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This essay emerges from a joint symposium of the *Hastings Business Law Journal* and the *Hastings Science and Technology Law Journal* entitled "Regulating the Disruption Economy: Tech Startups as Regulatory Reformers." The symposium featured panels on virtual currency, crowdfunding, and the sharing economy.

Drawing from the symposium, this essay considers why startups are increasingly taking up the mantle of regulatory reform, how they are achieving their successes, and whether this is a positive development for our political economy. It tentatively proposes that: (1) features of the current venture-capitalist market and startup ecosystem, rather than the pace of technological advancement, might explain the timing, (2) a "bootleggers and Baptists" dynamic of popular messaging and well-resourced interest groups explains the successes, and (3) we should be cautiously optimistic about this "institutionalized disruption" of incumbents.

Beyond all the hype surrounding crowdfunding there is a curious incongruity. On the one hand, there exist apparently successful crowdfunding sites; on the other hand, more than three years after the Jumpstart Our Business Act ("JOBS Act") mandated an equity crowdfunding exception, we are still waiting for final regulations from the Securities and Exchange Commission.

This essay explores this irony, arguing that existing crowdfunding sites carefully manage around a fundamental ambiguity in the securities laws—a surprisingly fuzzy definition of what a "security" is. It then shifts to understanding the existing regulatory framework: the federal crowdfunding statute and proposed rules, as well as other existing alternatives issuers might consider. Second, this essay surveys other potential alternatives to place crowdsourced securities and even new state crowdfunding exemptions—but ultimately argues that none are attractive. As such, it is far more likely that crowdfunding sites will continue to operate as they currently do, rather than subject themselves to any new crowdfunding rules or seek alternative exemptions. Finally, it argues that, for all of its advantages, crowdfunding presents fundamental negatives that cannot be regulated away. As such, we must face a stark choice: either prophylactically ban the activity, or allow it with few restrictions. To think that we can craft a balanced regulatory framework for crowdfunding is delusional.

STUDENT NOTE

Within the last decade, Silicon Valley technology companies have increasingly engaged in a practice of providing nontraditional perks to employees, in what has been characterized as an "arms race" to attract engineering talent. As this practice expands throughout Silicon Valley, so do the costs associated with providing these perks. While companies view the practice as a tool to recruit talent, boost productivity, and increase efficiency, the IRS's renewed interest in scrutinizing the tax laws casts doubt on whether these stated objectives would remain robust in the future.

This Note focuses on the practice of providing employee perks from a shareholder governance perspective. In particular, this Note identifies the challenges shareholders face in properly assessing how the costs associated with in-kind perks affect share value under the current corporate legal framework. This Note then proposes an interim solution for shareholders to address concerns about employer-provided perks. Ultimately, this Note aims to foster a conversation between shareholders and management in order to provide these key stakeholders with the appropriate knowledge to effectively confront the long-term consequences of this practice.

Institutionalized Disruption: The Rise of the Reformer Startup

Abraham J.B. Cable∗

The following essay emerges from a joint symposium of the Hastings Business Law Journal *and the* Hastings Science and Technology Law Journal *entitled "Regulating the Disruption Economy: Tech Startups as Regulatory Reformers." The symposium was held on March 20, 2015, and featured panels on virtual currency, crowdfunding, and the sharing economy.*

Drawing from the symposium, this essay considers why startups are increasingly taking up the mantle of regulatory reform, how they are achieving their successes, and whether the reformer startup is a positive development for our political economy. It tentatively proposes that: (1) features of the current venture-capital market and startup ecosystem, rather than the pace of technological advancement, might explain the timing, (2) a "bootleggers and Baptists" dynamic of well-resourced interest groups and popular messaging explains the successes, and (3) we should be cautiously optimistic about this "institutionalized disruption" of incumbents.

I. INTRODUCTION

There is nothing new about startups operating in regulated fields. For instance, a significant percentage of venture-capital dollars have always been invested in biotech, where FDA approval looms large.[1] There is also nothing new about innovative technologies requiring new regulatory frameworks. Widespread use of social media, for

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1. NAT'L VENTURE CAPITAL ASS'N, 2015 NAT'L VENTURE CAPITAL ASS'N Y.B. (18 ed. 2015) [hereinafter NVCA YEARBOOK].

example, eventually necessitated enhanced protection of privacy and data security.[2] The recent symposium, however, reveals a different trend: startups premised on regulatory reform or acquiescence because they operate in the face or shadow of prohibitive regulatory regimes ("reformer startups").[3] Examples include sharing-economy companies (taxi and hotel licensing),[4] crowdfunding platforms (private-offering regulation),[5] and Bitcoin startups (financial regulation).[6] In each case, startups obtained significant funding or built large customer bases without resolution of regulatory uncertainty.[7]

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2. For an overview of the burgeoning field of privacy regulation, *see* DAVID J. SOLOVE & PAUL M. SCHWARTZ, PRIVACY LAW FUNDAMENTALS (3d ed. 2015).

3. It is, of course, difficult to ascertain how apparent the need for regulatory reform was at the time of founding. One view is that the regulatory uncertainties revealed themselves only after the companies attracted attention. *See* Jeffrey Rabkin, Special Assistant Attorney General, Office of the Attorney General, Dep't of Justice, Keynote Address at Hastings Business Law Journal and Hastings Science and Technology Law Journal Symposium: Regulating the Disruption Economy (Mar. 20, 2015) (suggesting that regulatory issues are often the result of honest mistakes by entrepreneurs). Another view is that entrepreneurs have a more intentional mindset of asking for forgiveness rather than permission. *See* Lucas E. Buckley, Jesse K. Fishman & Matthew K. Kauffman, *The Intersection of Innovation and the Law*, WYO. LAW., Aug. 2015, at 38 (noting that "[m]any innovative companies are using technology to invade highly-regulated industries"); *see also Shredding the Rules*, ECONOMIST (May 2, 2015), http://www.economist.com/news/business/21650142-striking-number-innovative-companies-have-business-models-flout-law-shredding [hereinafter *Shredding the Rules*] ("A striking number of innovative companies have business models that flout the law."); Rabkin, *supra* note 3 (suggesting that entrepreneurs are not the type to "read the back of the Scrabble box"). In any event, one can assume that these companies, often represented by elite national law firms and vetted thoroughly by venture-capital investors, began thinking about their regulatory status sooner rather than later.

4. *See* Sara Thornton, *The Transportation Monopoly Game: Why Taxicabs Are Losing and Why Texas Should Let Transportation Network Company Tokens Play*, 47 TEX. TECH. L. REV. 893, 901–04 (2015) (describing the origins of taxi regulations and their effects on ride-sharing companies); *see also* Roberta A. Kaplan & Michael L. Nadler, *Airbnb: A Case Study in Occupancy Regulation and Taxation,* 82 U. CHI. L. REV. DIALOGUE 103, 108–09 (2015) (discussing regulation of hotels in New York and potential effects on Airbnb's business operations).

5. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 49–80 (2012) (discussing the status of crowdfunding under the federal securities laws).

6. *See* Kevin V. Tu & Michael W. Meredith, *Rethinking Virtual Currency Regulation in the Bitcoin Age*, 90 WASH. L. REV. 271, 300–13 (2015) (discussing the possible application of state and federal money-transmitting laws and other regulations to virtual currency).

7. For a description of Bitcoin's successes, *see* Tu & Meredith, *supra* note 6, at 285 (noting that over three hundred thousand dollars in Bitcoin transactions are processed per day). *See also* Yuliya Chernova, *Big Day for Bitcoin Startups: Three Startups Haul in $23.5M in Funding*, WALL ST. J. (Mar. 26, 2014, 5:10 PM), http://blogs.wsj.com/venturecapital/2014/03/26/big-day-

Viewed this way, it is the regulatory successes rather than failures of these companies that most warrants our attention. While reformer startups hit some bumps in the road,[8] they mostly maneuvered their way to regulatory truces that opened enough room for growth. For example, financial regulators have signaled a hands-off approach to many aspects of Bitcoin.[9] Uber and Lyft operate under modified regulatory frameworks tailored to "transportation network companies."[10] San Francisco just enacted the nation's first

for-bitcoin-startups-three-startups-haul-in-23-5m-in-funding/. For a discussion of Airbnb's successes, *see* Kaplan & Nadler, *supra* note 4, at 104 ("Over the course of its brief existence, Airbnb has experienced exponential growth. Today it hosts more than one million listings in over one hundred and ninety countries and territories around the world."). For a discussion of Uber and Lyft's growth, *see* Stephanie Francis Ward, *Internet Car Companies Offer Convenience, But Lawyers See Caution Signs*, A.B.A. J. (Jan. 1, 2014, 10:00 AM), http://www.abajournal.com/magazine/article/internet_car_companies_offer_convenience_but_lawyers_see_caution_signs (indicating that Uber raised two hundred fifty-eight million dollars in a one-year period, and that Lyft had raised eighty-two million dollars). Crowdfunding is surprisingly prevalent given the Securities and Exchange Commission's ("SEC") reluctance to implement definitive regulation as directed by Congress. *See* Scott Andersen, Sr., *Equity & Debt Crowdfunding—Where We Are Now and What's Next*, CROWDFUND BEAT, http://crowdfundbeat.com/2015/05/13/equity-debt-crowdfunding-platforms-where-we-are-now-and-whats-next/ (last visited Oct. 26, 2015) (suggesting that billions of dollars are being raised through internet solicitations under Rule 506(c) of Regulation D and SEC no-action letters granted to funding platforms FundersClub and AngelList); *see also* Alex Feldman, *230 VCs, and Angels Invest in Crowdfunding Platforms,* CROWDSUNITE (Dec. 6, 2013), http://crowdsunite.com/blog/230-vcs-and-angels-invest-in-crowdfunding-platforms/ (reporting that angel and venture-capital investors have invested eight hundred million dollars in crowdfunding platforms).

8. *E.g.*, Boris Bindman, *Keep on Truckin', Uber: Using the Dormant Commerce Clause to Challenge Regulatory Roadblocks to TNCs*, 72 WASH. & LEE L. REV. ONLINE 136, 142 (2015) (discussing regulatory actions against ridesharing companies and their drivers).

9. Specifically, federal regulators have indicated that Bitcoin exchanges, but not Bitcoin miners or investors, may be money-transmitters subject to anti-money-laundering regulations. Several states have determined that Bitcoin firms are not money-transmitters under their regulatory schemes, and California and New York have enacted legislation to accommodate Bitcoin under existing regulatory regimes. *See* Tu & Meredith, *supra* note 6, at 304–13. Tu and Meredith summarize the U.S. regulatory climate for Bitcoin as follows: "As a whole . . . the regulatory response in the United States can be described as generally open to the continued growth and use of virtual currency as a viable payment alternative so long as appropriate regulations can be implemented to address issues associated with increasingly mainstream virtual currency usages and business models."

10. In California and several other jurisdictions, ride-sharing companies operate under a "transportation network company" license that is less demanding than traditional taxi licensing. *See* Ward, *supra* note 7 (noting adverse actions of regulators against ride-sharing companies, but also noting that "other municipalities are carefully backing the idea" of ride-sharing); Bindman, *supra* note 8, at 144 ("[Transportation network companies] are blowing through all of the yellow and red lights that have presented roadblocks to their operations. After evading

"Airbnb law" to accommodate the company's popularity.[11] Congress blessed crowdfunding and directed the Securities and Exchange Commission ("SEC") to follow suit.[12]

This essay examines the rise of the reformer startup by posing three questions: why now, why have these reform efforts succeeded, and is the reformer startup a positive development for our political economy? In addressing those questions, I sketch out the following possible answers: (1) a frothy venture capital ("VC") market and startup ecosystem explains the timing, (2) a combination of well-resourced startups and popular affection for Silicon Valley startups explains the success, and (3) a cautious optimism is warranted because reform-minded startups may be a helpful counterpart to the market and political power of incumbents.

II. WHY NOW? UNICORNS AND MEGAFUNDS

If reformer startups are a recent phenomenon, why are we seeing them now?

One possible answer is that the pace of technological innovation is quickening, creating a growing need for reform.[13] The symposium was shot through with references to a "knowledge gap" between tech-savvy entrepreneurs and less sophisticated regulators.[14] In light of

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classification and regulation under existing regimes, Uber and Lyft have themselves sought to exploit the logic of regulatory capture."); *see* Thornton, *supra* note 4, at 911–28 (comparing traditional taxi regulations and regulation of transportation network companies by Texas municipalities).

11. *See* Dana Palumbo, Note, *A Tale of Two Cities: The Regulatory Battle to Incorporate Short-Term Residential Rentals Into Modern Law*, 4 AM. U. BUS. L. REV. 287, 309–18 (2015) (discussing San Francisco's new law).

12. Congress created an exemption specifically for crowdfunding under the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"). *See generally* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments That Begs for a Happy Ending*, 102 KY. L.J. 865 (2014). Although the SEC has failed to finalize implementing regulations for the crowdfunding exemption, crowdfunding platforms have begun operations, with some restrictions on their investor pools, under alternative provisions of the JOBS Act that loosen regulation of online solicitations more broadly. *See generally supra* note 7.

13. *See* Rabkin, *supra* note 3 (suggesting we are at the "dawn of a new age" and citing Moore's Law regarding computing power and Metcalf's Law regarding network effects).

14. *E.g.*, Candice Taylor, Assoc. Litigation Counsel, Lyft, Address at *Hastings Business Law Journal* and *Hastings Science and Technology Law Journal* Symposium: Regulating the Disruption Economy (Mar. 20, 2015).

such a gap, lobbying efforts can be seen as an educational exercise, and reformer startups are doing the tough sledding of getting regulation right in a fast-moving world.[15]

But one might question the underlying premise of this view—that we are in the midst of particularly transformative innovation. The products represented at the symposium are certainly popular,[16] and they might even represent an important change in social organization.[17] But change is always afoot, and it is not self-evident that the current period of innovation stands out.[18] There is even a view from prominent economists that today's technological advances are modest compared to previous periods, at least when measured by their effects on economic productivity.[19] At the very least, measuring the pace of innovation seems a vexing task, and it is worth exploring whether there is something else distinctive about today's startup ecosystem that could explain the rise of the reformer startup.

The most conspicuous feature of today's startups is their size. By one recent count, there were over one hundred startups valued at over one billion dollars—so-called "unicorn companies."[20] These companies are startups in only a loose sense. True, they have short operating histories and they have not had an initial public offering of

15. In this vein, several panel participants characterized interactions between entrepreneurs and regulators as efforts to "educate" or "help" the former. *E.g.*, Taylor, *supra* note 14 (discussing efforts to help regulators understand the ride-sharing business).

16. *See supra* note 7 (discussing the successes of sharing-economy, crowdfunding, and Bitcoin startups in attracting customers).

17. Katie Biber, Senior Counsel, Airbnb, Address at *Hastings Business Law Journal* and *Hastings Science and Technology Law Journal* Symposium: Regulating the Disruption Economy (Mar. 20, 2015) (describing AirBNB as having "real social power").

18. For example, one could make the argument that changes in transportation technologies and industrial organization in the nineteenth and early twentieth centuries were particularly profound. *E.g.* STEPHEN E. AMBROSE, UNDAUNTED COURAGE: MERIWETHER LEWIS, THOMAS JEFFERSON, AND THE OPENING OF THE AMERICAN WEST 53–54 (1996) (observing that, prior to railroads, there had been very little innovation in transportation since ancient times).

19. *See Growth: The Great Innovation Debate*, ECONOMIST (Jan. 12, 2013), www.economist.com/news/leaders/21569393-fears-innovation-slowing-are-exaggerated-governments-need-help-it-along-great (discussing the work of Robert Gordon). Robert Gordon has colorfully suggested a "toilet test" for measuring the impact of innovation. His point is that few innovations measure up.

20. Rolf Winkler & Telis Demos, *Tech Firms Are Notably Scarce in IPO Market*, WALL ST. J. (Sept. 10, 2005, 10:14 PM), http://www.wsj.com/articles/ipo-parade-continues-without-many-tech-companies-1441929152 (estimating the number of startups with valuations in excess of one billion dollars).

stock ("IPO"). But they may have thousands of employees and may have obtained hundreds of millions (in some cases billions) in venture-capital and other forms of financing.[21] These well-heeled startups have capacity to engage with regulators in ways that the archetypical startup—making do on a shoestring budget—might lack.[22]

Another distinctive feature of the startup landscape is the size of today's venture-capital ("VC") market. According to the industry's leading trade association, "[b]y any measure, 2014 was a remarkable year for the venture capital market in the United States."[23] The total amount invested by VC funds in startups is the highest since the dot-com era.[24] In addition, the amount that endowments, pension funds, and other institutional investors invest with VC managers has been on the upswing.[25] In particular, top-tier VC managers are having unusual success in raising capital.[26]

It is plausible that a VC manager will put money to work more creatively in this market. Historically, VC managers might have shied away from an investment premised on regulatory reform in order to focus on the types of technological and operational challenges that

21. Winkler & Demos, *supra* note 20. (noting that Uber has raised over five billion dollars in financing and is valued at over fifty billion dollars).

22. The mere fact that Symposium panelists featured titles like "Manager of Government Relations" suggests the garage is far in the rearview mirror for these startups. *See* Mike Isaac, *Uber Picks David Plouffe to Wage Regulatory Fight*, N.Y. TIMES (Aug. 19, 2014), http://www.nytimes.com/2014/08/20/technology/uber-picks-a-political-insider-to-wage-its-regulatory-battles.html?_r=0 (reporting that Uber hired David Plouffe, former campaign manager for President Obama); *see also* Mike Isaac, *Airbnb Hires Chris Lehane, Former Aide to Bill Clinton, as Head of Policy*, N.Y. TIMES: BITS BLOG (Aug. 27, 2015, 9:00 AM), http://bits.blogs.nytimes.com/2015/08/27/airbnb-appoints-chris-lehane-former-adviser-to-bill-clinton-as-head-of-policy/ (reporting that Airbnb hired a former adviser to Bill Clinton).

23. NVCA YEARBOOK, *supra* note 1, at 9.

24. *Id.*

25. *Id.*

26. According to National Venture Capital Fund statistics, thirty-one venture-capital managers manage over one billion dollars. *Id.* at 17–19. Average fund size is greater than the industry's heyday in the early 2000s. *Id.* at 9. Though average fund size has actually come down in recent years, see *id.* at 20, that may be because the industry is bifurcating into very large funds and smaller seed funds. *Id.* at 17 (noting that "the bulk of the capital (measured by dollars) being committed today is being raised by larger, specialty, and boutique firms."). In short, top-tier venture capital firms are capturing an increasing percentage of available capital. *See* Mark Suster, *The Changing Structure of the VC Industry*, FORTUNE (July 22, 2014, 9:15 AM), http://fortune.com/ 2014/07/22/the-changing-structure-of-the-vc-industry.

are better suited for the typical VC manger's skill set.[27] But in a headier environment, where venture capitalists face tough competition for the most attractive traditional deals, funds might be more willing to leave their comfort zone.[28]

If a distinctive startup ecosystem—featuring atypically mature startups and a particularly flush VC industry—help explain the reformer startup, one might ask whether the trend is just a temporary disequilibrium. Perhaps macroeconomic developments and hard lessons will swing the pendulum, and the reformer startup will be no more than a historical footnote.

I suspect, however, that such a trend could have staying power. Even an investment model that is as path dependent as venture capital can sometimes find a new path.[29] If today's reformer startups succeed, it may clear the way for others to follow suit.

In the end, this explanation for the rise of the reformer startup is admittedly conjecture. But it is important to look hard for alternatives to claims of technological exceptionalism. As described in Part III below, we exhibit a collective enthusiasm for technological innovation. But if we reflexively believe there is a widening knowledge gap, we risk relying on the wrong policy prescriptions.

III. WHY SUCCESS? "BOOTLEGGERS AND BAPTISTS"

A separate question is how reformer startups are achieving their successes. As a preliminary matter, it is useful to consider why these successes might be surprising.

Companies featured at the symposium are all acting as a sort of intermediary, connecting drivers and passengers, property owners and travelers, payors and payees, and investors and issuers. In each

27. *See* Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RES. L. REV. (forthcoming 2015) (describing the skill set of the typical VC manager).

