Fraud in Crowdfunding and Antifraud Insurance

Timothy Li
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Abstract

The SEC should require crowdfunding issuers under the Jumpstart Our Business Startups Act to obtain private insurance against liability based on Section 4A(c) of the Securities Act, using a model of Directors & Officers’ liability insurance. Antifraud concerns could be a major reason for SEC holdup on crowdfunding rulemaking because the SEC must balance investor protection against the costs of disclosure. To address these concerns, a private insurance model could spread the costs of fraud in crowdfunding across the issuers by using the market to determine the “present value of shareholder litigation risk” for that issuer. The maximum recovery would be capped by the amount of the crowdfunding offering, and any recovery under the proposed insurance plan would require proof of a cause of action under Section 4A(c).

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Introduction

On August 3, 1999, the Securities and Exchange Commission (“SEC”) announced twenty-six enforcement actions against eighty-two defendants for defrauding investors out of more than $12 million. These enforcement actions were only a few out of multiple enforcement actions against “fraudulent secondary transactions in the over-the-counter markets of ‘microcap’ companies” throughout the late 1990s. Microcap companies are typically “thinly capitalized” companies that do not file periodic reports with the SEC. Many of the enforcement actions involved “freely tradable securities issued in Rule 504 offerings.” Rule 504 is a rule that the SEC promulgated in 1982 as a “limited offering exemption designed to aid small businesses raising ‘seed capital,’” in response to a mandate from Congress to expand access to capital for small businesses under the Small Business Investment Incentive Act of 1980 (“SBIIA”). Rule 504 caps the maximum aggregate offering price to $1 million over any 12-month period.

One problem with Rule 504, however, was that it allowed a nonreporting issuer to engage in general solicitation and advertising. Under Rule 504, a nonreporting issuer could “offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information.” This ability allowed broker-
dealers'\textsuperscript{11} to engage in fraudulent pump-and-dump schemes “to sell the securities at ever-increasing prices to unknowing investors.”\textsuperscript{12} In response to these schemes, the SEC “modified Rule 504 to limit the circumstances where general solicitation [was] permitted.”\textsuperscript{13} Rule 504 securities can now only be sold to accredited investors, unless the securities are registered under state law with a public filing and a disclosure document.\textsuperscript{14} The limits thus scaled back the ability of broker-dealers to engage in general solicitation and advertising to unsophisticated investors.

Thirteen years later, in 2012, Congress again directed the SEC to expand access to capital for small businesses through the Jumpstart Our Business Startups ("Jobs") Act,\textsuperscript{15} which created a new crowdfunding exemption for small businesses to raise up to $1 million. According to Professor Thomas Hazen, the Jobs Act revisits the same issues that the SEC faced following the SBIIA, including balancing access to capital for small businesses against disclosures necessary to protect unsophisticated investors.\textsuperscript{16} Professor Hazen argues that securities class action attorneys lack the incentive to file suit because the maximum loss to investors is $1 million.\textsuperscript{17} Professor Alan Palmiter further argues that SEC enforcement can cover only the most “egregious cases” of fraud because of limited agency resources.\textsuperscript{18} Professor Palmiter suggests that a private insurance model could be a solution to these issues, but does not explain how it would work.\textsuperscript{19}

This Essay proposes that the SEC adopt a private insurance model to help reduce the impact of fraud in crowdfunding, in which the cost of fraud is set by the market and spread

\begin{itemize}
\item \textsuperscript{12} Revision of Rule 504 of Regulation D, The “Seed Capital” Exemption, \textit{supra} note 2.
\item \textsuperscript{13} \textit{Id.}
\item \textsuperscript{14} \textit{Id.} Accredited investors are those with significant financial wealth or sophistication. \textit{See} 17 C.F.R. § 230.501.
\item \textsuperscript{16} Thomas Lee Hazen, \textit{Crowdfunding or Fraudfinding? Social Networks and Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure}, 90 N.C. L. REV. 1735, 1737, 1763 (2012) (arguing that disclosures can “encourage small business financing without unduly sacrificing investor protection”).
\item \textsuperscript{17} \textit{Id.} at 1759.
\item \textsuperscript{18} Alan R. Palmiter, \textit{Pricing Disclosure: Crowdfunding’s Curious Conundrum}, 7 OHIO ST. ENTREPRENEURAL BUS. L.J. 373, 375 (2012).
\item \textsuperscript{19} \textit{Id.} at 426 ("A system of private insurance . . . may be a solution")
\end{itemize}
across the issuers. The Essay proceeds in three parts: Part I introduces crowdfunding, Part II proposes private antifraud insurance and discusses the SEC’s authority to require the insurance, and Part III applies Directors and Officers’ liability insurance to the crowdfunding context.

