individuals

64. Franchisors should, of course, bear in mind the general restriction on including information in their disclosure documents that is not required or permitted. 16 C.F.R. § 436.6(d).
65. 15 U.S.C. § 77k(a).

who have lost their investment in the franchisee's securities be worth the risk to the franchise system overall? Instead of having just a few principal shareholders who have taken part in an unsuccessful franchise, there is now the prospect of several hundred or even more investors who have lost their investment by investing in a franchisee that has not succeeded. These investors would not be the best ambassadors for the franchise system and are likely to air their grievances about an investment loss online. One possible solution to this risk is by limiting a franchisor's consent to a crowdfunded offering only to franchisees that have previously shown their success in operating within the franchise system. Nonetheless, the risk to the brand is significant. A franchisor could also face lawsuits from hundreds of owners or investors who are upset with the franchisors' conduct or believe the system was oversold and they were fraudulently induced to invest. For example, the investors may rely on statements made on the franchisor's website, and while the franchisee's principal owner may have disclaimed reliance on representations outside of the FDD, can that disclaimer be imputed to all crowdfund investors?

Finally, as a third factor, and as discussed in more detail below, the franchisor should consider the risks involved with the franchisee's disclosure obligations in connection with registering the crowdfunded offering. Such risks include disclosing confidential information to franchisee shareholders who may not be bound by confidentiality obligations or disclosing information to shareholders who own competitive businesses.

Assuming the franchisor is comfortable with the risk of assuming secondary liability for a franchisee's violation of securities law and consents to the franchisee issuing securities, it will need to consider a variety of factors.

Among these factors are which shareholders will be required to sign personal guarantees. Most franchise agreements provide that the owners of a franchisee owning a certain threshold percentage interest in the franchisee, or sometimes even all owners, must sign a personal guarantee agreeing to be bound to the franchisee's monetary and other obligations under the franchise agreement. Accordingly, the franchisor will need to decide whether it will waive this requirement for any shareholders who purchase securities in a franchisee.

As a related factor, the franchisor will need to consider to what extent it will allow dilution of the franchisee's principal shareholders. In other words, the franchisor may be willing to consent to its franchisee issuing securities as long as the principal shareholders, with whom the franchisor wishes to deal, remain majority owners following the issuance of securities in the franchisee. Therefore, a franchisor may wish to consider conditioning its consent to a franchisee issuance of securities on a maximum level of shareholder dilution.

Another factor to consider is the scope of the financial disclosures that a franchisee must make in its registration statement. As explained earlier, any offering above $100,000 requires, at a minimum, reviewed financial statements and fully audited financial statements in some cases. Is the franchisor going to be willing to allow its franchisees to make these financial disclosures public in a registration statement? Will these financial disclosures provide

the public insights into unit-level franchise performance? What about the possible disclosure of trade secrets in the form of pricing strategies? Franchisees should consider whether disclosing this information to prospective investors violates their confidentiality obligations to their franchisors since many franchise agreements provide that financial results from the operation of the franchise cannot be disclosed to third parties.

With respect to non-financial disclosures, the franchisor will want to ensure that the franchisee will not be disclosing any confidential information or trade secrets. For instance, will competitors be able to obtain the franchisor's confidential information and trade secrets by purchasing shares of a franchisee who is obligated to disclose certain information to all shareholders? For this reason, it would be good practice to require the franchisee to provide a draft of its registration statement to the franchisor before making the document public to allow the franchisor the ability to review the information being disclosed. However, the franchisor should exercise caution only to review the proposed registration statement, and not recommend revisions or other changes, so as not inadvertently to fall into the category of a person who helped prepare the registration statement and thereby opening itself up to possible Section 11 liability for misstatements or omissions in the registration statement.[66]

From the perspective of the franchisor's disclosure obligations, if the franchisor decides to allow franchisees to offer securities as a routine part of raising capital, the franchisor should consider whether it may need to revise any portions of its FDD. For instance, the cost of compliance issues may be a cost that should be included with the initial investment figures contained within Item 7.[67] If the franchisor charges a fee to review, or to have its counsel review, a franchisee's proposed registration statement, that fee may need to be disclosed in Item 6.[68]

V. Conclusion

Title III of the JOBS Act and Regulation Crowdfunding have opened up possibilities for businesses to sell securities to unaccredited investors through a less rigorous process than a full securities filing. It may be a good option for franchisees that wish to raise sufficient capital to purchase and develop a franchise without resorting to taking out loans or for franchisees that wish to expand the number of units it owns. For franchisors, the benefits are less clear-cut, particularly in light of the maximum offering amount of $1 million in each twelve-month period. However, notwithstanding these issues, crowdfunding may play a role in the franchise industry, and an understanding of its rules and contours is important for practitioners in franchise law.

66. *See* Part IV.
67. Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5(g).
68. 16 C.F.R. § 436.5(f).