28. Christina Farr, *Venture Capitalists Face a More Competitive, Global Market*, VENTUREBEAT (Mar. 13, 2014, 12:15 PM), http://venturebeat.com/2014/03/13/venture-capitalists-face-a-more-competitive-global-market (suggesting that increased competition among VC managers means "[t]hey have become more global in their geographic outlook, more sophisticated in their analysis of opportunities and more innovative in terms of how, where and when to invest.").

29. *See* Suster, *supra* note 26 (suggesting that the bifurcation of the VC industry into large and small funds is an important "structural shift" in venture-capital investing).

case, incumbents provide similar intermediation (e.g., traditional banks or money transmitters offer services that compete with Bitcoin startups) or benefit from the absence of such intermediaries (e.g., traditional hotel groups benefit if property owners are not easily matched with travelers).

Public-interest theory predicts that these incumbents will fight hard to preserve the current regulatory environment as a barrier to entry.[30] In some cases, the incumbents are formidable. Financial-institution and hospitality-industry giants may have considerable resources to expend on preserving the status quo.[31] In other instances, the balance of power may be different. We can assume that Uber has a considerable war chest compared to local taxi owners.[32] But even in these instances, incumbents have a tremendous amount at stake and may have long patterns of interactions with regulators—"capture" in the language of public interest theory.[33] And regulatory flip-flops may have a high political cost to the regulator or lawmaker if the current regime plausibly produces public benefit. In the end, regulations tend to be "durable," even if not impenetrable, barriers to competition.[34]

How, then, are reformer startups making so much headway? Public-choice theory again offers some insight.

Public-choice theorists observe that the most ambitious efforts to influence law require a combination of economically minded interest groups and publicly minded rhetoric capable of achieving broader support. Bruce Yandle, for example, famously attributed Sunday

30. *See* MAXWELL L. STEARNS & TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW 67 (2009). One can adopt this view while being agnostic on the underlying merits of the regulatory regimes. Taxi and hotel licensing, securities regulation, and money-transmitting laws might have been enacted, and still operate, as public-regarding laws. Or they might be the result of self-interested rent seeking. For this essay's purposes, the point is that they become valuable to incumbents as they structure their businesses around the existing regime. *See id.* (discussing the concept of "rent extraction").

31. *See* Kaplan & Nadler, *supra* note 4, at 107 ("Airbnb hosts face strong headwinds from a well-funded coalition of landlords and hotel-industry leaders, which plans to spend millions of dollars on a public campaign criticizing Airbnb.").

32. *See* Rabkin, *supra* note 3 (answering questions regarding possible unfairness to taxi cab owners).

33. Dorit Rubinstein Reiss, *The Benefits of Capture*, 47 WAKE FOREST L. REV. 569, 578–83 (2012) (summarizing, and then critiquing, a conventional view of regulatory capture).

34. STEARNS & ZYWICKI, *supra* note 30, at 49 (describing rents from protectionist regulatory policies as being more "durable" than market-driven monopolistic pricing).

closing laws to a coalition of "bootleggers and Baptists."[35] Bootleggers had a strong economic interest in eliminating legal competition and the temperance movement gave the cause a moral charge that made it politically palatable.[36]

In the case of reformer startups, the narrow economic interests are easy enough to identify. The companies' investors, founders, and employees (presumably compensated by stock options) have plenty to gain.

The Baptists are harder to pin down. Make no mistake, reformer startups have their evangelists. Proponents of Uber and Lyft literally take to the street in support of ride-sharing.[37] "Tech missionaries" lobby on behalf of virtual currency.[38] The "crowdfunding exemption movement" has a meticulously maintained Wikipedia page (not to mention an unpredicted celebrity endorsement by Whoopi Goldberg!).[39] These are more fervent demonstrations of support than one might expect in connection with taxi regulation, payment systems, and private-offering regulation. But clearly, these technologies strike a chord—libertarian, egalitarian, or otherwise—with some subset of the population.

But what about the rest of us? Are we convinced of the transformative nature of these companies and their products? Does

35. *See id.* at 75, Yandle summarizes his theory as follows: "Durable social regulation evolves when it is demanded by both of two distinctly different groups. 'Baptists' point to the moral high ground and give vital and vocal endorsement of laudable public benefits promised by a desired regulation. Baptists flourish when their moral message forms a visible foundation for political action. 'Bootleggers' are much less visible but no less vital. Bootleggers, who expect to profit from the very regulatory restrictions desired by Baptists, grease the political machinery with some of their expected proceeds. They are simply in it for the money." Bruce Yandle, *Bootleggers and Baptists in Retrospect*, 22 REGULATION 3 (1999).

36. Yandle's theory emphasizes the importance of rhetoric in lowering the political cost of granting interest group concessions. *See id.* at 7 ("[R]hetoric matters a lot in the world of politics but . . . neither well-varnished moral prompting nor unvarnished campaign contributions can do the job alone. It takes both.").

37. Christina Farr, *Uber & Lyft Have a Secret Weapon in the Fight for Regulatory Approval: You*, VENTUREBEAT (Sept. 11, 2013, 10:15 AM), http://venturebeat.com/2013/09/11/ridesharing/ (describing grassroots appeal of ride-sharing companies and their reform efforts, and indicating that such broad-based support has influenced venture-capital investment decisions).

38. *See* Chris Moody, *Meet the People Trying to Make Bitcoin Work in Washington*, *Yahoo! News* (June 2, 2014, 10:15 AM), http://news.yahoo.com/bitcoin-lobbyists-212631321.html.

39. *See Crowdfunding Exemption Movement*, WIKIPEDIA, https://en.wikipedia.org/wiki/Crowdfunding_exemption_movement (last visited Oct. 26, 2015).

the rhetoric of the technology evangelists provide sufficient cover for politicians and regulators to remake long-standing legal regimes in the image of a relatively small number of well-funded startups?

Consider two possibilities. One view is that the rhetoric doesn't matter much, and what matters is straightforward consumer welfare (or perception thereof). These companies managed to scale rapidly in legal grey areas, and they delivered products at lower costs or with improved service. Inexpensive transportation, lodging, and money transmission are relatively salient benefits—felt more immediately by voters than the projected benefits of lifting a steel tariff, for example—and so they might obviate the need for the loftier messaging that Yandle and company envision.[40]

I would not be so quick to dismiss the social meaning of reformer startups, however. We may not share the evangelists' more grandiose visions—for example, that the right software code compels a fundamental rethinking of the state.[41] But reformer startups do seem to resonate with more broadly held views.

First, we often see technological innovation as the way forward in difficult times. For example, the "knowledge-based economy" is held out as a remedy for the dislocation caused by global economic trends.[42] Even those with no intent to share a ride, spend a Bitcoin, or host a stranger may believe that our collective prosperity increasingly

40. Again, one need not reach a conclusion about the underlying merits of the current regulatory regimes to adopt this view. The highly salient benefits provided by reformer startups may or may not be outweighed by health, safety, and security concerns. But those costs, even if significant, are arguably murkier, or more contingent, than the immediate price and service benefits and might therefore be difficult for consumers to internalize.

41. Alan Feuer, *The Bitcoin Ideology*, N.Y. TIMES (Dec. 14, 2013), http://www.nytimes.com/2013/12/15/sunday-review/the-bitcoin-ideology.html (describing Bitcoin as a philosophy and movement with anarchic and libertarian roots, which has as its goals "to unleash repressed economies, to take down global banking or to wage a war against the Federal Reserve"); *see also About,* SHAREABLE, http://www.shareable.net/about (last visited Oct 26. 2015) ("The sharing transformation shows that it's possible to govern ourselves, build a green economy that serves everyone, and create meaningful lives together.").

42. Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, 2 MICH. BUS. & ENTREPRENEURIAL L. REV. 195, 212–13 (2013) (discussing the effects that reduced transportation and communication costs have had on traditional manufacturing and natural-resource-extraction industries, and the perception that economic regions in the U.S. must be reoriented to participate in the "knowledge-based economy") (*citing* EDWARD GLAESER, TRIUMPH OF THE CITY 49 (2011); RICHARD FLORIDA, THE RISE OF THE CREATIVE CLASS AND HOW ITS TRANSFORMING WORK, LEISURE, COMMUNITY AND EVERYDAY LIFE 44 (2002)).

depends on inventing, rather than making, things.

In addition, we have a distinctive affinity for the entrepreneurs who turn these innovative ideas into businesses.[43] Entrepreneurship takes place everywhere,[44] but one senses that it is especially valued in the United States.[45] The origins of this sentiment are beyond the scope of this essay, but candidates include long-held commitments to upward mobility and decentralized power.

As the embodiment of both technological innovation and entrepreneurship,[46] Silicon Valley seems to have attained privileged status in our political economy.[47] Tax policy, securities regulation, and a dizzying array of public programs seek to spread and replicate its distinctive system for incubating new businesses.[48] Its appeal extends far beyond economic-development wonks. Silicon Valley's distinctive lexicon permeates television and movies.[49] We mourned the passing of Steve Jobs like a beloved public figure. In short, our heroes seem to wear hoodies these days.

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43. The concepts of entrepreneurship and technological innovation overlap but are not coterminous. Gordon Smith and Darian Ibrahim cite Joseph Schumpeter in identifying an "entrepreneurial opportunity" as any one of: new goods, new methods of production, new geographical markets, new raw materials, and new ways of organizing. D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1540–41 (2013).

44. *E.g.*, *id.* at 1533–34 (recounting one entrepreneur's tale of starting a business in remote Siberia).

45. This point is implied by an anecdote in Smith and Ibrahim's ambitious piece arguing that entrepreneurship is an animating value in U.S. law. They describe a German colleague who holds entrepreneurship in low regard. *See id.* at 1550. Similarly, scholars have argued that efforts to replicate the U.S. venture-capital market in other societies have failed because of less favorable cultural attitudes towards entrepreneurship. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1102–03 (2003) (discussing, with some skepticism, the extent to which cultural differences might affect efforts to "engineer" a venture-capital market).

46. In previous work, I have argued that policy makers are sometimes too quick to conflate entrepreneurship and Silicon Valley-style venture capital. *See* Cable, *supra* note 42, at 198 (*citing* PAUL KEDROSKY, RIGHT-SIZING THE U.S. VENTURE CAPITAL INDUSTRY 1 (2009), http://www.kauffman.org/uploadedfiles/usventcap061009r1.pdf).

47. I borrow the term "privileged status" from my colleague Jodi Short, who noted that participants in one panel were ascribing such status to the term "innovation."

48. Cable, *supra* note 42, at 197–98 (explaining a variety of public programs supporting Silicon Valley-style entrepreneurship); *see generally* JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP HAVE FAILED—AND WHAT TO DO ABOUT IT (2009) (describing efforts in the U.S. and globally to emulate Silicon Valley).

49. *See* Abraham J.B. Cable, *Startup Lawyers at the Outskirts*, 50 WILLAMETTE L. REV. 163, 178 (2015) (discussing the social impact of Silicon Valley).

And here is where the reformer startup may go off script a bit. In Yandle's formulation, the bootleggers must work behind the scenes and rely on the Baptists to be the public face of the movement. Reformer startups, however, can plausibly occupy the pulpit themselves. As a society, we are inclined to see some broader significance in their economic successes. With potentially deep pockets and a shiny public image, reformer startups are potential lobbying juggernauts.

IV. A CAUTIOUS OPTIMISM

So far, this essay suggests that market conditions in Silicon Valley explain the rise of the reformer startup, and that a "bootleggers and Baptists" dynamic explains reformer startups' successes. If true, what to make of it all?

There is a cynical view that we are witnessing nothing more than old-fashioned rent-seeking with only a veneer of broader importance. By this view, neither the incumbents nor the current crop of startups can be trusted to pursue anything but self-interest, and the regulatory environment is available to the highest bidder (net of political costs).

At the other extreme, reformer startups represent the public interest. The success of their products exposes current regulation as wrongheaded. Reformer startups and their grassroots advocates educate, or expose, regulators and lawmakers who would otherwise be hopelessly anachronistic or beholden to incumbents.

Perhaps we can draw something from each view. We should be careful about treating innovation and entrepreneurship as trump cards in policy debate. In the current environment, it can be hard to tell who is the David and who is the Goliath. Each regulatory battle has its own political economy, and we cannot assume that the benefits of innovation necessarily outweigh traditional health, safety, and investor protections.

On the other hand, I am cautiously optimistic about the big picture. Silicon Valley's distinctive systems of finance, labor, and industrial organization are the envy of the world.[50] Together, they form an important institution—the startup ecosystem—that enables

50. *See* LERNER, *supra* note 48 (discussing efforts to import the Silicon Valley model).

long-shot efforts to unseat incumbents. This "institutionalized disruption" could be an important counter to the inertia of anticompetitive regulation. In the long run, I hope we might see more thoughtful regulation if well-financed and politically palatable startups regularly take aim at the status quo. Only time will tell.

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Crowdfunding Delusions

*Reza Dibadj**

I. INTRODUCTION

The idea behind crowdfunding is, in principle, an attractive one. Individuals band together via the Internet in support of a common cause—a political candidate, disaster relief, and the like.[1] Business has not been immune to the phenomenon, with the enticing idea that small investors can pool together funds so that a company could produce a good or service.[2] At first glance, the idea is intellectually appealing since it aspires to democratize funding beyond accredited investors.[3] Think, for example of Pebble Technologies' Bluetooth-enabled watches: Using the crowdfunding platform Kickstarter, the company was able to crowdfund many times its initial objective.[4]

* Professor of Law, University of San Francisco. I thank the editors of the *Hastings Business Law Journal* for giving me the opportunity to present the ideas in this essay at the *Journal's* Symposium on "Regulating the Disruption Economy" on March 20, 2015, in San Francisco, California.

1. Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1736 (2012) ("Crowdfunding is the fundraising analog to crowdsourcing, which refers to mass collaboration efforts through large numbers of people, generally using social media or the Internet."); Migliozzi & Flatow, Securities Act Release No. 9216, WL 2246317 (June 8, 2011) ("Crowdsourcing is the use of social media and the Internet to organize a large group of individuals to achieve a common goal. . . ."); *see also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed At Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) ("Crowdfunding includes a variety of business financing models that use the Internet.").

2. *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 [hereinafter Bradford, *Crowdfunding*] ("Crowdfunding is, as its name indicates, funding from the crowd—raising small amounts of money from a large number of investors."). Various flavors of crowdfunding have been explored in the literature. *See id.* at 14–15 ("One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.").

3. *See infra* notes 80–81 and accompanying text (discussing Regulation D).

4. *See, e.g.*, *Pebble Time Kickstarter Project Raised $20.3 Million*, CNN MONEY, (Mar. 25, 2015, 11:16 PM), http://money.cnn.com/2015/03/27/technology/pebble-time-most-funded-kick

Indeed, crowdfunding generates a buzz in the otherwise staid field of securities regulation.[5]

Beyond all the hype, however, there is a curious incongruity. On the one hand, there exist apparently successful crowdfunding sites such as Kickstarter and IndieGoGo[6]; on the other hand, more than three years after the Jumpstart Our Business Act ("JOBS Act") mandated an equity crowdfunding exception, we are still waiting for final regulations from the Securities and Exchange Commission ("SEC").[7]

This essay begins by exploring this irony in Part I, arguing that existing crowdfunding sites carefully manage around a fundamental ambiguity in the securities laws—a surprisingly fuzzy definition of what a "security" is.

Part II shifts to understanding the existing regulatory framework: both the federal crowdfunding statute and proposed rules, as well as other existing alternatives issuers might consider. It starts by analyzing the contribution of the JOBS Act, the new section 4(a)(6) of the Securities Act of 1933 ("1933 Act"), and the SEC's October 2013 585-page proposed rules. While well intentioned, it concludes that this legal framework is ultimately unworkable, largely due to the very high transaction costs imposed. As such, to the extent the final rules are imminent, my prediction is that they will have little impact on actual fundraising practices. Second, Part II surveys other potential alternatives to place crowdsourced securities—sections 4(a)(2) and 4(a)(5), Regulation D, and Regulation A/A+, and even new state crowdfunding exemptions—but ultimately argues that none are attractive. As such, it is far more likely that crowdfunding sites will continue to operate as they currently do, rather than subject themselves to any new crowdfunding rules or seek alternative exemptions.

starter [hereinafter *Pebble Time Kickstarter*].

5. *See, e.g.*, Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 477 (2014) [hereinafter Heminway, *Public/Private*] ("In less than ten years, this fusion of social media and traditional corporate finance—a mode of corporate finance through which firms raise investment capital by reaching out over the Internet to a broad, undifferentiated mass of potential investors—grew from a creative impulse to a movement that catalyzed federal legislative action.").

6. *See infra* notes 28–31 and accompanying text.

7. *See infra* notes 34–53 and accompanying text.

Finally, Part III explores the implications of this pessimistic prediction along two dimensions. First, it argues that, for all of its advantages, crowdfunding presents fundamental negatives that cannot be regulated away. As such, we must face a stark choice: either prophylactically ban the activity, or allow it with few restrictions. To think that we can craft a balanced regulatory framework for crowdfunding is delusional.

Regardless of the direction securities law and policy gravitates towards, however, perhaps most important is to ponder crucial themes that the crowdfunding saga raises in a microcosm. Some are more obvious; for example, how to fund small businesses, the relative institutional roles of Congress and the SEC, the effectiveness of disclosure, and the role of intermediaries. Others are more subtle, such as bending the public/private distinction, uncoupling value-added services from capital, and whether the wisdom or madness of crowds is consistent with the efficient market hypothesis. Regardless, the real value of the contemporary crowdfunding saga may be to alert us to these challenging realities.

II. CROWDFUNDING WITHOUT RULES?

Section 5 of the Securities Act mandates that any security issued must either be registered or that the issuer must find a registration exemption.[8] Given that an exemption for equity crowdfunding does not yet exist, then how do crowdfunding sites exist?[9]

One possibility would be to argue that the issuer is a nonprofit or other charitable organization and thus, the security is exempt from registration under section 3(a)(4) of the 1933 Act.[10] Assuming the

8. *See* Securities Act of 1933 §§ 5(a), (c), 15 U.S.C. §§ 77e(a), (c) (2012).

9. *See, e.g.*, Bradford, *supra* note 2, at 6 ("[C]rowdfunding does not mesh well with federal securities regulation. Entrepreneurs seeking debt or equity financing through crowdfunding will often be selling securities, and securities offerings must be registered under the Securities Act of 1933 . . . unless an exemption is available."); Heminway & Hoffman, *supra* note 1, at 882 ("We became interested in this venture finance model because it has huge appeal in a number of obvious respects, yet we could not understand how some of the crowdfunding websites and crowdfunded ventures (especially those offering profit-sharing interests to funders) were complying with federal securities laws.").

10. The Act exempts "[a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit." Securities Exchange Act of 1934 § 12(g)(2)(D), 15 U.S.C. § 78l(g)(2)(D).

business is for-profit, however, this relatively narrow exemption would not be available—and even if it were exempt from registration, it would still be subject to the liability and antifraud provisions of the securities acts as a "security."[11]

As such, the basic manner in which crowdfunding sites might escape securities regulation would be to argue that what they are offering is not a "security."[12] This argument is only possible given a fundamental ambiguity in the federal securities laws.[13]

A. DEFINITION UNDER FEDERAL COMMON LAW

The question of what constitutes a "security" is deceptively difficult.[14] One of the supervening ironies of securities regulation is that we have an entire area of law devoted to regulating "securities," yet we still do not have a clear definition of what these are. To be sure, the 1933 Act does define the term,[15] but those familiar with the

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Having a profit motive would disallow the exemption. *Compare* SEC v. Children's Hosp., 214 F. Supp. 883 (D. Ariz. 1963) (exemption unavailable), *with* Deutsche Bank Microcredit Dev. Fund, SEC No-Action Letter, WL 1355511 (Apr. 8, 2011) (exemption available).

11. Notably sections 12(a)(2) and 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934.

12. *See also* Hazen, *supra* note 1, at 1737 ("*Unlike raising money for charities or other nonprofit ventures*, a business seeking investors through crowdfunding implicates the securities laws which provide investor protection by requiring disclosure and, in many instances, registration of securities offered to the public.") (emphasis added).

13. *See* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREP. BUS. L. J. 335, 356 (2012) [hereinafter Heminway, *What Is a Security*] ("The advent of crowdfunding has put significant pressure on the regulation of securities under the 1933 Act and the 1934 Act, in general, and the definition of a security, in particular.").