I. Crowdfunding Defined by the Jobs Act

The Jobs Act defines the basic parameters of the new crowdfunding exemption within Section 4(a)(6) and Section 4A of the Securities Act. The maximum offering price that the issuer can raise over any twelve-month period is $1 million, and issuers must provide audited financial statements for any offerings of more than $500,000 over any twelve-month period. The exemption also limits the funds that can be raised from each investor. For any investor with an annual income or net worth below $100,000, the issuer cannot sell securities exceeding the greater of $2000 or 5% of the investor’s annual income or net worth. For any investor with an annual income or net worth at or above $100,000, the issuer cannot sell securities exceeding the lesser of $100,000 or 10% of the investor’s annual income or net worth. This Part first discusses the required disclosures under the crowdfunding exemption before discussing the elements of liability under the exemption and the problems with litigation-based enforcement.

A. Required Disclosures under the Crowdfunding Exemption

Crowdfunding issuers are required to provide investors with specific disclosures that must be filed with the SEC. The disclosures include the purpose and price of the offering, the target amount, and the deadline for reaching the target amount; information about the company,

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20 The proposed insurance would not meet the *Howey* test because there is no expectation of profits. See S.E.C. v. W.J. Howey Co., 328 U.S. 293, 300 (1946). The insurance could still be a security, however, because Section 2(a)(1) of the Securities Act defines a security to include a “guarantee of” a security. See 15 U.S.C. § 77b(a)(1) (2006). Securities also include stocks, investment contracts, notes, and evidences of indebtedness. *Id.*
24 *Id.* § 77d(a)(6)(B)(i).
25 *Id.* § 77d(a)(6)(B)(ii).
its business plan, its capital structure, and its financial condition; and a list of the company’s officers, directors, and major shareholders.\textsuperscript{27} Issuers cannot provide compensation to promoters unless they disclose that compensation.\textsuperscript{28} They also cannot advertise other than advertising that directs investors to the registered funding portal or registered broker for the offering.\textsuperscript{29} A registered funding portal is an entity that need not register with the SEC as a broker-dealer, as long as it registers with the SEC as a funding portal, joins an SEC-registered national securities association, and is subject to the SEC’s examination, enforcement, and rulemaking authority.\textsuperscript{30}

Issuers must also provide to investors (and file with the SEC) annual reports containing the issuers’ financial statements and results of operations.\textsuperscript{31} They must disclose material risks to investors and any other information the SEC establishes by rulemaking.\textsuperscript{32} These disclosures are relevant for enforcement because they could contain material misstatements or omissions\textsuperscript{33} if there is a substantial likelihood that a reasonable investor would consider them to be important.

\textbf{B. Elements of Liability under the New Section 4A(c) of the Securities Act}

After a crowdfunding offering, any purchaser in the offering can bring an express private right of action against an issuer who makes a material misstatement or omission in connection with the offering under Section 4A(c) of the Securities Act.\textsuperscript{34} Section 4A(c) provides that “a person who purchases a security in a transaction exempted by the provisions of [Section 4(a)(6)] may bring an action against an issuer.”\textsuperscript{35} To bring a cause of action, the plaintiff must prove:

\textit{[T]he issuer—}

\textsuperscript{27} 15 U.S.C. § 77d-1(b)(1); Hazen, \textit{supra} note 16, at 1755.
\textsuperscript{28} 15 U.S.C. § 77d-1(b)(3); Hazen, \textit{supra} note 16, at 1755.
\textsuperscript{29} 15 U.S.C. § 77d-1(b)(2); Hazen, \textit{supra} note 16, at 1755.
\textsuperscript{30} 15 U.S.C. § 78c(h) (Supp. 2012) (exemption for registered funding portals); \textit{id.} § 78c(a)(4)(A); \textit{id.} § 78c(a)(80).
\textsuperscript{33} A misstatement or omission is material if there is a “substantial likelihood that a reasonable investor would attach importance [to it] in determining whether to purchase the security registered.” \textit{See} 17 C.F.R. § 230.405.
\textsuperscript{34} 15 U.S.C. § 77d-1(c). For a definition of material misstatements or omissions, see \textit{supra} note 33.
(A) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of [Section 4(a)(6)], makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission; and (B) does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.36

By comparison, Section 11 of the Securities Act covers material misrepresentations or omissions contained in a registration statement, and Section 12(a)(2) covers material misrepresentations or omissions that an issuer has made in connection with the offer or sale of any security.37 As under Section 12(a)(2), a successful claim under Section 4A(c) entitles a plaintiff to rescissory damages.38 Rescissory damages allow the plaintiff to “recover the consideration paid for such security with interest thereon . . . or for damages if such person no longer owns the security.”39

Section 4A(c) therefore contains multiple elements. First, the plaintiff must trace his purchase to the crowdfunding offering. Although this element may be more difficult to prove in other types of securities class actions, here, the plaintiff could show that he purchased his shares through the registered funding portal, making it fairly easy to trace his purchase to the offering.40

Second, the plaintiff must demonstrate a proper defendant. Unlike Section 11, which provides a list of proper defendants, Section 4A(c) is silent, suggesting that as under Section 12(a)(2), a proper defendant includes any person who sold to the plaintiff.41 Liability under

36 Id. 77d-1(c)(2). For a definition of material misstatements or omissions, see supra note 33.
40 See id. § 77d-1(c)(2)(A).
41 Section 11 includes as proper defendants not only the issuer, but also any signers, directors, and experts named with their consent. Compare 15 U.S.C. § 77k(a) (2006), with 15 U.S.C. § 77l(a)(2), and 15 U.S.C. § 77d-1(c)(2)(A).
Section 12(a)(2) extends to nonissuers who “solicit securities sales to further their own or the issuer’s financial interest.”\(^{42}\) Section 12(a)(2) thus includes any person involved in the selling effort.\(^{43}\) Section 4A(c), however, limits liability to the “issuer” rather than “any person.”\(^{44}\) Yet it still defines the issuer to include the “director[s] or partner[s] of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer.”\(^{45}\) It is important that issuers include directors, partners, and officers, because the same person could reincorporate under a new crowdfunding startup after being held liable for fraud in connection with a previous one.\(^{46}\) This definition, however, suggests that liability under Section 4A(c) does not extend to all persons in the selling effort, unlike liability under Section 12(a)(2).\(^{47}\)

Third, the plaintiff must demonstrate a bad act, defined in Section 4A(c) as any material misrepresentation or omission “by means of any written or oral communication” in connection with the offering.\(^{48}\) Although the bad act seems to match that in Section 12(a)(2), the definition differs from Section 12(a)(2) because the latter limits liability for any written communications to those contained within prospectuses.\(^{49}\) The Securities Act defines prospectuses to include any written or broadcast offer or confirmation of sale.\(^{50}\) The definition of prospectuses, however, expressly excludes certain written communications, such as bare bones announcements.\(^{51}\) Thus, Section 4A(c) could cover more forms of written communication than Section 12(a)(2) covers.\(^{52}\)

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\(^{42}\) Palmiter, supra note 18, at 405.

\(^{43}\) Id.


\(^{45}\) 15 U.S.C. § 77d-1(c)(3). Ambiguity exists concerning whether the term “issuer” includes all officers or only principal executive officers, but that is beyond the scope of this Essay. See Palmiter, supra note 18, at 407.

\(^{46}\) See 15 U.S.C. § 77d-1(a)(5) (providing that funding portals may need to conduct a “background and securities enforcement regulatory history check on each officer, director and person holding more than 20 percent of the outstanding equity of every issuer” to “reduce the risk of fraud” with respect to crowdfunding transactions).

\(^{47}\) Compare id. § 77d-1(c)(2), with 15 U.S.C. § 77l(a)(2).

\(^{48}\) Id. § 77d-1(c)(2)(A). For a definition of material misstatements or omissions, see supra note 33.


\(^{51}\) Id. § 77b(a)(10)(b).

Fourth, the plaintiff need not demonstrate culpability because Section 4A(c) places the burden on the defendant of proving a “reasonable care” defense. Defendants can avoid liability by establishing that the “issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.” The reasonable care defense under Section 4A(c) thus matches the corresponding reasonable care defense under Section 12(a)(2).

Fifth, the plaintiff need not show causation, but does need to plead lack of knowledge of the alleged material misrepresentation or omission, matching the causation defense in Section 12(a)(2). Defendants can raise causation as a defense because Section 4A(c) expressly bars any plaintiff who had knowledge of the misstatement or omission from recovering any losses.