14. *See id.* at 353 ("The concept of a security—the subject (and an object) or securities regulation—is significantly more complex than it appears.").

15. Securities Act of 1933, subsection 2(a)(1) states that:

> The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim

securities laws recognize that the definition is too broad to be workable.

As such, the most relevant definition of "security" emerges from a United States Supreme Court case, *SEC v. Howey*,[16] which focuses on the term "investment contract"[17] and famously states: "an investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party."[18] The three components of the *Howey* test, then, focus on: (i) investment vs. consumption, (ii) common enterprise, and (iii) profits from the efforts of others.[19] There is rich case law exploring these factors.[20]

B. TESTING THE DEFINITION

How do crowdfunding efforts stack up against this definition?[21] It is critical to note that if the crowdfunded instruments—whether equity or debt—offer the prospect of a financial return on investment, they would very likely be deemed securities.[22]

> certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012). This is rather broad definition, which is further muddied by the prefatory clause "unless the context otherwise requires." Securities Act of 1933 § 2(a), 15 U.S.C. § 77b(a) (2012).

16. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); *see also* Reves v. Ernst & Young, 494 U.S. 56 (1990) (notes); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (closely held corporations). *Howey*, however, remains by far the most significant articulation, and the most relevant for interests sold via crowdfunding sites.

17. The term appears as a separate category in section 2(a)(1) of the 1933 Act, but *Howey* has been used more generally to define the word "security." *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1)(2012).

18. *Howey*, 328 U.S. at 298–99.

19. The word "solely" has effectively been de-emphasized in subsequent Supreme Court opinions. *See, e.g.*, United Hous. Found. v. Forman, 421 U.S. 837, 852 n.16 (1975).

20. *See, e.g.*, SEC v. Edwards, 540 U.S. 389 (2004); Marine Bank v. Weaver, 455 U.S. 551 (1982).

21. For detailed application of *Howey* to crowdfunding, *see* Heminway & Hoffman, *supra* note 1, at 885–906.

22. *See* Bradford, *Crowdfunding, supra* note 2, at 31 ("Crowdfunding sites organized on the lending model probably are offering securities if the lender is promised interest. Crowdfunding sites organized on the equity model are usually offering securities.").

After all, the offering would be an "investment" and there would be the expectation of "profits" under *Howey*.[23] Consider, for example the SEC's cease-and-desist orders against BuyaBeerCompany.com,[24] a putative campaign to purchase the Pabst Brewing Company, as well as Prosper Marketplace, which was offering crowdfunded debt instruments.[25] Other crowdfunding sites offering instruments which would arguably meet the *Howey* definition, such as ProFounder and 33Needs, are now defunct.[26]

But what about today's popular crowdfunding sites such as Kickstarter and IndieGoGo?[27] Each site very carefully avoids the *Howey* definition by sidestepping "investment" and "profit." For instance, note how careful Kickstarter is on its website:

> What do backers get in return?
>
> Backers that support a project on Kickstarter get an inside look at the creative process, and help that project come to life. They also get to choose from a variety of unique rewards offered by the project creator. Rewards vary from project to project, but often include a copy of what is being produced (CD, DVD, book, etc.) or an experience unique to the project.

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23. *See supra* note 17 and accompanying text. *See also* Heminway & Hoffman, *supra* note 1, at 895 ("[I]t is difficult to fathom how a financing plan or program that involves the exchange of funds for profit-sharing interests in a third-party's venture over the Internet would not qualify as a contract, transaction, or scheme under the Howey test.").

24. *See* Migliozzi & Flatow, *supra* note 1.

25. *See* Prosper Marketplace, Inc., Securities Act Release No. 8984, 94 SEC Docket 1913 (Nov. 24, 2008), ("The loan notes issued by Prosper pursuant to this platform are securities and Prosper . . . violated Sections 5(a) and (c) of the Securities Act, which prohibit the offer or sale of securities without an effective registration statement or a valid exemption from registration.").

26. *Cf.* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 865 (2014) [hereinafter Heminway, *Investment Crowdfunding*] ("Legally, entrepreneurs could not offer or sell a profit-sharing or revenue-sharing interest in the project or business for which they sought funding unless the offering was registered under the Securities Act of 1933 . . ."); *id.* at 877 ("Histories of the crowdfunding movement and investment crowdfunding are related in varying degrees of detail and with varying areas of emphasis. Many, if not most, of these histories, however, ignore the reality that various crowdfunding websites have been offering and selling investment interests that are securities without registering those offerings under the 1933 Act.").

27. *See*, *e.g.*, Bradford, *Crowdfunding*, *supra* note 2, at 16 ("Kickstarter and IndieGoGo are the leading reward/pre-purchase crowdfunding sites.").

> *Project creators keep 100% ownership of their work, and Kickstarter cannot be used to offer equity, financial returns, or to solicit loans.*[28]

IndieGoGo is even more direct:

> Can I offer my contributors shares in my venture or a return on their investment?
>
> *Campaign owners are not allowed to offer any form of "security" (as such term is defined in the Securities Act of 1933).* This means that campaign owners are not allowed to offer perks such as notes, stocks, treasury stocks, security futures, security-based swaps, bonds or debentures. For a comprehensive list, please take a look at the Securities Act of 1933 on the SEC website.[29]

It goes without saying that these sites are precisely avoiding the *Howey* definition—notably, that this is not a for-profit "investment," but rather it is consumption. Backers receive, for example, a Pebble watch, but not any shares in the company making the watch.[30]

The fact that sites like BuyaBeerCompany.com and ProFounder lost enforcement actions and Kickstarter and IndieGoGo operate seemingly without regulatory interference does not, of course, settle the matter. At a conceptual level, one could be forgiven for wondering whether a Supreme Court case from 1946 should be the arbiter of taste in crowdfunding. More practically, it leaves the question of mixed motivation unanswered. As one expert observes:

> Crowdfunding interests in the form of investment contracts are especially difficult to categorize since the range of terms they embody is particularly fluid.

28. *Kickstarter Basics*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter+basics?ref=footer (last visited Oct. 31, 2015) (emphasis added).

29. *Prohibited Perks*, INDIEGOGO, https://support.indiegogo.com/hc/en-us/articles/204255166 (last visited Oct. 31, 2015) (emphasis added). I leave aside here the question of how realistic it would be for someone contributing on IndieGoGo to decipher the 1933 Act.

30. *See Pebble Time Kickstarter*, *supra* note 4. *See also* Heminway & Hoffman, *supra* note 1, at 896 ("Many crowdfunding websites raise funds to support the production of goods and services by artists and others, and these crowdfunded ventures often reward funders with free or discounted products or services created or sold by the funded business."); Hazen, *supra* note 1, at 1739 ("If a crowdfunding effort seeks donations without any express or implied possibility of a return to the donor, there is no offering of securities, and thus, the securities laws are not implicated.").

> Investors may have mixed motives in purchasing them. While they have an expectation of "profits" generated by from a common enterprise and the efforts of others, they also may acquire these financial and related interests with the clear understanding that they will have no governance rights over the enterprise and will never recoup the full value of their investment through current returns, repayment or resale.[31]

As such, Congress and the SEC have stepped into the game as part of the JOBS Act to try to provide a coherent regulatory framework. Unfortunately, as Part II discusses, the statute and proposed regulations, by trying to be too many things to too many people, ultimately do not succeed.

III. OVERLY AMBITIOUS REGULATIONS, POOR ALTERNATIVES

Against the backdrop of existing crowdfunding, in 2012 Congress added section 4(a)(6) to the 1933 Act, and in October 2013 the SEC promulgated proposed rules for crowdfunding.[32] First, I provide an overview of the new statute and proposed rules. Next, I conclude that the current regulatory framework is overly ambitious in its attempt both to foster crowdfunding, as well as to deter fraud. To be sure, there are ambiguities—both in terms of the statute's language and attendant liability—but the fatal flaw of the current statutory and regulatory framework is the imposition of very high transaction costs.

A. CROWDFUND ACT AND PROPOSED RULES

1. Legal Framework

As part of the 2012 JOBS Act, the United States Congress passed Title III of the JOBS Act, "The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" ("CROWDFUND Act"), now included in section 4(a)(6) of the 1933

31. Heminway, *What Is a Security*, *supra* note 13, at 368.
32. As of September 2015, we are still awaiting final rules from the SEC.

Act.[33] Likely concerned with the SEC's failure to implement exceptions in the past,[34] the guidance is unusually specific. Section 4(a)(6) specifies that the issuer cannot raise more than one million dollars during a twelve-month period.[35] It bifurcates investors into two categories: those whose annual income or net worth is less than $100,000 and those whose annual income or net worth is at or above that amount.[36] The aggregate amount sold to the former during any twelve-month period cannot exceed the greater of $2,000 or five percent of the purchaser's annual income or net worth; by contrast, the amount sold to the latter cannot exceed ten percent of annual income or net worth not to exceed $100,000.[37] It also specifies that the transaction must be conducted via a registered broker-dealer or funding portal.[38]

Significantly, section 4A(b)(1) imposes disclosure requirements on issuers; notably, offerings above $500,000 require audited financials, offerings between $100,000 and $500,000 must be reviewed by an independent public accountant, and offerings below $100,000 require disclosure of the issuer's latest tax return and financial statements certified by an officer.[39] Section 4A(b)(4) in turn requires ongoing disclosure to investors at least annually.[40] Finally, while these crowdfunded securities would be "covered" securities exempt from state blue sky laws,[41] there would be a one-year holding period during which they could not be resold.[42]

33. *See* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195 (2012) (providing detailed description and analysis of statute) [hereinafter Bradford, *Unfulfilled*].

34. *See infra* notes 152–155 and accompanying text.

35. Securities Act of 1933 § 4(a)(6)(A), 15 U.S.C. § 77d(a)(6)(A) (2012).

36. *Id.*

37. *Id.*

38. *Id.*

39. Securities Act of 1933 § 4A(b)(1)(D), 15 U.S.C. § 77d-1(b)(1)(D) (2012).

40. Securities Act of 1933 § 4A(b)(4), 15 U.S.C. § 77d-1(b)(4) (2012).

41. Securities Act of 1933 § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C) (2012).

42. Securities Act of 1933 § 4A(e)(1), 15 U.S.C. §77d-1(e)(1) (2012). There are exceptions to the 1-year rule, notably for transfers to accredited investors and family members. *Id.*

In its 585-page proposed rules,[43] the SEC ended up largely repeating section 4(a)(6).[44] The rules did, however, try to achieve three things: they tried to (i) clarify some ambiguities and nuances in section 4(a)(6), (ii) suggest an approach to fairly esoteric concepts such as integration and 1934 Act triggers, and most importantly, and (iii) expand upon disclosure requirements and estimated costs.

The SEC clarified that if both the investor's income and net worth are less than $100,000, then the $2,000 or five percent (whichever is greater) applies,[45] and that the issuer may rely on the intermediary to assess these limits.[46] It also specified that issuers must use a single intermediary[47] who, in turn, must register with the SEC as a broker or funding portal, as well as join FINRA.[48]

It also noted that section (4)(a)(6) offerings are not to be integrated with other offerings, thereby isolating the one million dollar cap only to 4(a)(6) offerings,[49] and that crowdfunded securities are exempt from the 2,000 holder limit which would otherwise trigger full reporting obligations under section 12(g) of the Securities and Exchange Act of 1934 ("1934 Act").[50]

Perhaps most importantly, it expanded on disclosure requirements and estimated costs. The issuer must have some sort of a business plan and file a new Form C with both financial and non-financial disclosures.[51] The proposed rules, of course, are subject to change—as frustrated commentators have noted, however, the final rules have not yet been released.[52]

43. Crowdfunding, Exchange Act Release Nos. 9470; 70741, WL 5770346 (Oct. 23, 2013) [hereinafter SEC Release No. 9470]; *see also* Press Release, SEC, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677.

44. *See, e.g.*, Brian Korn, *SEC Proposes Crowdfunding Rules*, FORBES (Oct. 23, 2013, 2:41 PM), http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/ ("[T]oday's proposed rules are a virtual reprint of the parameters outlined in the JOBS Act.").

45. SEC Release No. 9470, *supra* note 43, at 10.

46. *Id.*

47. *Id.*

48. *Id.* at 128.

49. *Id.* at 16.

50. *Id.* at 275.

51. *Id.* at 43.

52. *See, e.g.*, Kendall Almerico, *SEC Delays Equity Crowdfunding Piece of JOBS Act for Another Year*, FORBES (Dec. 14, 2014), http://www.entrepreneur.com/article/240558; Kevin Harrington, *Will JOBS Act Equity Crowdfunding Ever Happen?*, FORBES (Feb. 3, 2015, 2:42

2. *Critiques*

There are numerous critiques of the exemption. Most focus on the ambiguities and poor drafting—both in terms of what the rule mandates, as well as uncertain implications for liability. While I discuss these criticisms first, my contention is that the fatal flaw in the legal framework is the imposition of very high transaction costs—notably on issuers, but also on intermediaries. Put simply, the exemption is too expensive to be meaningful.

a. Ambiguities and Poor Policy Choices

The foundational statute, section 4(a)(6), is far from a paragon of clarity, and one could endlessly debate the policy choices that have been made around investment limits, requirements for intermediaries, and the like. As one might expect, there have been numerous criticisms of the exemption. One scholar, who has written about the "ambiguities, internal inconsistencies, and outright drafting errors"[53] in the statute, laments:

> The new crowdfunding exemption is disappointing. It is poorly drafted, leaving many ambiguities and inconsistencies for the SEC or the courts to resolve. Its mandatory disclosure requirements are too complicated and expensive for the small offerings it is designed to facilitate. Its individual investment limits are too high, exposing investors to more risk than many of them can afford. Its regulation of crowdfunding intermediaries is haphazard, unnecessarily disadvantaging non-broker intermediaries, but failing to include a crucial investor protection provision. Its failure to include a "substantial compliance" provision to protect innocent and immaterial violations, coupled with its complicated regulatory requirements, makes inadvertent violations likely. . . . Because of these and a number of other

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PM) http://www.forbes.com/sites/kevinharrington/2015/02/03/will-jobs-act-equity-crowdfunding-ever-happen/ ("Almost three years [after the JOBS Act] the SEC still has not published the final rules, and JOBS Act equity crowdfunding remains on hold. How is this possible?").

53. Bradford, *Unfulfilled*, *supra* note 33, at 215.

> problems, the promise of crowdfunded securities offerings remains unfulfilled. The new exemption is not the regulatory panacea crowdfunding supporters hoped for, and it is unlikely to spawn a crowdfunding revolution.[54]

Another expert summarizes the legislation as "an overwhelming mishmash of regulatory requirements."[55]

Crucially, liability is also far from clear. More specifically, section 4A(c) states that "[a]n action brought under this paragraph shall be subject to the provisions of Section 12(b) and Section 13, *as if the liability were created under Section 12(a)(2)*."[56] Leaving aside for the moment the interpretative ambiguities in section 12(a)(2),[57] one wonders why the statute says "as if"? Perhaps the phrase has no significance, or perhaps it is meant to address the oddity of using section 12(a)(2) to police crowdfunding: the US Supreme Court has held that section 12(a)(2) applies only to public offerings such as initial public offerings (IPOs),[58] yet crowdfunding is not such a registered public offering. And this is not even to mention that the liability of the funding portals remains poorly defined[59]—an aspect that could emerge as important as unsuccessful issuers become bankrupt and judgment-proof, while plaintiffs look for redress.

My point is not to pile onto these criticisms. While I am in no way defending the drafting, it does not bother me as much because it is fairly typical of securities statutes and regulations. Overall, the securities laws are riddled with ambiguities and interpretative puzzles, not to mention very debatable policy choices—yet somehow as

54. Bradford, *Unfulfilled*, *supra* note 33, at 198.

55. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1437 (2012).

56. Securities Exchange Act of 1934 § 4A(c)(1), 15 U.S.C. § 77d(a)(6)(C) (2012).

57. *See*, *e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561, 567 (1995). Section 12(a) seems to impose a negligence standard. The statutory language says that any person who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable . . . to the person purchasing such security from him . . . ." Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(2) (2000).

58. *See* Gustafson, 513 U.S. at 566.

59. *See generally* C. Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others*, 83 U. CIN. L. REV. 371 (2014).

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My own view, moreover, is that in the end it will simply be the high costs of complying with the crowdfunding framework that will be its ultimate undoing.

b. Exorbitant Cost

My basic objective when trying to get a rough sense of cost is to understand how the cost of using the crowdfunding exemption would compare to that of going public, where the underwriting fee is typically seven percent, but one needs to add additional costs for a rough estimate of about ten percent, already quite high.[60] Fortunately, coming up with a rough estimate turned out to be relatively straightforward. First, I took data from the SEC's Proposed Rules,[61] which appears in three bands of offering sizes: less than $100,000, $100,000-$500,000, and greater than $500,000. I then tried to characterize a cost as initial or ongoing (or both), then simply added up each type of cost and calculated it as a percentage of the mid-point of each offering band; namely, $50,000, $250,000, and $750,000. The results are summarized below:

60. *See, e.g.*, Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1105–31 (2000).

61. *See* SEC Release No. 9470, *supra* note 43, at 358–59.

	Initial	*Ongoing*	*Offerings of $100,000 or less*	*Offerings of more than $100,000, but not more than $500,000*	*Offerings of more than $500,000*
Compensation to the intermediary	x		$2,500-$7,500	$15,00 - $45,000	$37,500 - $112,500
Costs per issuer for obtaining EDGAR access codes on Form ID	x		$60	$60	$60
Costs per issuer for preparation and filing of Form C for each offering	x		$6,000	$6,000	$6,000
Costs per issuer for preparation and filing of the progress updates on Form C-U	x		$400	$400	$400
Costs per issuer for preparation and filing of annual report on Form C-AR		x	$4,000	$4,000	$4,000
Costs for annual review or audit of financial statements per issuer	x	x	Not required	$14,350	$28,700
Costs per issuer for preparation and filing of Form C-TR to terminate reporting			$600	$600	$600

Initial costs	$8,960-13,960	$35,210-65,210	$72,060-147,060
Ongoing costs	$4,000	$18,350	$32,700
Average offering[62]	$50,000	$300,000	$750,000
Initial costs %	18-28%	12-22%	10-20%
Ongoing costs %	8%	6%	5%

The results are, to put it mildly, discouraging: depending on the size of the offering and the estimate range, anywhere from ten to twenty-eight percent in initial costs alone—with the smaller offerings estimated to be significantly more expensive on a percentage basis. One could be forgiven for wondering whether an entrepreneur would be willing to bear these substantial transaction costs—consider, for example, a small offering where almost three dollars of every ten dollars raised would be going to intermediaries and compliance. As one observer laments:

> Can this new regulatory-laden exemption be useful to small entrepreneurs? It is difficult to imagine that for offerings under $250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities. The mandated use of intermediaries, the significant role that intermediaries are expected to play, and the mandated disclosures all point to an impracticable exemption for relatively small offerings.[63]

Beyond the issuers themselves, there are also estimated costs to serve as an intermediary, which I summarize below, directly from the SEC's Proposed Rules:[64]

62. I assume the midpoint, as the SEC does. *See* Proposed Rules, *supra* note 61, at 358 n.918.

63. Cohn, *supra* note 55, at 13; *see also* Korn, *supra* note 44 ("To produce an offering disclosure document, enlist a funding portal, run background checks and file an annual report year after year might well cost upwards of $100,000.").

64. SEC Release No. 33-9470, *supra* note 43, at 385–86; *see also* Heminway, *Investment Crowdfunding*, *supra* note 26, at 883 ("Potential intermediaries also face significant costs, including the cost of registration.").

	Initial Cost	Ongoing Cost
Intermediaries that register as brokers	$770,000	$220,000
Intermediaries that register as funding portals	$417,000	$90,000
Intermediaries already registered as brokers	$295,000	$70,000

To the extent they are accurate, these costs are arguably less troubling since the intermediary would be a repeat player who could presumably spread these costs across many offerings. One arguably concerning aspect of the cost structure, however, would be that it would seem to encourage existing broker-dealers to register as funding portals—something which would presumably discourage new entrants into the funding portal business.