Additional defenses under Section 4A(c) include a rebuttal of the plaintiffs’ case, the lack of loss causation, the statute of limitations, and unclean hands. Loss causation requires that material misrepresentations or omissions rather than the general market conditions caused the plaintiffs’ loss. The statute of limitations bars any claims raised more than one year from the date of discovery or three years from the date of occurrence. Unclean hands prevents plaintiffs from recovering losses when the plaintiffs are at least as culpable as the defendants.

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54 Id.
55 Compare 15 U.S.C. § 77l(a)(2) (providing that the issuer must “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”), with 15 U.S.C. § 77d-1(c)(2)(B) (providing that the issuer must “sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission”). This defense raises the question of whether the courts could nevertheless apply a reasonable investigation standard to Section 4A(c)’s reasonable care defense as the Seventh Circuit did with Section 12(a)(2). See John Nuveen & Co., Inc. v. Sanders, 450 U.S. 1005, 1007 (1981) (Powell, J., dissenting); Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1223 (7th Cir. 1980).
56 Compare 15 U.S.C. § 77d-1(c)(2)(A) (“ . . . provided that the purchaser did not know of such untruth or omission . . .”), and 15 U.S.C. § 77l(a) (“ . . . the purchaser not knowing of such untruth or omission . . .”), with 15 U.S.C. § 77k(a) (2006) (“ . . . unless it is proved that at the time of such acquisition he knew of such untruth or omission . . .”). For a definition of material misstatements or omissions, see supra note 33.
58 See Palminter, supra note 18, at 418 (listing defenses that are available under Section 4A(c)).
61 See Fuller v. Dilbert, 244 F. Supp. 196, 213 (S.D.N.Y. 1965) aff’d sub nom. Righter v. Dilbert, 358 F.2d 305 (2d Cir. 1966) (barring plaintiff from recovering losses when the plaintiff contributed to the securities law violation).
In addition to Section 4A(c), Section 17 of the Securities Act\(^{62}\) and SEC Rule 10b5\(^{63}\) of the Securities and Exchange Act\(^{64}\) could also be relevant in the enforcement of crowdfunding fraud. Section 17 provides that it is unlawful to “employ any device, scheme, or artifice to defraud” in connection with the offer or sale of a security.\(^{65}\) Rule 10b5 could also apply to crowdfunding enforcement because Rule 10b5 applies to any material misstatement or omission in connection with the purchase or sale of any security.\(^{66}\) Nevertheless, because Rule 10b5 requires scienter, i.e., the intent to deceive or a highly reckless disregard for the truth,\(^{67}\) plaintiffs may prefer to file suit under Section 4A(c), which does not require scienter.\(^{68}\)

C. Problems with Traditional Enforcement via Private Securities Litigation

One problem with traditional enforcement through private securities litigation is that litigation does not work well without strong economic incentives.\(^{69}\) Professor Thomas Hazen highlights the need for investor protection against crowdfunding fraud while underscoring the inadequacy of traditional remedies of securities litigation in addressing crowdfunding liability.\(^{70}\) Even if the SEC requires the disclosure of a prospectus to investors in a crowdfunding offering, the $1 million in available damages for a material misrepresentation or omission does not justify the economics of filing suit for damages based on the traditional contingency fee model.\(^{71}\)

In securities class actions against public reporting issuers, for example, settlements for class actions with estimated damages of less than $50 million were 10.5% of damages or about

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\(^{63}\) See 17 C.F.R. § 240.10b-5.


\(^{65}\) 15 U.S.C. § 77q(a).

\(^{66}\) See 17 C.F.R. § 240.10b-5 (SEC Rule 10b5).

\(^{67}\) See Hazen, supra note 16, at 1757–58 (defining scienter and noting that 10b5 requires scienter).

\(^{68}\) Compare 17 C.F.R. § 240.10b-5 (SEC Rule 10b5), with 15 U.S.C. § 77d-1(c)(2)(B) (Supp. 2012) (providing that culpability is not necessary to prove the plaintiff’s cause of action under Section 4A(c)).

\(^{69}\) Hazen, supra note 16, at 1757–59.

\(^{70}\) Id. at 1759.

\(^{71}\) Id.
$5 million.\textsuperscript{72} Legal fees, typically contingency fees, were 20–30\% of the total settlement, or about $1 million in legal fees.\textsuperscript{73} By comparison, damages of $1 million in crowdfunding cases—assuming similar percentages—would correspond to only $20,000 in legal fees. For offerings of $500,000 that avoid the auditing requirements, the legal fees would be only $10,000.\textsuperscript{74}

Adequate investor protection is nonetheless essential, and the SEC should address investor protection problems because the Jobs Act authorizes the SEC to reduce the risk of fraud.\textsuperscript{75} Although capping the money that each investor can invest could reduce risk exposure, “fraud can come in small packages, too.”\textsuperscript{76} Professor Hazen suggests that it is “naïve to assume that limiting offerings to small amounts per investor will deter scammers from taking advantage of investors via crowdfunding.”\textsuperscript{77} For unsophisticated investors with less than $100,000 in net worth, “[f]raud in small packages can be just as effective,” because these investors might be the “least able to bear the risk.”\textsuperscript{78} Professor Hazen contends that “[e]xposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals” for the “perceived need to lower the disclosure barriers for small businesses.”\textsuperscript{79}

Yet Professor Hazen only proposes increased disclosures to prevent fraud before it occurs; he does not suggest a solution to compensate investors for losses after an issuer makes a material misrepresentation or omission. Instead of proposing increased disclosures, this Essay proposes private insurance as a mechanism to cover losses to crowdfunding investors after the occurrence of a material misrepresentation or omission. Particularly for issuers with no assets, insurance could make it more feasible for plaintiffs to sue issuers for a $1 million recovery.

\textsuperscript{72} Palmiter, \textit{supra} note 18, at 417.
\textsuperscript{73} Id. at 418.
\textsuperscript{74} See id. at 417–18.
\textsuperscript{75} For an analysis of the SEC’s authority to reduce the risk of fraud under Section 4A, see \textit{infra} Part II.B.
\textsuperscript{76} Hazen, \textit{supra} note 16, at 1765.
\textsuperscript{77} Id.
\textsuperscript{78} Id. at 1765–66.
\textsuperscript{79} Id. at 1767.
II. Proposed Private Insurance Model to Reduce the Impact of Fraud in Crowdfunding

The SEC should adopt a private insurance model to reduce the impact of fraud in crowdfunding. Because the maximum recovery under Section 4A(c) is $1 million, securities class action attorneys lack the incentive to file suit. Because of limited agency resources at the SEC, enforcement actions by the SEC would cover only the most “egregious cases.” This Part first discusses private insurance as a model to spread the costs of fraud in crowdfunding across the issuers and second addresses the SEC’s authority to require the issuers to obtain insurance.

A. Antifraud Insurance Against Material Misrepresentations or Omissions

A private insurance model could help reduce the effects of crowdfunding fraud because the insurance would recoup investor losses from the fraud. Professor Alan Palmiter analogizes crowdfunding to a financial transaction in which the “effects of a failed product/service are relatively small, compared to the costs of accountability—whether through public enforcement, private litigation, or arbitration.” Professor Palmiter suggests a solution of private insurance. Because the cost of insurance would be borne by investors, an insurance-based system could avoid the costs of litigation-based enforcement. The insurance company would be a “natural gatekeeper” that could identify possible fraudulent offerings before issuance to the public.

Professor Palmiter further suggests that insurance companies could evaluate whether an issuer’s disclosure and pricing to investors would be adequate to ensure success, but he does not define success, underscoring the inherent difficulty in evaluating the “success” of any equity investment. For some investors, success could mean a return above zero. For others, any

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80 Palmiter, supra note 18, at 417–18.
81 Id. at 375.
82 Id. at 426.
83 Id.
84 Id.
85 Id.
86 See id.
return below market average is a failure. Even if the purpose of the proposed insurance was to ensure adequate disclosure and pricing, that purpose would constitute underwriting rather than insurance and would not be workable. Professor Palmiter acknowledges the role of underwriting in registered public offerings and argues that “the heavy costs of private enforcement (whether through individual or class litigation), public enforcement and even arbitration,” make it necessary “to reassure investors that there will be accountability for failed crowdfunding offerings.”87 This argument is weak, however, because investments in startup or microcap companies are significantly more risky than investments in large cap public companies.88

One goal of crowdfunding could also be to increase access to capital for crowdfunding issuers rather than to provide a bargain price for crowdfunding investors. Consistent with this goal, Section 4A(c) does not provide for liability of crowdfunding issuers who place higher than justified values on their securities and fail to attract sufficient investors. Nor does liability exist for issuers who overprice their offering, but do not make any material misrepresentations or omissions. Therefore, the proposed insurance should not cover mispricings in crowdfunding offerings because each issuer’s proper market capitalization value is subjective.