Of course, all of these are just estimates taken from proposed SEC rules.[65] But one might surmise that the statute will fail "in its primary purpose to assist entrepreneurs and others seeking to raise small amounts of capital through broad-based solicitation."[66] Put simply, "[w]hy and how does the crowdfunding exemption come up short in achieving its objectives? In one word, the answer is: *costs*."[67]

As one observer sums up:

> The proposed rules are extremely impractical because of the restrictions and procedural hurdles a crowdfunding issuer, investor and funding portal will have to endure to raise capital. *Compared to other forms of crowdfunding and capital raising, equity crowdfunding to the public has the worst "bang for your buck" in all of corporate finance.*[68]

65. Heminway, *Investment Crowdfunding*, *supra* note 26, at 884 ("Although the SEC has estimated the compliance costs attendant to each aspect of its rulemaking under the CROWDFUND Act, the actual costs and realizable benefits of the crowdfunding exemption, as implemented through the SEC's rulemaking, will depend on the number and nature of the issuers, investors, and intermediaries that participate in investment crowdfunding—which are unknown at the present time.").

66. Cohn, *supra* note 55, at 1; *see also id.* at 6 ("Promoters seeking to raise small amounts from small investors are now subject to such a wide range of disclosure and regulatory requirements that it is hard to imagine typical crowdfunding promotions being carried out under such conditions.").

67. Heminway, *Investment Crowdfunding*, *supra* note 26, at 880.

68. Korn, *supra* note 44, at 2 (emphasis added).

It would simply be too expensive for issuers to use the exemption to raise money, and it goes without saying that entrepreneurs are well-attuned to costs.[69] To be fair, one should grant that the transaction costs are imposed in an attempt to minimize the risk of fraud, especially given the SEC's historical focus on "micro-cap" fraud.[70] Notwithstanding this noble intention, however, there are at least two problems. The first is whether the mechanisms set in place—notably the expectations of funding portals to review information with investors, answer questions, make sure investors have not exceeded the 12-month aggregate investment limits, avoid conflicts of interest, and the like[71]—are realistic. Yet even assuming that these mechanisms will operate perfectly, there remains the question of whether the transaction costs outweigh the investor-protection benefits in the sense that the former are so high that the exemption is, ab initio, a non-starter.[72]

The supervening irony in all of this, of course, is how the regulatory framework increases transaction costs for a funding mechanism fundamentally created because of a technology that reduces transaction costs—the Internet.

B. POOR ALTERNATIVES

Given these limitations, are there other possible exemptions under which crowdfunding might flourish? The short answer is no, but in order to arrive at this conclusion an overview of other possibilities is in order.[73] In a nutshell, the statutory exemptions are too vague as to be practical, and neither Regulation D nor Regulation

69. *See, e.g.*, Sherwood Neiss, *It might cost you $39K to crowdfund $100K under the SEC's new rules*, VENTUREBEAT (Jan. 2, 2014, 2:14 PM), http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/.

70. *See* Bradford, *Crowdfunding*, *supra* note 2, at 105 and accompanying text.

71. *See, e.g.*, Securities Act of 1933 § 4A(a), 15 U.S.C. § 77d-1(a) (2015).

72. *See also* Cohn, supra note 55, at 11 ("During the rush to promote legislation to aid small companies, did anyone point out to Congressional members or staff that the requirement to certify financial statements by the CEO is not required for any other federal or state registration exemption, that financial statements are not required for Rule 504 small business exemption for offerings up to $1 million, and that audited financial statements are expensive and rarely available for small businesses?").

73. Needless to say, this section does not approach a comprehensive overview of offering exemptions under the 1933 Act.

A fit the bill. For their part, new state crowdfunding exemptions, while superficially attractive, are unlikely to become significant.

To begin, one might consider two statutory exemptions, sections 4(a)(2) and 4(a)(5) of the 1933 Act. Section 4(a)(2), which simply states that "the provisions of section 5 shall not apply to transactions by an issuer not involving a public offering,"[74] is problematic for two reasons: first and more generally, its meaning is still quite fuzzy nearly a century after drafting;[75] second and more specifically, it remains unclear whether crowdfunding is "public" or "private."[76] Section 4(a)(5), permitting offerings to one or more accredited investors,[77] is similarly of marginal use: crowdfunding involves the general public, not accredited investors,[78] and this statutory exemption has effectively been superseded by Regulation D.

One should quite naturally ask about Regulation D, the most important set of exemptions in the securities laws. Regulation D is comprised of three distinct exemptions: Rules 504, 505, and 506. First and foremost, Regulation D does not allow solicitation and advertising[79]—a limitation that makes it unattractive for crowdfunding.[80] There are two limited exceptions to this ban, but neither would really help with crowdfunding.[81]

74. Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d-1(a)(2) (2015).

75. *See generally* SEC v. Ralston Purina Corp., 346 U.S. 119 (1953).

76. *See infra* notes 167-71.

77. Section 4(a)(5) of the 1933 Act exempts from registration "transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b)(1) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe." Securities Act of 1933 § 4(a)(5), 15 U.S.C. § 77d(a)(5) (2015).

78. Accredited investor defined in 15 U.S.C. § 77b(15)(ii) (2015), which essentially defers the definition to the SEC. *See infra* note 81.

79. *See* 17 C.F.R. § 230.502(c) (2015).

80. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 918 ("The most serious obstacle to using Regulation D to exempt crowdfunded offerings from registration is its overall prohibition of general solicitation and advertising.").

81. The first is that solicitation and advertising are allowed if all the purchasers are accredited investors, and their accredited status is verified. *See* 17 C.F.R. § 230.506(c) (2015). As discussed below, however, accredited investors would not be the target audience in a crowdfunding context. *See infra* notes 83–85 and accompanying text. The second is that solicitation and advertising are allowed under 17 C.F.R. § 230.504(b)(1) (2015)—usually this applies if the offering is limited to states that provide for a registration and disclosure document, or to states that limit sales to accredited investors. As discussed below, however, section

Rule 506, which permits offerings of unlimited size,[82] would really not be applicable because it can be used only with sophisticated[83] or accredited[84] investors—neither of which presumably fits crowdfunding.[85] Rule 505, allowing offerings up to five million dollars,[86] also applies to accredited investors—there is an exception for up to thirty-five nonaccredited (and unsophisticated) investors,[87] but this threshold is significantly too low for crowdfunding.

The situation with Rule 504, which allows offerings up to one million dollars,[88] is significantly more nuanced. On the one hand, it looks very attractive: It does not require either initial or ongoing disclosure, does not require funding portals, and can be sold to an unlimited number of unaccredited and unsophisticated investors.[89] The problem with Rule 504, however, stems from that fact that its offerings are not "covered" securities, and are thus subject to the state blue sky laws—given the inherently interstate nature of crowdfunding with the Internet,[90] this restriction becomes very problematic. In the words of one scholar:

> Assuring compliance with Rule 504 for a crowdfunded venture is not straightforward. It may be difficult to determine the states in which crowdfunding interests

230.504 is of limited use given the interstate nature of crowdfunding. *See infra* notes 89–91.

82. *See* 17 C.F.R. § 230.506 (2015).

83. The definition of sophisticated is notoriously vague in the securities laws. *See, e.g.*, C. Edward Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081 (1988).

84. *See* 17 C.F.R. § 230.501(a) (2015). The most significant is subsection 230.501(a)(5), which includes natural persons whose net worth (excluding primary residence) exceeds $1 million, or whose income over the past two years exceeds $200,000 (or $300,000 if married, filing jointly).

85. *See, e.g.*, Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. (forthcoming 2016), *available at* http://ssrn.com/abstract=2539786 ("a true crowd-based approach requires opening up the process to more than accredited investors").

86. *See* 17 C.F.R. § 230.505 (2015).

87. *See* 17 C.F.R. §§ 230.505(b)(2)(ii), (e)(iv) (2015).

88. *See* 17 C.F.R. § 230.504 (2015).

89. *See, e.g.,* Cohn, *supra* note 55, at 13–14 ("Rule 504, [codified in 17 C.F.R. § 230.504], for example, also a federal registration exemption for offerings up to $1 million, does not require a disclosure document, does not require the use of an intermediary, does not require any investor qualification regarding education or understanding of risks, and does not require annual and other reports to the SEC and investors.").

90. *See infra* note 121 and accompanying text.

> are offered and sold, and assuming that the applicable state laws meet the proper threshold level of investor protection, the cost of complying with multiple state laws could be high, if not prohibitive.[91]

As such, while Rule 504 cannot be categorically excluded, it presents significant challenges; indeed, if it were a viable option, then presumably there would have been less lobbying for a new and distinct crowdfunding exemption.

Regulation A/A+ is even less attractive. Section 3(b)(1) has for decades granted the SEC exemptive authority for offerings under five million dollars.[92] The SEC used this authority to promulgate Regulation A.[93] At first glance, Regulation A might appear attractive to crowdfunding because it allows solicitation and advertising.[94] Unfortunately, though, Regulation A is problematic for two principal reasons. First, it is not a "covered" security and hence would also be subject to the state blue sky laws and all the attendant problems this would present for issuers.[95] Second, and perhaps more significantly, it requires disclosure in the form of a "mini-registration" statement,[96] whose cost and difficulty is generally considered to be a central factor in Regulation A's general lack of success.[97] Overall, "the expense of producing the offering circular, in addition to the costs associated with state securities law compliance, makes this exemption too costly for many crowdfunded ventures."[98]

91. Heminway & Hoffman, *supra* note 1, at 919–20.

92. *See* 28 U.S.C. § 77c(b)(1) (2015).

93. *See* 17 C.F.R. §§ 230.251–.263 (2015).

94. *See* 17 C.F.R. §§ 230.254–.255 (2015).

95. *See, e.g.*, Hazen, *supra* note 1, at 1762 ("Regulation A, which, at least in theory, could be used for crowdfunding, does not preclude state law from mandating its own registration and disclosure.").

96. *See* 17 C.F.R. § 230.254(a) (2015); *see also* Hazen, *supra* note 1, at 1746 ("Unlike the other small issue exemptions, Regulation A is available for offerings using a general solicitation of investors but is conditioned upon dissemination of a disclosure document."); Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 502 (2014) ("Regulation A offerings may be made for up to $5 million, which should be ample for early round financing of small start-ups. But Regulation A still requires issuers to file a document with the SEC, Form 1-A, that involves considerable disclosure.").

97. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS (2012) (noting significant delays in SEC review of Regulation A filings as well as high abandonment rate by issuers).

98. Heminway & Hoffman, *supra* note 1, at 921.

Perhaps in an attempt to revive Regulation A, the JOBS Act added section 3(b)(2) which exempts offerings up to fifty million dollars.[99] In addition, an offering limit that is ten times greater, these new offerings, known as "Regulation A+" or "Tier 2 Regulation A," are also "covered" securities.[100] The fundamental problem as it might relate to crowdfunding, however, is that these new offerings require significant initial and ongoing disclosure—including audited financial statements, and annual and semi-annual reports.[101] To the extent these are even more onerous than section 4(a)(6)'s reporting requirements, this new option becomes a nonstarter.

Finally, we are left with new crowdfunding exemptions crafted by the states.[102] While superficially attractive, these new exemptions are unlikely to have much impact given the interstate nature of the Internet and crowdfunding.[103] Phrased more technically, such state exemptions can only exist if they can be fit into the intrastate offering exemption, section 3(a)(11) of the 1933 Act, which is interpreted strictly and requires that the issuer and all offerees be in-state, not to mention that the proceeds be used in-state as well.[104] While in theory

99. *See* Securities Act of 1933 § 3(b)(2), 15 U.S.C. § 77c(b)(2) (2012).

100. *See* Amendments For Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 2501, WL 1788375 (Mar. 2015).

101. *See id.*

102. *See, e.g.*, Stacy Cowley, *Tired of Waiting for U.S. to Act, States Pass Crowdfunding Laws and Rules*, N.Y. TIMES (June 3, 2015), http://www.nytimes.com/2015/06/04/business/smallbusiness/states-pass-crowdfunding-laws-for-small-businesses.html?_r=0 ("Twenty-two states and the District of Columbia have enacted such rules, nine of them within the last six months. Eleven states are considering creating such laws and procedures. Three more states—Florida, Illinois, and New Mexico—have rules or legislation awaiting the governor's signature."); Herrick K. Lidstone, Jr., *Crowdfunding in Colorado Is Now Available: Let The Offerings Roll*, COLO. BAR ASS'N: BUS. LAW NEWSL., Aug. 2015, http://www.cobar.org/index.cfm/ID/22954/subID/29470/CORP/#Crowdfunding.

103. *See, e.g.*, Am. Liberty Ass'n v. Pataki, 969 F. Supp. 160, 173 (S.D.N.Y. 1997) ("[T]he Internet represents an instrument of interstate commerce . . . ."); Heminway & Hoffman, *supra* note 1, at 959–60 ("[T]he inherent cross-border nature of Internet securities offerings (including crowdfunded offerings).").

104. *See, e.g.*, Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2015); Exemption for Local Offerings, Securities Act Release No. 4434, WL 61651 (1961); Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969) (discussing subsection 3(a)(11)); SEC v. Milanowski, Litigation Release No. 20536, WL 1820691 (April 23, 2008) (D. Nev. summary judgment entered Mar. 15, 2010) (finding fund manager unable to raise 3(a)(11) exemption as a defense to allegations of fraud because of his failure to register shares of Fund with SEC); *see also* Steven Overly, *As Federal Regulators Move Slowly on Equity Crowdfunding, States Adopt Their Own Rules*, WASH. POST (Aug. 24, 2014), http://www.washingtonpost.com/business/capitalbusiness/as-federal-regulators-move-slowly-on-equity-crowdfunding-states-adopt-their-own-rules/2014/08/22/81

these state exemptions might be used for offerings whose out-of-state reach could somehow be restricted over the internet,[105] they are unlikely to be significant. As one observer notes, "limiting the offering pool to residents of a single state—as is required for a federally exempt intrastate offering—renders the exemption unusable for crowdfunding efforts given the interstate reach of the Internet."[106] As the SEC has indicated:

> In the context of an offering conducted in accordance with state crowdfunding requirements, such measures would include, at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law, and limiting access to information about specific investment opportunities to persons who confirm they are residents of the relevant state (for example, by providing a representation as to residence or in-state residence information, such as a zip code or residence address).[107]

Perhaps unsurprisingly, preliminary research suggests the intrastate exemptions have not been popular.[108]

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c6da54-2942-11e4-958c-268a320a60ce_story.html ("Indeed, states can only regulate business within their borders. That means their provisions automatically shrink the scope of a business's crowdfunding efforts to investors who reside within the state.").

105. *See, e.g.*, *Hazen, supra n*ote 1, at 1745 ("Small issues that are *purely* local in nature may qualify for section 3(a)(11)'s intrastate exemption, which is not dependent on the size of the offering but also would not be suitable for crowdfunding because it cannot be limited to the confines of a single state." (emphasis added)).

106. *See, e.g.*, Hazen, *supra n*ote 1, at 1749; Heminway & Hoffman, *supra* note 1, at 912 n.160 ("While the intrastate offering exemption . . . may be applicable in some situations involving crowdfunding, most crowdfunded ventures seek to raise capital from investors residing in various states. Because of its unlikely applicability in this context, we do not further analyze the possible application of the intrastate offering exemption in the crowdfunding context.").

107. SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 141.04, https://www.sec.gov/divisions/corpfin/guidance/securities actrules-interps.htm (August 6, 2015).

108. *See* Ibrahim, *supra* note 85, at 137 ("[M]y preliminary review of those exemptions finds that they have not been used much . . . .").

IV. THE PATH FORWARD

So where do we go from here? Simply put, my prediction is that the new crowdfunding exemption, in trying both to allow crowdfunded capital while at the same time protecting investors, is doomed to fail. It is simply not possible to do both in this context.

In order to arrive at this prediction, I first explore the advantages and disadvantages of allowing crowdfunding, then argue that unfortunately the two are not necessarily reconcilable. As such, the securities regime faces a stark choice: either allow crowdfunding with few restrictions, or ban it.

A. ARGUMENT: PROS AND CONS

1. Brilliant Idea

There are a number of strong arguments to be made in favor of crowdfunding. Looking at the problem first from the point of view of issuers, public policy should encourage small business growth, and it is well known that small businesses face a funding shortfall. In the words of one scholar, "[c]rowdfunding offers significant promise for small business issuers, who face a capital funding gap. Traditional sources of business financing—bank lending, venture capital, and angel investors—are unavailable to many startups and other very small offerings."[109] There is a very modern allure to allowing entrepreneurs to raise money using the Internet, which may at least in part explain Congress' enthusiasm for crowdfunding.[110]

Looking at the problem through the lens of investors also appears compelling. Crowdfunding epitomizes democratization: why

109. Bradford, *Unfulfilled*, *supra* note 33, at 196; *see also* Heminway, *Investment Crowdfunding supra* note 26, at 865 ("Even promising small businesses have trouble finding friends-and-family, seed, angel, and venture capital in sufficient quantities to allow them to succeed and thrive."); Bradford, *Crowdfunding*, *supra* note 2, at 5.

110. *See* Ibrahim, *supra* note 85, at 105 ("In an age where bipartisan support for anything in Congress is rare, allowing entrepreneurs to use the Internet to raise money is a rarity: everyone seems to like it."); Heminway, *Public/Private*, *supra* note 5, at 485 ("[I]n response to public outcry, extensive lobbying efforts, and a perceived political need for the U.S. Congress to do something—anything—bipartisan in nature to better serve small businesses in the lingering shadows of the recent global financial crisis . . . .").

should unregistered offerings be limited to accredited and sophisticated investors, as for example under Rule 506?[111] The concern becomes particularly acute if one considers two factors specific to crowdfunding. First, why should someone be allowed to invest in a Kickstarter or IndieGoGo campaign, yet have to forego the upside?[112] Second, offshore crowdfunding sites, under laxer regulations in other jurisdictions, could appeal to American investors, thereby sidestepping American securities regulation[113]—indeed, my rather unscientific sampling of current crowdfunding sites suggests this phenomenon is already happening.[114]

Overall, then, "crowdfunding enables entrepreneurs to more quickly and easily identify supporter-investors who are willing and able to fund their businesses and projects. . . . Crowdfunding gives these investors a way to participate in corporate finance that they may not otherwise have."[115] The narrative that emerges is very seductive:

> Equity crowdfunding holds the appeal of being quintessentially American. It is the classic rags to riches story, where an enterprising young person turns a smart idea into a globe-straddling company and along the way makes fortunes for those investors perspicacious enough to see the idea's value early on.[116]

When phrased in this romantic language, who could disagree?

111. *See supra* notes 82–85 and accompanying text.

112. *See, e.g.*, Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Investors are already contributing substantial amounts of money to unregulated crowdfunding offerings, although not for securities. Those crowdfunding investments are subject to the same risk of loss as crowdfunded securities, but do not offer the upside potential of a securities investment.").

113. *See, e.g.*, *id.* at 14 ("Not surprisingly, given the international reach of the Internet, some of those foreign sites also sell to U.S. investors, and some of the investments they sell would almost certainly qualify as securities under U.S. law.").

114. *See, e.g.*, BUZZBNK https://www.buzzbnk.org/ (last visited Oct. 30, 2015) (serving U.K.); CROWDCUBE, https://www.crowdcube.com (last visited Oct. 30, 2015) (serving U.K.); INVESTIERE, https://www.investiere.ch (last visited Oct. 30, 2015) (serving Switzerland); SONICANGEL, www.angelgroup.me/ (last visited Oct. 30, 2015) (serving Belgium).

115. Heminway & Hoffman, *supra* note 1, at 931.

116. Dorff, *supra* note 96, at 13; *see also* Heminway, *Investment Crowdfunding*, *supra* note 26, at 879 ("Given presidential support and bipartisan backing in Congress (after all, who wants to oppose a bill that effectively promises to increase and broaden the base of investment capital and, perhaps, spur entrepreneurial activity and job creation during an economic downturn?), there undeniably was significant political pressure to pass the CROWDFUND Act.").

2. Dismal Idea

Yet not so fast. Crowdfunding also presents dramatic risks to investors. Most simply and importantly, investing in small emerging companies is risky—and most will fail.[117] This problem is exacerbated in the crowdfunding context by a number of troubling factors.