For the same reasons, a rating model for crowdfunding offerings based on the bond rating model, in which rating agencies rate corporate bonds as investment grade or junk status, would not be workable. The rating model would not work because it is unclear what “investment grade” would indicate when equity investments could still lose all their value even without fraud. The proposed insurance would also differ from bond insurance because antifraud insurance would not cover all losses from crowdfunding—e.g., ordinary business losses due to market forces. Crowdfunding investors must still bear the risk of 100% loss, which could occur more

87 Id.
often than not with thinly capitalized microcap investments. The proposed insurance would therefore not be responsible for making the offering successful, but only for recovering the losses from any material misrepresentations or omissions made in connection with the offering.

Professor Palmiter also argues that insurance companies could “vet small business issuers” to “compete and gain a reputation as a purveyor of solid investment returns.”

Insurance companies, however, do not have the expertise to replace the role of underwriters in registered public offerings of “matching investors and investment risk.” Nor would insurance companies be able to recoup the high risk of failure in microcap investments even without any misrepresentations or omissions. Similarly, although funding portals could double-perform as insurance providers, double-performance increases the concentration of risk, making it more preferable to have arms-length transactions between funding portals and insurance companies.

In sum, the role of the proposed insurance should not be to cover all losses, but only those due to a material misrepresentation or omission. An insurance scheme covering all failed crowdfunding offerings would be very expensive, if not exceed the entire price of the offering itself. Even underwriters in registered public offerings are not held liable unless the plaintiffs can prove a material misrepresentation or omission related to the offering materials. Therefore, Professor Palmiter’s suggestion that the insurance could perform an underwriting function may not be correct; the insurance should only cover material misrepresentations or omissions.

B. SEC Authority to Require Antifraud Insurance

Although the Jobs Act does not provide express authority for the SEC to require issuers to obtain insurance, the SEC may have implied authority to require insurance under Section 4A.

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89 See id.
90 Palmiter, supra note 18, at 426.
91 See id.
92 See id.; Microcap Stock: A Guide for Investors, supra note 88. For a definition of materiality, see supra note 33.
of the Securities Act.\footnote{See 15 U.S.C. § 77d-1 (Supp. 2012).} Section 4A separates the requirements for registered funding portals from those for crowdfunding issuers.\footnote{Id.} Regarding the registered funding portals, Section 4A(a)(5) provides the SEC with the express authority to “take such measures to reduce the risk of fraud with respect to such transactions.”\footnote{Id. § 77d-1(a)(5).} Section 4A(a)(5) therefore provides the SEC with an express mandate to reduce the risk of fraud in regulating the funding portals.

Congress further provides guidance on appropriate measures that the SEC may impose on the registered funding portals. These measures could include “a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer.”\footnote{Id. § 77d-1(a)(12).} Section 4A(a)(12) also expressly provides a catchall provision that the SEC may impose other requirements on registered funding portals by rule or regulation for the “protection of investors and in the public interest.”\footnote{Id.} Thus, even if the SEC’s express authority only extends to “background and securities enforcement regulatory history check[s],” the SEC’s implied authority to “reduce the risk of fraud” could provide the SEC with authority to require funding portals to reject issuers who lack antifraud insurance.\footnote{See id. § 77d-1(a)(5).}

Regarding the crowdfunding issuers, the SEC’s authority is less expansive under Section 4A(b), which provides no express mandate to the SEC to reduce the risk of fraud.\footnote{See id. § 77d-1(b).} Section 4A(b)(5) nevertheless includes the same catchall provision discussed above that the SEC may prescribe rules or regulations for the “protection of investors and in the public interest.”\footnote{See id. § 77d-1(b)(5).} Thus, the SEC could still have the implied authority to require the issuers to obtain insurance under Section 4A(b)(5), even if the SEC does not have the express authority to require insurance.
One alternative would be for the SEC to require the registered funding portals rather than the issuers to obtain antifraud insurance, because Congress provided the SEC with the express authority to regulate the funding portals to reduce the risk of fraud. Section 4A(c), however, does not address the liability of the funding portals, and the definition of issuer does not include funding portals. One commentator has argued that the funding portals should not be liable for material misrepresentations or omissions in connection with crowdfunding offerings. He argues that the SEC should promulgate rules to clarify whether additional disclosures provided by issuers through the funding portals would “impute liability” to the funding portals. To address these concerns, the SEC could simply require the funding portals to disclose whether each crowdfunding issuer using the funding portal has the antifraud insurance, rather than require the funding portal itself to obtain the insurance or indemnify the issuers.