First, issuers that resort to crowdfunding may not have traditional financing options—friends and family, angel investors, venture capitalists, and banks—available to them.[118] And unaccredited, unsophisticated investors might perhaps be less discerning in their investment strategy. Consider, for instance, that existing crowdfunding platforms have raised money for some unusual ventures, apparently including more than $55,000 to fund a potato salad.[119] Moreover, the offerings are done via the Internet, "a common vehicle for securities fraud."[120] The Rule 504 saga of the mid-1990s—where the SEC relaxed, then had to reinstate the restrictions on solicitation and advertising in Rule 504 offerings based on concerns about fraud—is instructive in this regard:

> [I]n the mid-1990s, many companies relied on Rule 504 for online offerings without registration or any disclosure even close to what would be provided in a registered offering. Typically, companies would issue stock through the Internet and then provide a bulletin

117. *See, e.g.*, Cowley, *supra* note 102, ("Small companies are inherently risky investments—only half survive for five years, according to government data—and private businesses are not required to disclose much about how they operate. It can be nearly impossible for potential investors to really know what risks they face."); *see also* Robb Mandelbaum, *As the Delay Continues on Crowdfunding Rules, Concerns About Investor Risks Grow*, N.Y. TIMES (May 22, 2014), http://boss.blogs.nytimes.com/2014/05/22/as-the-crowdfunding-delay-continues-concerns-about-the-risks-grow/; Heminway & Hoffman, *supra* note 1, at 933 ("Small businesses, especially start-ups, fail at a relatively high rate, and investors are likely to lose all of their investment.").

118. *See generally* Ibrahim, *supra* note 85.

119. *See* Jonah Bromwich, *Crowd-Funding Gets Wacky*, N.Y. TIMES, Dec. 17, 2014 ("After joking with friends, a computer programmer from Ohio named Zack Brown created a campaign that asked for contributions to help raise $10 for a homemade batch of potato salad . . . . The campaign raised more than $55,000.").

120. Heminway & Hoffman, *supra* note 1, at 933, 935 ("Promoters of crowdfunding interests often are anonymous individuals and unknown entities."); Hazen, *supra* note 1, at 1769 ("If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud.").

> board or other online trading vehicle whereby initial purchasers could sell their shares to other investors. Frequently, these online offerings would be accompanied by considerable hype concerning the newly issued securities. In part as a response to these so-called "pump and dump" schemes, the SEC amended Rule 504 to prohibit not only a general solicitation but also to impose restrictions on resale unless the securities are registered under state law or issued under a state law exemption permitting a general solicitation.[121]

In addition, the securities are unlikely to be traded on efficient markets, where uninitiated investors could effectively "free-ride" on the coat tails of professionals.[122] There is the additional problem of "micro-fraud" perpetuated by and on small issuers whose securities are very thinly traded.[123]

The additional significant challenge that a small investor would face is the difficulty of diversifying bets among various investments—in other words, it would be impractical with presumably little capital to build a portfolio the way venture capital firms do. The latter, of course, realize that they will lose money on many, if not most, of their investments.[124] The bottom line is that crowdfunding "involves a

121. Hazen, *supra* note 1, at 1747–48; *see also* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, 64 Fed. Reg. 11090 (Mar. 8, 1999); Heminway & Hoffman, *supra* note 1, at 952 ("The SEC did, in fact, remove the proscription in Rule 504 offerings for a seven-year period during the 1990s only to reinstate it because of renewed concerns about fraud.").

122. *See, e.g.*, Ibrahim, *supra* note 85, at 146 ("While there are certainly well-known criticisms and shortcoming of the ECMH, it is still at least a crude mechanism that makes disclosure work for unsophisticated investors in the public markets context. Title III crowdfunding site would not be efficient markets, so the ECMH cannot benefits its unsophisticated participants.").

123. *See Microcap Fraud*, SEC, http://www.sec.gov/spotlight/microcap-fraud.shtml; *cf.* Hazen, *supra* note 1, at 1766 ("Fraud in small packages can be just as effective and damaging to the victims, many of whom may be least able to bear the risk of even a small investment in a speculative business.").

124. *See, e.g.*, Ibrahim, *supra* note 85, at 137–38 ("Unsophisticated investors are unlikely to appreciate the significant risk of losing their entire investment in a startup that fails (as most startups do). Compare this with angels and VCs who understand that most startups fail and therefore diversify for protection.").

potentially dangerous combination of investment risk and relatively unsophisticated investors."[125]

In the end, then, the policy arguments in favor and against crowdfunding are conducive to a dizzying schizophrenia:

> The relative ease with which an unsophisticated investor may lose money in investments with small business issuers, the high rate of securities fraud in the small business context, and the anonymity of the Internet may give us pause about extending exemptive relief to crowdfunded offerings. However, crowdfunding has the capacity to fuel small business growth and satisfy the demand for a securities market that serves the everyman.[126]

Given this mess, what to do?

B. A PESSIMISTIC PREDICTION

My pessimistic prediction, which I fervently hope will prove incorrect, is that the current attempt to legalize crowdfunding will have precious little impact. Crowdfunding will likely hobble along in a legal grey area.[127] At best, what some enterprising issuers might do is to parallel offerings: perhaps a small amount to unaccredited investors under the new crowdfunding rules,[128] but the bulk of the

125. Bradford, *Unfulfilled*, *supra* note 33, at 196; *see also* Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Investing in small businesses is very risky. Small business investments are illiquid, and small businesses, especially startups, are much more likely to fail than are more established companies. Losses due to fraud and self-dealing are also much more likely."). Dorff, *supra* note 96, at 31 ("Eventually, investors will realize that money invested in crowdfunding enterprises will nearly always be money lost."); Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Crowdfunding possesses no magical properties that prevent investors from losing money just like other investors.").

126. Heminway & Hoffman, *supra* note 1, at 937.

127. *See, e.g.,* Harry McCracken, *Indiegogo is Getting Ready for Equity Crowdfunding*, FAST COMPANY (Sept. 14, 2015), *available at* http://www.fastcompany.com/3050200/the-big-idea/indiegogo-is-getting-ready-for-equity-crowdfunding (as the co-founder of the Crowdfunding Professional Association puts it, "[f]acilitating regulated investments is very different from giving away T-shirts or hats or putting people's names in the credits of a movie."); Moira Vetter, *In With the In Crowd? The Entrepreneur's Guide to Crowdfunding (Or Not)*, FORBES (July 31, 2015), *available at* http://www.forbes.com/sites/moiravetter/2015/ 07/31/in-with-the-in-crowd-the-entrepreneurs-guide-to-crowdfunding-or-not/ ("SEC compliance can be mind numbing. Equity crowdfunding comes with regulatory responsibilities that may be too much for you to take on.").

128. Perhaps even to just below the $100,000 or $500,000 thresholds, to avoid the more

offering to accredited investors under Regulation D or perhaps even the new Regulation A+.

The other intriguing option is for companies—both startups eventually looking for venture capital, and those well-funded, deep-pocketed ones—to continue to use the existing nonequity crowdfunding platforms as a clever and inexpensive way to test products, while at the same time passing the costs to the backers.[129]

The more interesting question, though, is how to conceptualize a path forward. My argument is simple: we are deluding ourselves if we think we can have it both ways. Crowdfunding simply is not amenable to investor protection, and disclosure will not solve our problem.[130] As such, we need to pick our poison: Either make crowdfunding readily available, or ban it. Trying to do too much—as section 4(a)(6) and the Proposed Rules arguably do—is a recipe for disaster.

The arguments against banning crowdfunding track the negatives outlined above. Put simply, the notion is that "these investments are going to be *terrible*"[131] and that "there *is* no way to rescue retail crowdfunding. The problem is not with how Congress set up the system or how the SEC will eventually implement it. The problem is that this was always a terrible idea."[132] Indeed, in an attempt to protect investors, at least one commentator urges the SEC to put an end to section 4(a)(6) via excessive regulation:

> The best solution would be to scrap the crowdfunding portion of the JOBS Act entirely. But since Congress is highly unlikely to reverse itself so quickly, the SEC should use the power granted to it by the JOBS Act to achieve effectively the same end by piling on so many

onerous financial disclosure requirements that begin at the next level. *See, e.g.*, Neiss, *supra* note 69.

129. *See, e.g.*, Katherine Rosman, *Crowdfunding Isn't Just for the Little Guys: Deep-Pocketed Companies Test the Market on Indiegogo*, WALL ST. J. (July 9, 2014), http://www.wsj.com/articles/crowdfunding-isnt-just-for-the-little-guys-1404955610 ("By using these sites [such as IndieGoGo], bigger companies are finding they can do valuable market research often while passing the costs on to willing donors.").

130. In other words, I remain unconvinced that "a careful balancing of investor protection and capital formation" is possible in the crowdfunding context. *See* Bradford, *Crowdfunding*, *supra* note 2, at 8.

131. Dorff, *supra* note 96, at 496.

132. *Id.* at 523.

> additional investor protections and disclosure requirements that portals find it undesirable to list crowdfunding opportunities, and businesses are driven to look elsewhere for capital.[133]

Regardless of whether one might personally agree with this assessment, a better policy argument might be to craft a simple exemption—perhaps setting maximum investment limits and making crowdfunded securities exempt under section 3(a)[134]—and allow investors to spend their money, if they so choose. The analogy might be to gambling or to charitable donations, both of which are legal.[135]

I propose this largely because crowdfunding is the perennial horse that has already left the barn—not allowing it will lead to phenomena such as underground and offshore sites.[136] There is also something odd about taking people's money but disallowing any investment—as just one telling example, RocketHub puts investments in the same category as alcohol, drugs, gambling, and pornography.[137] There is, of course, the question of whether startups themselves will want to sell shares in themselves broadly or to a select few investors[138]—but allowing crowdfunding as an investment will eventually answer this question. If investors are willing to part with their money, why not give them some upside potential—as elusive

133. Dorff, *supra* note 96, at 498; *see also id.* at 523 ("At this point, the SEC's best option is to kill retail crowdfunding with excessive regulation.").

134. *Cf.* Heminway & Hoffman, *supra* note 1, at 912 ("Section 3(a) does not currently provide an exemption for crowdfunding interests.").

135. *Cf. id.* at 942 ("One way to address the uncertainties created by deregulating the offer and sale of crowdfunding interests under the federal securities laws is by regulating those transactions under another one or more existing areas of law (e.g., through gambling regulation or the regulation of charitable donations) or by regulating them under a new scheme of regulation created especially for crowdfunding.").

136. *See* Cohn, *supra* note 55, at 4 ("the crowdfunding phenomenon is growing at a rate that does not allow for continued benign sweeping under the enforcement radar screen.").

137. RocketHub's FAQ section asks "What can NOT be offered as a good or service at this time?" The following goods are not allowed: alcohol, drugs, gambling (including lotteries, raffles, or sweepstakes), *investment opportunities (including equity, loans, and revenue sharing),* pornography, and weapons. RocketHub, FAQs, https://www.rockethub.com/education/faq#not-offered (last visited Oct. 10, 2015) (emphasis added); *see also* Bradford, *Crowdfunding*, *supra* note 2, at 25 ("there are now no major, publicly accessible equity crowdfunding sites in the United States").

138. *See, e.g.*, McCracken, *supra* note 127 (in the words of the CEO of one startup, "Who you have around the table is as important as, if not more important than, the money you're bringing in."); Vetter, *supra* note 127 ("I would rather 'hand pick' my prospective investors than mass market to people I don't know, who will not be adding strategic value.").

and naïve as it might be, even the possibility of any upside would be better than zero.[139]

C. Taking Opportunities

Regardless of whether readers might agree or disagree with my proposal, the biggest tragedy is that we are missing the opportunity to examine major questions in securities regulation: as it turns out, the crowdfunding saga presents many themes in microcosm. More obviously, it broaches fundamental dilemmas such as defining securities, the small-business funding gap, the relative institutional roles of Congress and the SEC, the efficacy of disclosure, and the role of intermediaries as gatekeepers. More subtly, crowdfunding blends public and private, uncouples value-added services from capital, and asks whether crowds are consistent with efficient markets. Debating these issues would have real value; sadly, though, the framework's failures drown out such discourse.

1. Some Fundamental Questions

The ambiguities of how to define a "security" have been discussed above.[140] Crowdfunding would seem to provide a perfect opportunity to discuss whether a Unites States Supreme Court decision from 1946 should still be the benchmark for defining securities well into the twenty first century.[141] Similarly, crowdfunding forces us to ask whether—notwithstanding the concern with "microfraud"[142]—it makes sense to make the securities laws so difficult and expensive for small businesses to comply with.[143] As one scholar points out:

> Congress could have used crowdfunding as an opportunity to re-examine some of the basic premises

139. It is important to remember that "the crowdfunding backers don't share in the profits. Equity crowdfunders, however, receive actual shares in the companies they back." Cowley, *supra* note 102.

140. *See supra* notes 33–60 and accompanying text.

141. *See supra* notes 15–32 and accompanying text.

142. *See supra* notes 118–124 and accompanying text.

143. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 880 ("Funding small businesses while complying with applicable securities laws and regulations is tricky.").

> of securities regulation of small businesses and to seriously rethink how the Internet can be used to protect investors in less traditional, less expensive ways. Instead, it threw together a poorly drafted regulatory bundle of old ideas that is complicated, expensive, and unlikely to have much of an effect on the small business capital gap.[144]

Relatedly, crowdfunding could make us re-think what is arguably the fundamental premise of the entire securities regime: disclosure. There is new research that suggests mandated disclosure has, simply put, been a failure.[145] In the words of one scholar: "[t]he sheer volume of disclosure occasioned by the mandatory disclosure regime—especially when some of the information has little, if any, relevance in determining market prices or company-specific or systemic risks—may render mandatory disclosure ineffective or inefficient in serving its desired regulatory objectives."[146]

More specifically, securities exemptions typically require that solicitation be accompanied by disclosure[147]—contrast for example Rule 504 (no solicitation, no disclosure) with Regulation A (solicitation, disclosure).[148] But is this dichotomy correct? Moreover, will the average investor in the "crowd" understand, or even read, the disclosures whose creation is at least partially to blame for such high transaction costs?[149] This concern is only exacerbated when the Internet is the offering medium, given its tendency to provide an overwhelming amount of information which can be difficult to sift through.[150]

144. Bradford, *Unfulfilled*, *supra* note 2, at 222; *see also* Heminway & Hoffman, *supra* note 1, at 951 ("There also may be a future time at which it would be advisable to initiate an overhaul of all small business capital formation regulation.").

145. OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 33 (Princeton Univ. Press 2014).

146. Heminway, *What is a Security*, *supra* note 13, at 349.

147. *See, e.g.*, Hazen, *supra* note 1, at 1748 ("Any exemption that involves a general solicitation of investors will require an offering circular or other affirmative disclosure.").

148. *See supra* note 1, at 1763; *see also supra* notes 81–84 and accompanying text.

149. *Id.*; *see also supra* notes 64–74 and accompanying text.

150. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 934 ("the Internet may over-inform and, as a result, obfuscate or bury important information in connection with securities offerings.").

The crowdfunding debacle also provides an exceptional opportunity to consider the relative institutional roles of Congress and the SEC. Sections 4(a)(6) and 4A are drafted in detail that one seldom sees in the securities regime—why?[151] To put it bluntly, likely because the Congress was fed up with the SEC's inertia on small offerings. It is important in this regard to remember that the SEC for decades had the statutory authority under section 3(b)[152] and section 28[153] to craft a crowdfunding exemption, but it did not.[154] As such, we have the legislature trying to do the regulatory agency's job, perhaps with predictable results.[155]

The idea of funding portals also invites a conversation on the role of intermediaries as gatekeepers in the securities regime. Given our struggles with the bifurcated regulatory regime for broker-dealers[156] on the one hand and investment advisors[157] on the other,[158] does it make sense to introduce yet another concept, namely the funding portal?[159] To the extent it does, might it have been better to

151. Contrast, for example, with section 10(b) of the 1934 Act which vaguely prohibits "any manipulative or deceptive device or contrivance . . . ." (codified in 15 U.S.C. 78j (2015)).

152. *See* Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1) (2012) ("Commission may from time to time by its rules and regulations . . . add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors . . . but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.").

153. Section 28 of the 1933 Act is even more generous, noting simply that the "Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 28. U.S.C. § 77z-3 (1998).

154. *See, e.g.*, Hazen, *supra* note 1, at 1749 ("the SEC already had statutory authority to craft an exemption that could apply to crowdfunding"); Bradford, *Crowdfunding*, *supra* note 2, at 87.

155. *See* Cohn, *supra* note 55, at 15 ("the SEC has a dismal record regarding the interests of small business. Congressional leaders therefore felt compelled to move into the regulatory vacuum. Yet, for all their good intentions, legislators are not experts in the nuances of securities laws. . . .").

156. *See* Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 77c (a)(4) (2012).

157. *See* Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2015).

158. *See, e.g.*, Reza Dibadj, *Brokers, Fiduciaries and a Beginning*, 30 REV. OF BANKING AND FIN. L. 205 (2010).

159. *Cf.* Bradford, *Crowdfunding*, *supra* note 2, at 49 ("If the investments offered on crowdfunding sites are securities, crowdfunding site operators could be brokers subject to regulation under the Exchange Act or investment advisers under the Investment Advisers Act.").

introduce something like the "Nomads" on London's AIM market, as at least one commentator has suggested.[160]

2. Intriguing Subtleties

So far, I have touched on some fairly obvious issues that crowdfunding brings to the fore; namely, defining securities, funding small businesses, and questioning disclosure and institutional roles. There are, however, additional more subtle topics, which center on crowds and efficient markets, the public/private distinction, and unbundling value added from capital.

The entire securities regime putatively revolves around efficient markets[161] and the mythical reasonable investor.[162] But are these assumptions applicable when we are talking about crowds?[163] One scholar puts the question particularly well when she asks: "[d]oes the securities-crowdfunding crowd have the attributes of a wise crowd, or will it have a tendency to madness?"[164] To what extent do crowds typify the concerns in behavioral economics and noise theories about the efficient market hypothesis?[165]

Another nuanced, but conceptually fascinating feature of crowdfunding is that it challenges the public/private divide in securities regulation.[166] Traditionally, the regulatory regime has been bifurcated: the entire machinery of public offerings on the public side,

160. *See* Ibrahim, *supra* note 85, at 151–59.

161. *See, e.g.,* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 550 (1984).

162. *See* Basic v. Levinson, 485 U.S. 224, 240 (1988) ("materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.").

163. *See, e.g.,* Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the "Crowd*," 38 VT. L. REV. 827, 829 (2014) [hereinafter Heminway, *Crowd*] ("Individual members of the crowd may or may not have the attributes of the reasonable investor—the type of investor protected by U.S. federal securities laws and rules.").

164. *Id.* at 844. *See also* Ibrahim, *supra* note 85, at 148 ("The concept of the "crowd" under Title III is messy and ambiguous.").

165. *See, e.g.*, Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 851–72 (1992); Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 3 (2003).

166. *See* Heminway, *Public/Private*, *supra* note 5, at 479 ("The very notions of a crowdfunded offering and issuer of securities challenge pre-existing public-private distinctions.").

and the relatively light-touch on the private side, typically when the offering is sold to accredited investors.[167] Crowdfunding challenges this. On the one hand, it is an exemption like those offered to "private" offerings; on the other, it is "public" in that there is solicitation and the securities are offered to the public at large.[168] As one example of this tension, consider that the JOBS Act had to exempt crowdfunded companies from the normal requirement under section 12(g) and Rule 12g-1 of the 1934 Act to categorize companies with more than two-thousand shareholders and ten million dollars in assets to reporting requirements as if they were a public reporting company.[169] The last time the SEC conflated public and private, Regulation A,[170] success was not forthcoming[171]—is the new crowdfunding exemption repeating the same mistake?

Finally, and perhaps most subtly, crowdfunding broaches the topic of unbundling governance rights and value-added services from capital. Consider, for instance, that startup companies seeking funds from angel investors and venture capital firms typically also receive "value-added" services in the form of strategic and management guidance, but crowdfunding essentially uncouples these services from the transfer of capital itself. To the extent that startups are thirsting for crowdfunding dollars, does this imply they do not value these services, or that crowdfunded funds are simply cheaper?[172] This idea is of course different, but has a conceptual similarity to another form of unbundling that occurred in the early days of crowdfunding: that of

167. *See supra* notes 156–159.

168. *See* Heminway & Hoffman, *supra* note 1, at 929–30 ("Crowdfunded offerings, as currently conducted, are not private offerings; by their nature, crowdfunded offerings are not limited offerings (in terms of their ability to reach potential investors) and are not isolated offers and sales of securities.").

169. Jumpstart Our Business Startups (JOBS) Act of 2012, H.R. 3606, 112th Cong. §§303, 501 (2nd Sess. 2012) (enacted).

170. *See* Heminway, *Public/Private*, *supra* note 5, at 488 ("Regulation A had earlier blurred the line between public and private offerings for mandatory disclosure under the 1933 Act by requiring limited offering disclosures structured to look like the disclosures used in registered public offerings. . . .").

171. *See supra* notes 92–98 and accompanying text.

172. *See* Ibrahim, *supra* note 85, at 140 ("the inherent passivity of Title III investors—a seeming negative—would actually appeal to entrepreneurs who wish to *unbundle* the cash and value-added service components of traditional entrepreneurial finance").

unbundling governance rights (notably, voting rights) from capital contributions, what one scholar has termed "unequity."[173]

V. CONCLUSION

The securities regime in the United States faces a fundamental, perhaps intractable, problem: "to reconcile the regulatory requirements of 1933 with the realities of the twenty-first century."[174] Crowdfunding, whose "socio-legal bounds are as yet relatively untested,"[175] presents a particular challenge: A resolutely twenty-first century phenomenon butting heads against a regulatory framework designed for the early twentieth century.[176]

It is unlikely that the limbo in which crowdfunding finds itself will emerge unless we are willing to face a normative choice: Either we think that individuals should be able to invest capital in risky ventures or not. If we decide the former, then we should have a streamlined regulation with significantly fewer requirements and concomitant lower transaction costs. On the other hand, if we decide the latter, then we should simply not allow crowdfunding. To think that we can allow it while at the same time protect investors may be a bit of a delusion.

To the extent my prediction about the new crowdfunding regime is accurate, my fervent hope is that we move beyond and learn from the opportunity crowdfunding has given us to examine some questions, both fundamental and esoteric, in securities regulation.

173. *See* Heminway, *What Is a Security*, *supra* note 13, at 360 (defining unequity as "a particular type of financial interest that provides for profit-sharing or revenue-sharing on a short-term basis, with no accompanying governance rights").

174. Bradford, *Crowdfunding*, *supra* note 2, at 150.

175. Heminway, *Public/Private*, *supra* note 5, at 477.

176. *Cf.* Heminway, *Crowd*, *supra* note 163, at 831 ("Crowdfunded securities offerings are a relatively recent, high-growth phenomenon borne, at least in part, from frustration with traditional capital-raising methods and processes.").

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Employee Perks in Silicon Valley: Technology Companies Lead the "Arms Race" as Corporate Law Trails in Representing Shareholder Interests

*Thuy Nguyen**

I. INTRODUCTION

The practice of providing "in-kind" perks to employees that go beyond the traditional benefits of health care coverage and retirement plans has spread throughout Silicon Valley technology companies at a rapid pace within the last decade.[1] At the same time, the value of these perks has increased exponentially.[2] The widespread adoption of this practice suggests that employers view the practice as beneficial to their business strategy in two interrelated ways. First, corporate directors and officials view the practice as a tool to recruit talent, boost productivity, and increase efficiency. Second, companies have typically been able to avoid paying taxes on the majority of the in-kind perks they provide to employees.[3]

From a shareholder governance perspective, however, there are substantial weaknesses in these two approaches. With respect to developing human resources in general, there is currently no accurate metric for measuring how the receipt of in-kind perks contributes to an employee's work performance. Thus, shareholders are unable to

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1. John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 290 (2013).

2. Ian Sherr, *Vexed in the City: Working in Silicon Valley Tech Is Much More Lucrative Than You Think*, CNET (Aug. 21, 2014, 4:00 AM), http://www.cnet.com/news/vexed-in-the-city-working-in-silicon-valley-tech-is-much-more-lucrative-than-you-think/.

3. *Id.*

properly assess whether the costs associated with in-kind perks ultimately decrease or increase share value. In addition, should shareholders wish to question the use of corporate funds to provide lavish perks, there is no effective avenue of recourse under the current corporate legal framework. With respect to the tax advantages associated with providing in-kind perks, while this practice has enjoyed rapid exponential growth uninterrupted for the most part, the law is beginning to catch up. Several scholars have argued that the majority of perks offered fail to qualify for the type of tax breaks that the law intended.[4] In response, the Internal Revenue Service ("IRS") has expressed the intent to revise the tax code based on these recommendations.[5] The IRS's interest in monitoring and regulating in-kind perks in Silicon Valley thereby casts doubt on the financial advantages of this practice.

This Note addresses this issue by proceeding in three main parts: Part I surveys the types of perks offered by employers, Part II analyzes the impact of impending changes to the practice of employer-provided perks, and Part III criticizes the ineffectiveness of the current legal avenue shareholders might pursue to effect change and summarizes an interim solution. Ultimately, this Note seeks to identify significant gaps in the practice of employer provided perks, in order to foster a conversation between shareholders and management regarding the long-term consequences of this practice.

II. RISE OF EMPLOYEE PERKS IN SILICON VALLEY

In order to understand the implications of employer-provided perks, it is important to first examine the current landscape. This section will define the geographical boundaries of which the perks are concentrated; the demographic to which the perks are directed; and the perks themselves, in terms of type, scale, and value.

Starting in the 1990s, the technology industry in Silicon Valley

4. *See, e.g.*, Austin L. Lomax, Note, *Five-Star Exclusion: Modern Silicon Valley Companies Are Pushing the Limits of Section 119 by Providing Tax-Free Meals to Employees*, 71 WASH. & LEE L. REV. 2077, 2105 (2014).

5. Mark Maremont, *Silicon Valley Cafeterias Whet Appetite of IRS*, WALL ST. J., Sept. 2, 2014, at B1, http://www.wsj.com/articles/silicon-valley-cafeterias-whet-appetite-of-irs-1409612488.

has cultivated a reputation for not only offering employees substantial pay,[6] but also lavish perks.[7] In terms of location, the Silicon Valley area is generally known to encompass the following:[8] all of the Santa Clara, San Mateo, and San Francisco counties; Fremont, Newark, and Union City of Alameda County; and Scotts Valley of Santa Cruz County.[9] With respect to the beneficiaries of these perks, technology companies generally craft benefits packages specifically geared towards engineers, software experts, coding whizzes, and other key workers.[10] These employees are known as the "backbone of the industry's current boom."[11]

Silicon Valley technology companies offer perks in varying degrees of type, scale, and value. Some employers offer limited perks.[12] For example, a local research lab for IBM subsidizes lunches for employees.[13] Similarly, employees at Apple must pay to use the on-campus gym, but the company offers subsidized lunch, free coffee, tea, and apples.[14]

Yet, most companies provide completely subsidized perks frequently, or even daily. For example, Google employees are encouraged to dine at any one of the cafeterias and eateries on campus completely free of charge.[15] Smaller companies with more

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6. Before the practice of providing employee perks began attaining momentum, Silicon Valley companies utilized stock options to attract and retain employees, which is now considered a standard benefit. *See* Alisa J. Baker, *Stock Options–A Perk that Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20.

7. Paul Caron, *Who Pays for Employee Perks at High-Tech Companies?*, TAXPROF BLOG (Nov. 25, 2014), http://taxprof.typepad.com/taxprof_blog/2014/11/who-pays-for-employee-perks-.html.

8. While the Silicon Valley is generally known loosely as the "Bay Area," there is not a universal agreement on the precise geographical boundaries of the region.

9. While the Silicon Valley Index doesn't faithfully include the county of San Francisco, it is included in this note because of the increasing presence of high tech companies in San Francisco and consequently, the spread of employee perks. *See Profile of Silicon Valley*, SILICON VALLEY INDEX, http://www.siliconvalleyindex.org/index.php/profile-of-the-region (last visited Oct. 1, 2015).

10. Caron, *supra* note 7.

11. Sherr, *supra* note 2.

12. *Id.*

13. *Id.*

14. *Id.*

15. Lomax, *supra* note 4 (citing Kevin Smith, *Google Employees Reveal Their Favorite Perks Working for the Company*, BUS. INSIDER (Mar. 6, 2013, 11:02 AM), http:// www.businessinsider.com/google-employee-favorite-perks-2013-3?op=1 (listing a variety of employee reactions to the many perks that Google offers)).

limited office space employ the services of local catering companies.[16] Genentech, a biotechnology corporation headquartered in South San Francisco, provides take-home dinners and helps employees find last-minute care for sick children.[17] Many companies throughout Silicon Valley offer buses equipped with wireless Internet ("Wi-Fi") to transport employees to and from work, allowing them the luxury of working while commuting.[18] Evernote, a productivity app maker headquartered in Redwood City, offers free house-cleaning services twice a month to every full-time worker, from receptionists to top executives.[19] Employees at other companies, including Netflix and Twitter, enjoy unlimited vacation time.[20]

Other perks are offered intermittently. For instance, ThousandEyes, a network monitoring company based in San Francisco, brought employees to Lake Tahoe for three days in the summer.[21] For one of those days, the company provided employees with vouchers for recreational activities, including zip lining, golfing, and boating.[22] Employees at Evernote receive a $1,000 stipend to "disconnect from work" each year.[23]

Some perks verge on extravagant, or even excessive. At Dropcam, a company that manufactures live-streaming cameras, CEO Greg Duffy welcomes employees by offering free helicopter rides to the destination of their choice.[24]

Company perks even extend to employee families as well. For instance, some companies offer employees money to help offset costs of childbirth and adoptions.[25] When employees at Yahoo adopt or give birth to a child, they are given $500, a gift basket, and up to eight

16. Cadie Thompson, *Silicon Valley Start-Ups Take Perks to New Level,* CNBC (Aug. 19, 2013, 1:50 PM), http://www.cnbc.com/id/100971904.

17. John C. Goodman, *Silicon Valley Employers Go Wild with Lavish Employee Benefits*, FORBES (Oct. 30, 2012, 9:17 AM), http://www.forbes.com/sites/johngoodman/2012/10/30/silicon-valley-employers-go-wild-with-lavish-employee-benefits/.

18. Sherr, *supra* note 2.

19. Matt Richtel, *Housecleaning, Then Dinner? Silicon Valley Perks Come Home*, N.Y. TIMES (Oct. 20, 2012), http://www.nytimes.com/2012/10/20/us/in-silicon-valley-perks-now-begin-at-home.html?_r=0.

20. Sherr, *supra* note 2.

21. *Id.*

22. *Id.*

23. *Id.*

24. Thompson, *supra* note 16.

25. Sherr, *supra* note 2.

weeks of paid leave.[26] Similarly, Google gives $500 "baby bonding bucks" along with up to twenty-two weeks leave for biological moms.[27] At Facebook, employees are given a gift of $4,000 and approximately sixteen weeks of maternity leave.[28]

Still, other perks simply buck tradition. Two Silicon Valley giants, Apple and Facebook, now offer female employees the "game-changing" perk of covering the costs to undergo medical procedures to freeze and store their eggs.[29] At both companies, the benefits plan covers up to $20,000 in medical procedures and costs.[30] Employees at Facebook began taking advantage of the coverage in 2014.[31]

To be sure, not all companies participate in the perks game. For instance, the head of the human resources software startup Zenefits argued that he abstains from offering too many of the Silicon Valley staples to his employees for fear of attracting employees who join the company purely for perks.[32] However, companies that refrain from providing extensive perks "are becoming the exception, not the rule."[33]

The competition to see which companies can devise and dole out the most desired and original perks has been characterized as an "arms race."[34] Silicon Valley employers strive to outdo each other in terms of nonsalary and nonequity benefits.[35] ThousandEyes CEO Mohit Lad describes the practice as an effort to be original.[36] It goes beyond "just giving free lunches," but further, it is about cultivating a unique corporate "identity."[37] In fact, the practice has become so prevalent that a new sub-industry has surfaced.[38] Companies are

26. *Id.*
27. *Id.*
28. *Id.*
29. Danielle Friedman, *Perk Up: Facebook and Apple Now Pay for Women to Freeze Eggs*, NBC NEWS (Oct. 14, 2014, 2:56 PM), http://www.nbcnews.com/news/us-news/perk-facebook-apple-now-pay-women-freeze-eggs-n225011.
30. *Id.*
31. *Id.*
32. Sherr, *supra* note 2.
33. *Id.*
34. *Id.*
35. Flora Zhang, *Twitter Buys 19th Century Log Cabins for Cafeteria*, CNN: MONEY (Mar. 6, 2014, 10:38 AM), http://money.cnn.com/2014/03/06/technology/social/twitter-cabins/.
36. Sherr, *supra* note 2.
37. Sherr, *supra* note 2.
38. Rachel Feintzeig, *Lavish Perks Spawn New Job Category*, WALL ST. J. (Nov. 20, 2014, 7:19

retaining human resources ("HR") specialists and tasking them with looking for more creative, often valuable benefits.[39] For some companies and HR specialists, the expectations are beginning to become too much to handle. Jill Hernstat, a recruiter at executive search firm Hernstat & Co., observed that prospective or current employees would often broadcast the perks they received at their former job.[40] The expectation then would be for the new employer to offer more perks than the former employer, or at the very least, make a matching offer. This is the practice that Hernstat has characterized as spiraling to the point where it has become "out of hand."[41]

Obviously, the practice impacts two main classes of people: (1) the employers, including the management team, and (2) the employees. However, the increasingly prevalent role that employer-provided perks play in the human resources component of Silicon Valley technology companies should draw the attention of another class of key stakeholders: corporate shareholders.

III. THE SHAREHOLDER GOVERNANCE PROBLEM

Given the volume and enormous costs associated with the practice of providing perks, it follows that corporate shareholders have a strong interest in the underlying business rationale of the policy, and potentially, any options available to exercise their rights as shareholders. While these increasingly extravagant perks have garnered considerable attention from the government and the public, less attention has been paid to corporate shareholders. Specifically, there is little, if any, literature available analyzing how these perks affect shareholder value. If the value of employee benefits remained stagnant, then the concern would not be as pronounced. However, the alarming rate at which the benefits have spread throughout technology companies in Silicon Valley—combined with the soaring costs and value of the benefits—warrants a closer examination of the legal and business ramifications as they relate to shareholders. This

PM), http://online.wsj.com/articles/lavish-perks-spawn-new-job-category-1416529198; Caron, *supra* note 7.

39. Feintzeig, *supra* note 38.

40. Sherr, *supra* note 2.

41. *Id.*

section will outline the business rationales corporate executives offer to support the practice of providing employee perks, and explain how impending changes in tax law affect the wisdom of these business rationales.

A. Intended Purposes of Employee Perks

The history of Silicon Valley involves intense competition for employees with competent engineering skills, a phenomenon described as an "insatiable demand for engineering talent."[42] As early as the 1970s, the practice of providing perks evolved as a method for companies to vigorously compete in the market for talent.[43] Companies began to offer "incentives such as generous signing bonuses, stock options, high salaries, and interesting projects to attract top people."[44] These aggressive recruiting practices progressed through the 1980s and into the 1990s.[45] While the demand for engineers diminished in the years following the burst of the dot-com bubble, it quickly swelled again less than a decade later.[46] One expert described the market for engineering talent in Silicon Valley by 2011 as "the most competitive" he had ever seen.[47] Today, companies continue to maintain the mindset that paying engineers "like superstars" is the only way to compete in Silicon Valley's "hypercompetitive" job market.[48] Despite the significant costs associated from these employee perks, companies nonetheless justify the practice on three main grounds: the perks serve to increase productivity, recruit talent, and retain valuable human resources.

1. Efficiency

42. Coyle & Polsky, *supra* note 1, at 290.

43. *Id.*

44. *Id.* (citing AnnaLee Saxenian, Regional Advantage: Culture and Competition in Silicon Valley and Route 128 35 (9th prtg. 2000)).

45. Coyle & Polsky, *supra* note 1, at 290–91 (citations omitted).

46. *Id.*

47. *Id.* at 291 (citing Jessica Guynn, *What Recession? It's Boom Time Again in Silicon Valley*, L.A. Times (July 17, 2011), http://articles.latimes.com/2011/jul/17/business/la-fi-tech-boom-20110717).

48. Daniel Terdiman, *Silicon Valley Talent Wars: Engineers, Come Get Your $250K Salary*, CNET (Sept. 22, 2014, 4:00 AM), http://www.cnet.com/news/silicon-valley-talent-wars-engineers-come-get-your-250k-salary/.

First, most companies justify the policy of providing perks on the basis that the perks help employees perform more efficiently.[49] Scientific research seems to support this rationale. Research conducted by psychology experts revealed that social and relaxing activities, such as yoga and cardio-kickboxing, tend to increase creativity.[50] These activities cause a spike in the superior anterior temporal gyrus ("aSTG"), the part of the brain responsible for drawing together distantly-related information.[51] In turn, a spike of aSTG enhances creativity, engagement, and innovation.[52] As a result, engineers who experience this surge can more efficiently perform their job.[53]

On a practical level, the perks simply save employees time, freeing up valuable time that could otherwise be spent working.[54] For example, if the employer provides a barber on office premises, employees would not need to spend time waiting at a salon.[55] Hewlett-Packard, Facebook, Google, and Apple provide doctors and health clinics on campus, thereby saving employees from cutting their workday short to attend an off-site medical appointment.[56] Buses equipped with Wi-Fi allow employees to work during the commute.[57] One study conducted by the University of California, Berkeley,[58]

49. John Waggoner, *Do Happy Workers Mean Higher Company Profits*?, USA TODAY: MONEY (Feb. 20, 2013, 3:32 PM), http://www.usatoday.com/story/money/personalfinance/2013/02/19/ treating-employees-well-stock-price/1839887/.

50. John Kounios & Mark Beeman, *The Aha! Moment: The Neural Basis of Solving Problems with Insight*, THE CREATIVITY POST (Nov. 11, 2011), http://www.creativitypost.com/science/the_aha_moment._the_cognitive_neuroscience_of_insight#sthash.ztgdhNqU.dpuf; *see also* Jonah Lehrer, *How To Be Creative*, WALL ST. J., (Mar. 12, 2012, 6:25 PM), http://www.wsj.com/articles/SB10001424052970203370604577265632205015846.

51. *See supra* note 50.

52. *Id.*

53. Martha Mendoza, *Tech Firms Offering More Perks To Recruit, Retain Talent*, HUFFINGTON POST (Mar. 31, 2013, 10:54 AM), http://www.huffingtonpost.com/2013/03/31/tech-firms-increase-office-perks_n_2988687.html.

54. *Id.*

55. Sherr, *supra* note 2.

56. *Id.*; Zhang, *supra* note 35.

57. Sherr, *supra* note 2.

58. Danielle Dai & David Weinzimmer, *Riding First Class: Impacts of Silicon Valley Shuttles on Commute & Residential Location Choice* (U.C. Berkeley, Working Paper No. UCB-ITS-WP-2014-01, Feb. 2014), http://www.danielledai.com/academic/dai-weinzimmer-shuttles.pdf.

found that ten percent of technology employees surveyed would quit if their employers stopped providing shuttle service to and from the worksite.[59] Paul Saffo, Stanford University lecturer and managing director of Foresight at Discern Analytics stated, "[o]utsiders see these things as an extravagance; the companies see them as a productivity tool."[60]

2. Recruiting and Retaining Talent

Another driving force behind the practice of offering extensive perks is the necessity to attract and retain talent.[61] The perks benefit employers in two stages: when the employer is initially looking for suitable candidates, and when the candidates become employees. During the former stage, the benefit to the employers is fairly straightforward: the perks attract a larger pool of candidates, from which the employer may select qualified employees. As a general rule, more is better. Simply put: If a prospective employee were facing two job opportunities that offered the same salary—all other things being equal—the employee would likely choose the company that offered an additional perk over the other company.