Congress further provides an express mandate in general to the SEC in Section 4(c) to “issue such rules as the [SEC] determines may be necessary and appropriate for the protection of investors.” In sum, although the SEC may not have the express authority to require issuers to obtain insurance, the SEC may have the implied authority to impose this requirement on issuers through the catchall provisions in Section 4(c) or Section 4A(b)(5). The proposed insurance would only cover material misstatements or omissions within the meaning of Section 4A(c). It would not reduce the risk of crowdfunding fraud ex ante, but it could mitigate the effects of the fraud on investors, particularly in cases in which an issuer has no remaining assets.

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102 See supra notes 96–99 and accompanying text.
103 See supra notes 44–45 and accompanying text defining the issuer.
105 Id. at 4.
108 See supra Part I.B. For a definition of material misstatements or omissions, see supra note 33.
III. Applying Directors and Officers’ Liability Insurance to the Crowdfunding Context

Under the proposed insurance, the SEC would require all crowdfunding issuers to obtain private insurance against securities liability under Section 4A(c) of the Securities Act, with the cost to be set by the marketplace. The insurance would follow the already-existing Directors and Officers’ (“D&O”) liability insurance purchased by registered public companies. The maximum recovery would be capped by the crowdfunding offering (up to $1 million). Any recovery under the insurance plan would require proof of a cause of action under Section 4A(c). This Part first addresses how the insurance could spread the costs of crowdfunding fraud before discussing the types of D&O insurance, fraud exclusion, moral hazard, securities settlements, and strike suits.

A. Spreading the Costs of Fraud through Crowdfunding Insurance

The proposed insurance would spread the costs of crowdfunding fraud across the issuers because the SEC would require each issuer to obtain at least $1 million in coverage before the issuer could participate in crowdfunding. The price of the insurance for each issuer would depend on the individual risk rating of the issuer and would reflect the “annualized present value of shareholder litigation risk” for that issuer.\(^\text{109}\) Thus, even if not all issuers can obtain insurance at a reasonable price, this inability would be an early warning sign from the insurance companies that the issuer should review its disclosures for possible material misstatements or omissions.

The issuers would aggressively defend complaints because SEC enforcement actions could disqualify the issuers—including officers, directors, and major shareholders—from future crowdfunding or could cause insurance companies to raise premiums.\(^\text{110}\) To reduce the costs of litigation, the SEC could set up an administrative proceeding for crowdfunding investors to file

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\(^{109}\) See Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market, 74 U. CHI. L. REV. 487, 509 (2007) (“D&O insurance companies have strong incentives—avoiding losses and out-selecting competitors—to assess the risk of shareholder litigation accurately,” and “to understand shareholder litigation risk. D&O insurance underwriting practices are a good place to start.”).

\(^{110}\) See supra notes 45–46, 96–99 and accompanying text defining issuers and authorizing background checks.
complaints. A Notice of Proposed Rulemaking (“NPRM”) under the Administrative Procedure Act\textsuperscript{111} would be necessary, but the SEC already has Administrative Law Judges (“ALJs”).\textsuperscript{112} SEC Enforcement could pursue a recovery from the issuer and its insurance carrier on behalf of crowdfunding investors before the ALJ, thereby avoiding the costs of plaintiffs’ legal fees.\textsuperscript{113}

**B. Types of D&O Insurance**

The proposed insurance should follow three already-existing types of D&O insurance: D&O Coverage, Corporate Reimbursement Coverage, and Entity Securities Claims Coverage.\textsuperscript{114} First, D&O Coverage insures the “direct liability of a corporation’s directors and officers, thus protecting them from individual financial responsibility arising out of their corporate acts.”\textsuperscript{115} D&O Coverage assumes that the “corporation will provide indemnification to the individual [directors] and officers to the fullest extent permitted by law,” and it “covers claims for which corporate indemnification is not permitted.”\textsuperscript{116} Second, Corporate Reimbursement Coverage “reimburses the insured organization for its obligation to indemnify directors, officers, and other insured persons.”\textsuperscript{117} Third, Entity Securities Claims Coverage provides “liability coverage to the corporate entity itself, most often only for securities claims.”\textsuperscript{118} In addition, although small cap companies purchase on average $28 million in D&O insurance, they usually purchase more than one policy to reach their targets because most policies have limits of $10 million or less.\textsuperscript{119}