During the latter stage, the employer benefits when the perks give employees a heightened sense of job satisfaction, inducing them to stay with the company. In addition to the obvious need to hold on to talent, employers need to retain employees in order to safeguard company secrets. Because of technological advances and greater employment mobility, employers are becoming increasingly concerned with trade secret misappropriation in the employment arena.[62] In Silicon Valley, trade secret law is particularly important because intellectual property is one of the most valuable assets to technology companies in the area.[63] Companies are concerned about trade secret misappropriation, both during the time an employee is away from the workplace, as well as during the period following an

59. Dai & Weinzimmer, *supra* note 58, at 12.
60. Zhang, *supra* note 35.
61. Mendoza, *supra* note 53.
62. Hanna Bui-Eve, Note, *To Hire or Not to Hire: What Silicon Valley Companies Should Know About Hiring Competitors' Employees*, 48 HASTINGS L.J 981, 993 (1997).
63. Bui-Eve, *supra* note 62.

employee's termination.[64] In the former situation, employers fear that employees could disclose company secrets off campus. Thus, companies often provide perks that encourage shorter breaks and longer hours spent at the office, such as the famous "sleep pods" provided at Google.[65]

In the latter situation, businesses have become more concerned with the prospect of losing their intellectual properties through departing employees.[66] Traditionally, fearing possible disclosure of its technological knowledge, loss of the employee's expertise, and the subsequent loss of its competitive advantage, former employers sue to enjoin the disclosure or use of its trade secrets; alternatively, former employers sue to enjoin the departed employee from assuming similar responsibilities in his new job.[67] However, because covenants not to compete are generally unenforceable in California, employers must rely on these perks to fill this gap.

Furthermore, there is an additional advantage to offering perks over a higher salary or stock options. Paying employees in perks delivers a substantial "amount of utility in the short term, none of which can be saved until later periods."[68] As some scholars suggest, good perks are generally "extravagant and non-fungible"—these types of perks "cannot be easily convertible to cash, as that would enable the employee to save."[69] For instance, paying for an employee's regular haircut is a non-extravagant and fungible perk, because this is an expense that the employee would normally incur anyway; "the employee simply pockets the amount of the transfer in

64. *Id.* at 984.

65. Michael Moran, *Google Has Sleep Pods, Yelp Has Beer—Why Don't We Just Live at Work?*, GUARDIAN (Sept. 11, 2014, 6:57 AM), http://www.theguardian.com/commentisfree/2014/sep/11/google-sleep-pods-yelp-beer-work-leisure-offices; Zoe Mintz, *IRS Plans to Tax Free Meals Silicon Valley Companies Dole Out*, INT'L BUS. TIMES (Sept. 4, 2014, 4:48 PM), http://www.ibtimes.com/irs-plans-tax-free-meals-silicon-valley-companies-dole-out-1679106.

66. *Silicon Valley's No-Poaching Case: The Growing Debate over Employee Mobility*, KNOWLEDGE @ WHARTON (Apr. 30, 2014), http://knowledge.wharton.upenn.edu/article/silicon-valleys-poaching-case-growing-debate-employee-mobility/; Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 577–78 (1999).

67. Bui-Eve, *supra* note 62, at 985–86.

68. M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, 1863–64 (2005).

69. *Id.* at 1874–75.

cash."[70] In contrast, paying for a professional makeover would constitute a good perk, because it involves a luxury that the employee would not normally purchase.[71] These "good perks"—the type that a majority of Silicon Valley technology companies offer—give employees incentives to work harder, but do not allow employees to save for future periods. As a result, they provide an incentive for the employee to remain with the company in order to continue receiving such benefits.[72]

The need to recruit and retain talent is particularly acute when other potentially more effective, cost-efficient methods are impractical or no longer available. For instance, the practice of "acqui-hiring" is one such method that is not available to all companies.[73] "Acqui-hiring" is a "novel and increasingly common tool" by which the large and successful technology companies buy startups in order to satisfy their intense demand for engineering talent.[74] In an "acqui-hiring" transaction, the corporate buyer has little interest in acquiring the startup's projects or assets.[75] Instead, the primary motivation is to hire, by acquisition, the startup's engineers.[76] Thus, the buyer benefits by obtaining the services of engineers and entrepreneurs with expertise in a certain field.[77] Many Silicon Valley giants, including Facebook and Google, are engaging in "acqui-hiring" at a rapid pace.[78] However, smaller companies are priced out of this method because only the larger companies with sufficient capital can afford to execute such complex transactions. Therefore, the vast majority of Silicon Valley companies that wish to stay competitive in the market continue to use the practice of perks to attract and retain talent.

Companies have also attempted, unsuccessfully for the most part, to incorporate noncompete agreements or contracts to prevent

70. Henderson & Spindler, *supra* note 68, at 1874.
71. *Id.* at 1874–75.
72. *Id.* at 1863–64.
73. *See* Coyle & Polsky, *supra* note 1.
74. *Id.* at 281.
75. *Id.*
76. *Id.*
77. *Id.* at 294.
78. *Id.* at 283.

employees from working for competitors.[79] Peter Cappelli, Wharton Management Professor and Director of Wharton's Center for Human Resources, explained that one of the reasons this tactic is unlawful is because no-poaching agreements are unfair to employees.[80] The practice violates both antitrust principles and employment laws.[81] Fundamentally, it "benefits the companies at the expense of their employees."[82] In California particularly, this practice poses a "unique problem" because of the difficulty in enforcing noncompete agreements.[83] Therefore, the better practice in "terms of carrots and sticks" is for companies to make it attractive enough for employees not to leave and also more difficult for them to walk away with intellectual capital.[84]

A third method for recruiting talent which has become unavailable is a practice known as "no-poaching," in which companies conspire to avoid hiring each other's employees.[85] Professor of business economics and public policy at Wharton University, Joseph Harrington, describes the no-poaching agreement as "an unreasonable restraint of trade" and "a violation of Section 1 of the Sherman Antitrust Act of 1890."[86] When companies agree not to compete for each other's employees, the result is that workers receive lower wages because of the lack of competition.[87] This method is likely to have been shut down by a class action lawsuit brought against Apple, Google, Intel, and Adobe Systems that was recently settled.[88] While the companies avoided having to testify in court and risk the public peeking behind the curtain of their strategies, the negative attention and the threat of a lawsuit potentially serves as a deterrent to companies contemplating this method of retaining talent

79. Gilson, *supra* note 66, at 578.
80. *Silicon Valley's No-Poaching Case*, *supra* note 66.
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. Jeff Elder, *Tech Companies Agree to Settle Wage Suit*, WALL ST. J. (Apr. 24, 2014, 6:58 PM), http://www.wsj.com/news/articles/SB10001424052702304788404579522012693196966?mg=reno64-wsj&url=http3A2F2Fonline.wsj.com2Farticle2FSB10001424052702304788404579522012693196966.html.
86. *Silicon Valley's No-Poaching Case*, *supra* note 66.
87. Elder, *supra* note 85.
88. *Silicon Valley's No-Poaching Case*, *supra* note 66.

in the near future.[89] Following this setback, the companies returned to depending on perks as a primary recruitment and retention tool.

In light of the diminishing effectiveness of these tried practices, it seems logical that Silicon Valley companies embrace and commit to a policy of offering lavish employee perks.

B. Do the Benefits Really Fulfill Their Intended Purpose?

Proponents argue that statistical data supports a robust policy of providing employee perks.[90] One of the ways to determine whether employee perks actually fulfill their purpose is to measure return on investment ("ROI").[91] ROI is a commonly used performance measure that evaluates the efficiency of an investment or compares the efficiency of a number of different investments.[92] To calculate ROI, the benefit of an investment is divided by the cost of the investment.[93] According to Incentive Magazine, Fortune's "100 Best Companies to Work For" that offer "carefully crafted employee benefits package[s]" have reported a 10.6 percent annual return since 1998.[94] On the contrary, "companies with 40 percent or less employee engagement had a total shareholder return that was 44 percent lower than average."[95] Companies with more engaged employees produce twenty-nine percent more revenue on average, report a higher average customer loyalty, and boast higher retention rates of approximately forty-four percent.[96]

Another rationale propelled by Silicon Valley employers is that perks lead to employee satisfaction, and thus retention. Arguably, there is a direct correlation between happy employees and higher

89. *Silicon Valley's No-Poaching Case*, *supra* note 66.

90. John Feldmann, *Do Employee Perks Translate Into Employer ROI?*, UNDERCOVER RECRUITER, http://theundercoverrecruiter.com/employee-perks-translate-employer-roi/ (last visited Oct. 2, 2015).

91. *Id.*

92. *Return on Investment (ROI)*, ENTREPRENEUR: SMALL BUS. ENCYCLOPEDIA, http://www.entrepreneur.com/encyclopedia/return-on-investment-roi (last visited Oct. 2, 2015).

93. *Id.*

94. Bruce Shutan, *The Power of Perks*, INCENTIVE MAG. (Mar. 18, 2013), http://www.incentivemag.com/Strategy/Engagement/The-Power-of-Perks/.

95. Feldmann, *supra* note 90.

96. *Id.*

company profits, which in turn benefits shareholders. For example, Google, notorious for the assortment of perks it provides for its employees, has seen its stock soar 674 percent since the company began using perks in August 2004.[97] The simple reasoning that people enjoy the benefits of perks is not the only argument for which companies treat employees well.[98] Employers who endorse the policy refer to data, which strongly supports the "fact that organizations that focus on the engagement of their employees deliver stronger performance."[99] While the policy directly affects employee happiness, the policy is founded on sensible business strategies.[100] This business strategy involves providing employees with a sense of "engagement," which in turn results in higher productivity, lower turnover rates, cost savings, and an earnest desire to work for the good of the company.[101]

Slater Tow, a Facebook spokesperson, said the company was not trying to be New Age, but simply strategic. "We don't want to give aromatherapy for your dog," he said, "[w]e want things that are functional for you and your family."[102] Google's co-founders Larry Page and Sergey Brin expressed similar sentiments in their IPO letter: "We believe it is easy to be penny wise and pound foolish with respect to benefits that can save employees considerable time and improve their health and productivity." And that employees and shareholders alike should "[e]xpect [Google] to add benefits rather than pare them down over time."[103] These statements presume that the benefits are fulfilling their intended purposes.

To the extent that lavish employee perks recruit and retain talent and prevent the disclosure of proprietary information, the perks provide value to the companies, and consequently, corporate shareholders. However, the increasingly extravagant nature of employee perks begs the question of whether such perks are

97. Waggoner, *supra* note 49.
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*
102. Richtel, *supra* note 19.
103. *2004 Founders' IPO Letter*, GOOGLE INVESTOR RELATIONS (Aug. 18, 2004), https://investor.google.com/corporate/2004/ipo-founders-letter.html.

functional and optimal, or simply a waste of corporate resources.[104] Sophie Kitson, Vice President of Talent, People + Vibe at PagerDuty, insists that "the tech boom won't be here forever" and eventually employers "will regret inflating perks and salaries as the way to engage" employees.[105] As an immediate result, the immense competition and density of employers in the Silicon Valley could lead to retention problems.[106] Employees are "constantly tempted to jump employers, even if only to consistently bump up their compensation."[107]

C. THE EFFECT OF IMPENDING TAX LAW CHANGES

Even assuming that the perks are currently fulfilling their stated purposes, impending changes in tax law should concern shareholders with respect to corporate governance. Recruiters report that the difference in perk value may be as much as twenty percent above an employee's salary.[108] Thus, a software engineer at Facebook, Twitter, or Google who earns approximately $120,000 a year in salary on paper actually receives up to an additional $24,000 in benefits.[109] However, these additional benefits are not reflected in the employee's paycheck. These perks are not technically free, but rather an alternative to paying higher wages.[110] Under the current system, neither the company nor the employee is shouldering any taxes on the majority of employee perks.[111]

Economic policy expert John C. Goodman described the business rationale underlying the practice of providing extensive

104. Sophie Kitson, *Perks Don't Work,* TECHCRUNCH (Dec. 11, 2014), http://techcrunch.co m /2014/12/11/perks-dont-work.

105. Kitson, *supra* note 104.

106. *See* Ed Nathanson, *A Tale of Two Coasts: How Companies Compete for Talent in Boston vs. Silicon Valley* (Jan. 7, 2015), http://talent.linkedin.com/blog/index.php/2015/01/a-tale-of-two-coasts-how-companies-compete-for-talent-in-boston-vs-silicon-valley. Massachusetts-based CloudLock CEO Gil Zimmerman postulates that employer density and competition in Silicon Valley causes employees to leave businesses in search of greater compensation elsewhere.

107. *Id.*

108. Sherr, *supra* note 2.

109. *Id.*

110. *Id.*

111. *Id.*

perks, from an economic perspective.[112] Using the 2012 tax rates, Goodman explains how the perks make mathematical, and logical, sense to employers. Taking into account the highest marginal tax rate for the federal income tax of thirty-five percent, the 2.9 percent Medicare tax, and the maximum 9.3 percent state income tax, an individual in California would face a highest marginal tax rate of 47.2 percent.[113] Californians with a median income face high marginal tax rates, because a 9.3 percent rate is applied to those with less than $100,000 annual income.[114] For a Californian in the twenty-five percent federal income tax bracket, facing a 15.3 percent (Federal Insurance Contributions Act) payroll tax and a 9.3 percent California income tax, the combined marginal tax rate reaches almost fifty percent.[115] Consequently, both the individual and the employer are incentivized to spend up to forty-nine cents to avoid a dollar of income.[116] Under this logic, California employers are presuming that employees would choose to receive a dollar's worth of goods and services in-kind rather than fifty-one cents in cash.[117] Thus, even if the benefit is worth half its cost, it would still "be a good deal for the employees."[118] This is the combined effect of the progressive tax system and the fact that neither employers nor employees are paying taxes on these perks.

This pattern is an outgrowth of the Internal Revenue Code § 132, which governs de minimis fringe benefits.[119] De minimis fringe benefits are defined as "any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to their employees) so small as to make accounting for it unreasonable or administratively impracticable."[120] The Treasury Department provides a few examples of excludable benefits: personal use of the copying machine; occasional theater or

112. Goodman, *supra* note 17.
113. *Id.* (These tax rates are current through the writing of the article in 2012).
114. *Id.*
115. *Id.* (These tax rates are current through the writing of the artice in 2012).
116. *Id.*
117. *Id.*
118. *Id.*
119. Sherr, *supra* note 2.
120. 26 U.S.C. § 132(e)(1) (2013). For a detailed argument explaining why free meals provided by employers should be taxed, *see* Lomax, *supra* note 4.

sporting event tickets; occasional parties or group meals; holiday gifts of property; coffee, donuts, and soft drinks; and other similar incidentals.[121] It also provides instances of non-excludable fringe benefits, such as season tickets, country club or gym memberships, and use of corporate recreation facilities like hunting lodges or boats.[122] Whether a benefit is de minimis often turns on the frequency with which the employee receives the benefit.[123] A taxpayer must measure the frequency of the benefit in one of two ways. Primarily, frequency depends on how often an individual employee receives a particular benefit, rather than how often the total workforce receives a particular benefit.[124] If it is difficult to determine how often an individual employee receives a benefit, then the taxpayer can determine frequency based on how much the employer provides the benefit to the entire workforce.[125] These regulations indicate that receiving a daily benefit likely does not constitute de minimis fringe benefit.[126]

However, the extensive benefits that technology companies are giving their employees are eliciting questions about "who foots the bill for the perks."[127] In particular, these lavish benefits have attracted the attention of the IRS. A recent *Wall Street Journal* report reveals that the IRS could be targeting these fringe benefits, more specifically "employer-provided meals," for the next fiscal year.[128] In the agency's recently released Priority Guidance Plan for

121. *See* 26 C.F.R. § 1.132-6(e)(1) (2013) (listing these examples and others that are excludable under I.R.C. § 132).

122. *Id.*

123. *See* 26 U.S.C. § 132(e)(1) (2012) (noting that the taxpayers must account for the frequency they receive the benefit in question when determining that benefit's value).

124. *See* 26 C.F.R. § 1.132-6(b)(1) (noting that this "employee-measured" way of determining frequency does not allow an employee to exclude a benefit provided infrequently to the entire workforce if he receives that benefit every day).

125. *See* 26 C.F.R. § 1.132-6(b)(2) (stating the individual frequency is not important in circumstances when it is difficult to measure).

126. Several scholars have argued that perks such as free meals do not constitute de minimis fringe benefits, and thus should be taxed by the IRS. *See generally* Lomax, *supra* note 4, at 2090 (citing Treas. Reg. § 1.132-6(b)(1) ("For example, if an employer provides a free meal in-kind to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee")).

127. Erik Sherman, *Who Pays for Employee Perks at High-Tech Companies?*, CBS MONEYWATCH (Nov. 24, 2014, 12:32 PM), http://www.cbsnews.com/news/who-pays-for-perks-at-high-tech-companies/.

128. Maremont, *supra* note 5.

2014 to 2015, the IRS states that the free meals will now be considered a taxable fringe benefit, receiving the same treatment as that of a company car or phone.[129] As a result, employees who receive two meals a day, courtesy of their company, could be obligated to pay an additional $4,000 to $5,000 in taxes.[130]

One driving force behind the IRS's newfound attention is that taxpayers are beginning to realize and decry the consequences of these employee perks. The current tax policies regarding employer-provided perks benefit companies at the expense of public taxpayers.[131] If companies are not required to pay taxes for the meals, there will be fewer tax dollars to pay for government services and other programs.[132] Therefore, in a sense, taxpayers are subsidizing free cafeteria meals for some of the most profitable companies in the nation, which happen to be centrally located in one geographical area.[133]

Similarly, residents have expressed resentment towards shuttles transporting employees to and from San Francisco, a prime location where most Silicon Valley technology employees have chosen to live.[134] Many shuttle stops are located at public bus stops, and the shuttles occasionally impede access to public vehicles or block bicycles and auto traffic.[135] Residents have also raised complaints about noise and vibrations from shuttles, particularly on residential streets.[136] Moreover, there is anecdotal evidence that some technology employees choose to live close to shuttle stops, causing real estate prices to rise further and gentrify portions of San Francisco.[137] While perks such as these shuttle buses benefit Silicon

129. *See generally* Lomax, *supra* note 4, at 2090.

130. Mark Maremont, *Silicon Valley's Mouthwatering Tax Break*, WALL ST. J. (Apr. 7, 2013, 7:03 PM), http://www.wsj.com/articles/SB10001424127887324050304578408461566171752.

131. Kim Peterson, *IRS Says No to Free Silicon Valley Meals*, CBS NEWS (Sept. 3, 2014, 7:27 AM), http://www.cbsnews.com/news/irs-says-no-to-free-silicon-valley-meals/.

132. *Id.*

133. *Id.*

134. Neal J. Riley, *Supervisor Wants Rules for Shuttle Stops*, S.F. CHRON. (Oct. 25, 2012, 5:21 PM), http://www.sfgate.com/bayarea/article/Supervisor-wants-rules-for-shuttle-stops-3982606.php.

135. *Id.*

136. S.F. CNTY. TRANSP. AUTH., STRATEGIC ANALYSIS REPORT: THE ROLE OF SHUTTLE SERVICES IN SAN FRANCISCO'S TRANSPORTATION SYSTEM 5 (2011).

137. Rory Carroll, *Geek-Driven Gentrification Threatens San Francisco's Bohemian Appeal*, GUARDIAN (Mar. 5, 2013, 12:15 PM), http://www.theguardian.com/world/2013/mar/

Valley employees and employers,[138] they are beginning to impact third parties as well.

If the IRS makes good on its promise to begin taxing employee perks and Silicon Valley continues to offer these "expected" perks, the money spent will ultimately come out of shareholder value.[139] This becomes particularly problematic when a company that succumbed to pressure of offering generous perks suddenly begins to struggle. For example, Zynga, a social gaming company, used to serve employees fancy lunches and dinners every day.[140] However, as some of Zynga's former titles have begun to decline in popularity, the company's shares in turn have fallen eighty percent since 2012.[141] Unsurprisingly, Zynga cut back on certain perks, including ending haircuts to employees in early 2014.[142] However, regardless of whether Silicon Valley companies may continue providing perks under the current scheme, shareholders may still have a vested interest in examining employee perks more closely from a corporate governance perspective.

IV. AN INADEQUATE SYSTEM OF MEASURING THE VALUE OF PERKS

Even without the changes in tax law, shareholders face a considerable challenge in approaching the issue of employee perks: a deficient system in measuring the benefit the employee is receiving, and consequently, shareholder value. The practice of providing perks is premised on the theory that employees are receiving a benefit, and that benefit is what drives an employee's motivation, efficiency, productivity, or desire to stay at the employee's respective job. As

05/san-francisco-geek-gentrification-threatens; Miguel Helft, *Google's Buses Help its Workers Beat the Rush*, N.Y. TIMES (Mar. 10, 2007), http://www.nytimes.com/2007/03/10/technology/10google.html; Kevin Roose, *The Commuter Kings: Riding Along on Silicon Valley's Exclusive Shuttles*, N.Y. MAG. (Dec. 26, 2012, 10:54 AM), http://nymag.com/daily/intelligencer/2012/12/silicon-valleys-exclusive-shuttles.html; Jenny Pisillo, *Paying More to Be Near a Company Shuttle Stop*, SFGATE (Mar. 9, 2012, 9:30 AM), http://blog.sfgate.com/ontheblock/2012/03/19/paying-more-to-be-near-a-company-shuttle-stop/.

138. *See* Sherr, *supra* note 2.

139. Sherman, *supra* note 127.

140. *Id.*

141. *Id.*

142. *Id.*

Professor Jay Soled points out, receipt of in-kind benefits is profoundly difficult to value.[143] For example, how does one measure the value of a private helicopter ride with the CEO of the company?[144] When employees receive in-kind benefits, their consumption choices are typically constrained.[145] Consequently, a tax on the fair market value of the benefits the employee receives is improper.[146] Nevertheless, there is little doubt that those individuals who actually consume the benefit have experienced "a taxable accretion to wealth."[147] What emerges from this scheme is a "riddle" about just how much one has benefitted, and how to accurately measure the value of that benefit.[148]

A system of providing in-kind perks makes calculating employee compensation more complex. Under the traditional structure of compensation, employees are compensated in cash, with benefits such as health care standardized for the most part. Accordingly, shareholders would be able to access a reliable and transparent system of measuring employee compensation. Conversely, in-kind perks are not consumed by all employees, and for the ones who do benefit, it is difficult to measure the level of consumption. For example, engineers in a company may all have access to free cardio-kickboxing classes. One engineer may take advantage of this perk and attend every evening class available. In this scenario, the employee has received something of value that gives them motivation to work harder and the employer has benefitted from having a more satisfied and productive employee.[149] However, another engineer tries a class out, and decides to never come back. In this alternative situation, the employer has expended financial resources to fund the perk, but neither the employee nor the employer benefits from it. This is the complexity involved in

143. While Professor Soled's article discusses in-kind benefits in general, his arguments are equally applicable in the context of employer-provided perks. *See* Jay A. Soled, *Surrogate Taxation and the Second-Best Answer to the In-Kind Benefit Valuation Riddle*, 2012 BYU L. REV. 153, 158 (2012).

144. *See* Sherr, *supra* note 2.

145. Soled, *supra* note 143, at 154.

146. *Id.*

147. *Id.* at 154–55.

148. *Id.* at 155.

149. *See generally supra* note 49.

measuring the value of perks. From a corporate governance standpoint, this lack of transparency poses a threat to a healthy balancing of interests between shareholders and management.

A. PERKS LARGELY UNADDRESSED BY THE LAW

Shareholders may be upset that excessive perks have undervalued their share value. In addition to being crippled by an inadequate system of measuring the value of perks, shareholders are not afforded any meaningful legal recourse under the current state of the law. Several scholars have recognized that permitting this type of "value diversion" imposes a cost on shareholders that potentially reduces share value.[150] Assuming that shareholders perceive the costs of these perks as substantially outweighing their benefits, what legal remedies might shareholders employ to effect the change they desire?[151] The most applicable avenue to pursue is to file a derivative suit challenging the lavish perks as a waste of corporate assets, but the hurdles shareholders must jump through make this option virtually a nonoption.[152]

As part of the duty of care, directors have an obligation not to waste corporate assets by overpaying for property or employment services.[153] Corporate waste occurs when a corporation is caused to effect a transaction on terms that no person of ordinary and sound business judgment could conclude represents a fair exchange.[154] To succeed on a corporate waste claim, a shareholder plaintiff must prove that no such person could even "entertain the view that [the transaction under attack] represented a fair exchange."[155] Thus, for

150. Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487, 501 (1999).

151. *See* Michael J. Biles & Kimberly G. Davis, *Keeping Current: Corporate Compensation*, ABA BUS. LAW SECTION (2009), http://www.americanbar.org/content/dam/aba/publications/blt/2009/09/keeping-current-compensation-200909.authcheckdam.pdf.

152. While recent lawsuits demonstrate an emerging trend of shareholder plaintiffs raising allegations that directors' pay is excessive, less attention has been given to perks given to the average employee. *See Two Lawsuits Brought Over Alleged Excessive Director Compensation*, MERIDIAN COMP. PARTNERS (Aug. 19, 2014), http://www.meridiancp.com/insights/thought-leadership/two-lawsuits-brought-over-alleged-excessive-director-compensation/.

153. Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962).

154. *Id.*

155. Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962).

liability to exist, the defendants must have approved a transaction exchanging something of value for consideration so inadequate that "no person of ordinary, sound business judgment would deem it worth what the corporation has paid."[156] If, under the circumstances, any reasonable person might conclude that the deal made sense, then the judicial inquiry ends.

Because directors are presumed to have acted properly, the business judgment rule places the burden on the "party challenging the [board's] decision to establish facts rebutting the presumption."[157] If a shareholder plaintiff fails to meet this burden, the business judgment rule functions to protect the decisions that the officers and directors made in the course of their duties.[158] If, however, a plaintiff successfully establishes facts rebutting the rule's presumptions, "the burden shifts to the defendant directors to prove the 'entire fairness' of the transaction."[159]

The business judgment rule is a high hurdle, one that is very rarely satisfied by a shareholder plaintiff. For the most part, courts view that a finding of waste is appropriate only in "unconscionable cases" where the directors "irrationally squander or give away corporate assets."[160] The difficulty of this test reflects the law's understanding of what rules will help promote productive economic activity. If courts were permitted more freely to "second guess" business decisions, officers and directors will be less inclined to approve risky transactions.[161]

Corporate waste allegations have been lodged regarding compensation of senior officers and directors with varying degrees of success. *In re Walt Disney Co. Derivative Litigation* is one of the most prominent cases involving such corporate waste allegations.[162] In 2005, shareholders of the Walt Disney Company filed a lawsuit alleging waste and breach of fiduciary duty claims against the

156. *Id.*; *see also* Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979).
157. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).
158. Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001).
159. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); *see also* Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003) ("[W]hen the presumption of the business judgment rule has been rebutted, the entire fairness rule is implicated and defendants bear the burden of proof.").
160. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).
161. Steiner v. Meyerson, No. 13139, at *1 (Del. Ch. July 19, 1995).
162. *See In re* Walt Disney Co. Derivative Litig., et al., 906 A.2d 27 (Del. 2006).

directors.[163] The shareholder plaintiffs claimed that the $130-million exit package that executive president and director Michael Ovitz received after just fourteen months of work constituted waste.[164] After a thirty-seven-day trial before the Chancery Court, the shareholder plaintiffs did not prevail because they could not rebut the presumption of the business judgment rule.[165] The trial court found that a large severance package alone is not enough to show a lack of due care or to constitute waste. The Delaware Supreme Court affirmed the decision.[166] While the shareholders did not ultimately prevail, the fact that the corporate waste allegations survived through trial demonstrates two important points: excessive benefits is a cause of alarm to shareholders, and the courts are prepared to confront corporate waste claims.

Similarly, in 2009, a Delaware Chancery Court upheld a claim brought derivatively by shareholders for waste, where Citigroup awarded its outgoing CEO a retirement package worth $68 million.[167] Shareholder plaintiffs alleged that the multimillion-dollar compensation constituted waste because the departing CEO was allegedly responsible for the loss of billions of dollars to the company.[168] The court permitted the plaintiffs' suit to move forward because the complaint contained well-pleaded factual allegations regarding the claim for waste. The court's decision and this initial victory for shareholders "signaled that large executive compensation packages paid by corporations that lose money may not survive corporate waste analysis."[169]

Despite the attention given to executive compensation, employee compensation largely remains within the realm of the business judgment rule. While it might be good policy for judges to err on not questioning a company's compensation of its executives, which

163. *Id.* at 697.
164. *Id.*
165. *Id.* at 748.
166. *See supra* note 162, at 28 (Del. 2006).
167. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 138 (Del. Ch. 2009).
168. *Id.*
169. Herbert F. Kozlov et al., *In Re Citigroup: Delware Court of Chancery Allows Claim for Corporate Waste Based on Executive Compensation to Proceed, But Dismisses "Hindsight" Fiduciary Duty Claims*, REED SMITH: CORPORATE ALERT (2009), http://www.reedsmith.com/files/Publication/217a3b75-30a4-40d5-b38b-b6967113eaf8/Presentation/PublicationAttachment/119c3ebf-553c-4453-aa74-2359c58e4fa2/alert09077.pdf.

involves only a handful of individuals in a corporation, is the same policy sensible when applied to employee perks? There is an important distinction between executive compensation and employee perks: the sheer volume of people involved is drastically different. For example, Google had 43,862 employees in 2013.[170] In contrast, its executive and senior leadership is comprised of only twenty members.[171]

To have a chance of success, or even a partial victory as in the case of Citigroup shareholders,[172] shareholders would have to persuade the court on one important point: The business judgment rule should be applied on a national context as opposed to a localized or industry standard.[173] That is, the decisions that directors make regarding employee perks should be compared to the decisions of all other employers in the nation, and not only to the technology companies in Silicon Valley.

It is difficult, if not impossible, for a court to consider the business judgment of a company's directors in a vacuum. The court must examine that company's decisions relative to the decisions of other companies. The question then becomes: what is the composition of this other group? Potentially, this other group might comprise of similarly situated companies: technology companies located in Silicon Valley. However, beyond their similar industrial classification and shared geographical location, the underlying rationale for the policy of providing perks remains the same. Logically, all companies strive to recruit and retain talented employees, so what makes the technology industry so different that they feel the need to set a new industry standard?

There is no reason why technology companies in Silicon Valley should be treated any differently than the rest of the nation. These companies have been characterized as "outliers" in terms of the

170. *2015 Financial Tables*, GOOGLE INVESTOR RELATIONS, https://investor.google.com/financial/tables.html (last visited Oct. 2, 2015).

171. *Management Team*, GOOGLE COMPANY, http://www.google.com/about/company/facts/management/#sectio-leadership (last visited Oct. 2, 2015).

172. *Supra* note 167, at 106.

173. In addition to this point, shareholders will still be bound by the standard requirements for bringing a corporate waste claim. Shareholders will have to be very specific on their allegations, rather than general claims, and provide concrete evidence. *See surpa* note *156,* at 223; Aronson v. Lewis, 473 A.2d 805 (Del. Ch. 1984).

benefits to provide to employees.[174] They are known to experiment with the types of perks they provide. But to what extent does deviating from the norm get rewarded, or exempted from the responsibilities of the rest of their peers? In fact, new developments in benefits in other parts of the economy reflect a trend going in the opposite direction.[175] Generally, employee benefits provided by companies located elsewhere in the United States do not resemble those provided in Silicon Valley.[176] Employers are increasingly cutting back on benefits, such as retirement plans and health care, which used to be a standard component of a full-time employment package.[177] According to the Employee Benefit Research Institute, the percentage of workers with a retirement plan from their employer dropped from forty-seven percent in 1992 to below thirty-five percent a decade later.[178] Additionally, between the year 2000 and 2010, the percentage of employees with employer provided health benefits had dropped by ten percent, and has continued to decline since then.[179]

Ultimately, this data suggests that technology companies in Silicon Valley are offering more perks, in terms of type, scale, and value. At present, more might be better for some employees. However, companies should consider other important factors, including tax consequences,[180] shareholder value,[181] and industry practices.[182] Once these factors are taken into account, the benefits of a practice of offering extensive perks become less apparent. Should shareholders wish to pursue legal recourse as a consequence, the current legal framework is ineffective.

174. Christina Farr, *Silicon Valley Takes Benefits "Arms Race" to Health Care*, REUTERS (Oct. 2, 2014, 7:00 AM), http://www.reuters.com/article/2014/10/02/tech-benefits-idUSL2N0RO28D20141002 (quoting Jennifer Benz, Chief Executive of Benz Consulting).

175. Peter Cappelli, *Google Adds Benefits, Walmart Cuts Them; Oddly, the Logic Is the Same*, HARV. BUS. REV. (Nov. 7, 2014), https://hbr.org/2014/11/google-adds-benefits-walmart-cuts-them-oddly-the-logic-is-the-same.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. Goodman, *supra* note 17.

181. Bebchuk & Jolls, *supra* note 150, at 501.

182. Cappelli, *supra* note 175.

B. Increased Transparency as an Interim Solution

Against this legal landscape, shareholders could move towards progress by requesting increased transparency about the in-kind perks Silicon Valley companies provide to employees. Here, shareholders should take inspiration from the executive compensation context, discussed previously relating to the business judgment rule.[183] There are substantial parallels between executive compensation and employee perks. For one, the impetus behind introducing legislation is similar: in the former context, the concern that executive pay has grown to be increasingly excessive,[184] and in the latter, the concern that perks have become extravagant. In both situations, this excessiveness has led to increased publicity, public outcries, and concerns from corporate shareholders. And in terms of shared objectives, both situations call for increased transparency for the benefit of shareholders.

There are two specific aspects of executive compensation that should provide guidance on implementing legislation that would increase transparency on employee perks: the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[185] and state laws governing corporate accounting.[186]

First, the Dodd-Frank Act mandates shareholder advisory voting for executive compensation in public corporations.[187] This vote, known as "say-on-pay," enables shareholders to provide input on the size and nature of executive compensation packages. Under the statute, at least "once every [three] years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require

183. *See supra*, note 163 (discussing the litigation involving corporate waste allegations against directors for allegedly excessive executive compensation).

184. *See* Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 690 (2010) (stating that the issue of excessive compensation in the U.S. arose first during the 1930s).

185. Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78n-1 (2010).

186. *See* Michael J. Biles & Kimberly G. Davis, *Corporate Compensation*, BUS. L. TODAY (A.B.A. Bus. L. Section: Keeping Current), http://www.americanbar.org/content/dam/aba/publications/blt/2009/09/keeping-current-compensation-200909.authcheckdam.pdf (last visited Oct. 29, 2015).

187. Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 185.

compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives."[188] Say-on-pay applies to the company's CEO as well as executives named in the company's proxy compensation table.[189]

The Dodd-Frank Act is instructive because it is a manifestation of shareholders' active efforts to demand increased transparency when corporate waste becomes a concern. It not only sends the message to corporate officers and directors that shareholders perceive a potential problem, but that shareholders will act to address the problem at the legislative level. Indeed, the passage of the Dodd-Frank Act and its continued presence in corporate law indicates that shareholders' will enjoy a degree of success in demanding increased transparency.[190] As a result, management may be more responsive to shareholders' calls for change.

It is important to note, however, that the limited nature of employee perks in the Silicon Valley region pales in comparison to the widespread growth of executive compensation throughout the nation. Employee perks is a unique phenomenon concentrated mainly in Silicon Valley. Thus, in requesting transparency for employee perks in Silicon Valley technology companies, shareholders should be mindful that national legislation like the Dodd-Frank Act may be difficult to achieve, and progressive change on a smaller scale, perhaps at the state level, may be the most progressive approach. This is where state corporate laws provide guidance.

Under some state corporation laws, shareholders may pursue change in a company's executive compensation structure by filing a "books and records" request.[191] This type of request allows shareholders, under certain circumstances, to inspect a company's

188. Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 185.

189. Sharholder Approval of Executive Compensation, Frequency of Votes for Approval of Executive Compensation and Shareholder Approval of Golden Parachute Compensation, 17 C.F.R. § 240.14a-21(a) (2011).

190. Though the Dodd-Frank Act may have addressed some of the concerns expressed by shareholders, its effectiveness continues to be debated. *See generally* Eric C. Chaffee, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: A Failed Vision for Increasing Consumer Protection and Heightening Corporate Responsibility in International Financial Transactions*, 60 AM. U. L. REV. 1431 (2011); *see generally* Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731 (2013).

191. *See* Biles & Davis, *supra* note 186.

records.[192] For example, under Delaware General Corporations Law, a shareholder of a Delaware corporation has a statutory right to inspect the books and records of the corporation.[193] To exercise this right, the shareholder must satisfy form and manner requirements and have a proper purpose for the inspection. A "proper purpose" is defined as any purpose "reasonably related to such person's interest as a stockholder."[194] California's Corporations Code sets forth a similar minimum level of information that shareholders may access. Under section 1601, "[t]he accounting books and records and minutes of proceedings of the shareholders and the board and committees of the board . . . shall be open to inspection upon the written demand on the corporation of any shareholder . . . for a purpose reasonably related to the holder's interest as a shareholder."[195]

As with the Dodd-Frank Act, a right to access the "books and records" of a company has its shortcomings. Executive officers and directors may be reluctant to hand the documents over.[196] Shareholders may be forced to resort to filing a motion with the court. In 2009, a shareholder at Chesapeake Energy in Oklahoma did just that, after the company's directors awarded a $75-million bonus to its chief executive even as the company's stock plummeted.[197] Additionally, a filing with a court does not guarantee a right of inspection. A court may deny a request altogether "if the corporation can show that the request is adverse to the interests of the corporation, or if it would unreasonably burden the corporation."[198] Additionally, a "books and records" request can provide access to information, but does not ensure that a shareholder's concerns subsequent to the inspection will be acknowledged. The burden will fall to the shareholder to press for accountability and change.

192. *Id.*

193. DEL. CODE ANN. tit. 8, § 220 (West 2010).

194. *Supra* note 193.

195. CAL. CORP. CODE § 1601 (West 1977).

196. Jerry Burleson, *Shareholder Demand for Inspection of Records in California under Corporation Code § 1601*, JERRY BURLESON, http://www.jerryburleson.com/shareholder-rights/shareholder-demand-for-inspection-of-records-in-california-under-corporation-code-§1601/ (stating that requests to inspect corporate records may trigger corporate defensive interests) (last visited Oct. 29, 2015).

197. Gretchen Morgenson, *Shareholders Who Act Like Owners*, N.Y. TIMES (Mar. 28, 2009), http://www.nytimes.com/2009/03/29/business/29gret.html?_r=0.

198. Burleson, *supra* note 196.

Taking into account the advantages and shortcomings of the Dodd-Frank Act and the relevant corporations laws intended to increase transparency, shareholders can begin to craft legislation that will directly address concerns involving excessive employee perks. By leveraging this information in conjunction with a broad understanding of the corporate waste doctrine and the business judgment rule, shareholders will be able to adeptly shape the precise contours of effective legislation.

V. CONCLUSION

As the practice of providing employee perks climbs at an alarming rate, the need to pause and consider the practical and legal ramifications intensifies. While Silicon Valley technology companies have enjoyed economic advantages from this practice to date, corporate management and shareholders alike should take notice of impending changes in tax law relating to these perks. Shareholders will consequently see the challenges in measuring how the receipt of in-kind perks contributes to an employee's work performance. Shareholders who wish to challenge this practice will similarly realize that the corporate legal framework provides no effective means of recourse.

The technology sector in California is booming in a way not seen since the dot-com bubble,[199] and it is important for shareholders to prepare for changes in both the law and the economy. As shareholders should realize, employee perks—like executive compensation—can become a liability, if not kept in check.[200] Silicon Valley technology companies, as leading innovators, should proceed with caution rather than falling to peer pressure in an arms race. This Note seeks to foster a conversation regarding the long-term consequences of this practice in order to prepare companies and shareholders for impending changes in the law, so that all stakeholders can adequately protect their interests.

199. Paul Sebastien, *Silicon Valley's Maturity Problem*, RE/CODE (Apr. 21, 2015, 7:00 AM PDT), http://recode.net/2015/04/21/silicon-valleys-maturity-problem/.

200. Matt O'Brien, *What the Boss Makes: CEO Pay Getting More Ire from Shareholders*, SAN JOSE MERCURY NEWS, http://www.mercurynews.com/business/ci_28568465/what-boss-makes-ceo-pay-getting-more-ire (last visited Oct. 29, 2015).