All three forms of D&O insurance would be applicable to fraud in crowdfunding because both the corporate entity and the directors and officers individually could be liable under Section

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{113} See \textit{id}. Note that the issuer includes directors, partners, and officers. See \textit{supra} text accompanying notes 45–46.
\item \textsuperscript{114} These three types correspond to “A,” “B,” and “C” side coverage. See James A. McCorquodale and Michael G. Mahan, After the Sarbanes-Oxley Act: Director’ and Officers’ Insurance Needs, 45 No. 3 DRI FOR DEF. 43 (2003).
\item \textsuperscript{115} \textit{id}.
\item \textsuperscript{116} \textit{id}.
\item \textsuperscript{117} \textit{id}.
\item \textsuperscript{118} \textit{id}.
\item \textsuperscript{119} Baker & Griffith, \textit{supra} note 109, at 503–04.
\end{enumerate}
\end{footnotesize}
4A(c) of the Securities Act.120 Crowdfunding corporate entity-issuers may not have the assets or revenue stream to cover a $1 million liability from a securities suit, since the issuers are raising seed capital of $1 million or less. Both the corporate entity-issuer and the directors and officers may have no remaining assets by the time the fraud is brought to light by litigation. Thus, D&O insurance for up to $1 million in liabilities could be helpful for investors to recoup their losses.

C. Fraud Exclusion and Moral Hazard

Even though insurance companies may be reluctant to cover deliberate acts, the proposed insurance would have limited downside and repeat exposure risk and would exclude deliberate fraud because a cause of action under Section 4A(c) does not require intent. D&O insurance “protect[s] directors and officers against securities fraud lawsuits,” but denies coverage if the defendants are held liable in a “final judgment for deliberate securities fraud.”121 Thus, fraud exclusion could apply if it is “formally decreed in court” that the defendants committed fraud.122

Here, the proposed insurance first limits the maximum exposure because liability is capped at $1 million per offering (with a three-year statute of limitations).123 Second, it limits repeat exposure because once an issuer violates Section 4A(c), the issuer could not crowdfunding again, or the insurance company could raise premiums. Third, intent is not an element of the Section 4A(c) cause of action because an issuer could be held liable even if the issuer did not have the intent to make a material misrepresentation or omission, as with Section 11 and Section 12(a)(2), and unlike Rule 10b5.124 Plaintiffs would not try to prove intent if it is not necessary to prevail under Section 4A(c), particularly if intent or deliberate fraud could reduce their recovery.

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120 A Section 4A(c) issuer includes directors, partners, and officers. See supra notes 45–46 and accompanying text.
122 Id.
123 See supra note 60 and accompanying text.
Even putting aside fraud exclusion, the proposed insurance would need to address the risk of moral hazard for directors and officers. One factor that reduces moral hazard is the SEC’s power to preclude from crowdfunding any person who has been subject to an SEC enforcement action. Insurance companies should also deny insurance policies or raise premiums based on background checks of the issuers. The risk of moral hazard would also not be any different from that already existing for directors and officers of publicly traded companies with D&O insurance.

Another way to reduce moral hazard could be to retain joint and several liability for directors and officers. Joint and several liability would make each director and officer of the issuer individually liable for any bad acts of the issuer, even if a different director or officer committed the specific bad act in question. Joint and several liability may require new statutory authority because Section 15 of the Securities Act provides express authority for joint and several liability of control persons under Sections 11 and 12, but not under Section 4A(c).

Although joint and several liability could lead to increased strike suits, the courts could achieve a balance by imposing cost-shifting or sanctions in appropriate cases as the next section illustrates.

D. Securities Settlements and Strike Suits

The proposed insurance would also need to account for settlements because nonfrivolous securities suits could still settle. An admission of liability in securities class actions settlements seems rare, but the D&O insurance still covers defense costs and indemnifies the directors and officers.

Here, the proposed insurance would still cover the defense costs to prove that the stock price may have dropped for reasons other than a material misrepresentation or omission.

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126 See supra notes 45–46, 96–99 and accompanying text defining issuers and authorizing background checks.
128 Control persons include any “person who, by or through stock ownership, agency, or otherwise” has control over “any person liable” under Section 11 or Section 12 of the Securities Act. Id. § 77o.
The proposed insurance, however, should discourage meritless strike suits aimed at the antifraud insurance assets, which could drive up the costs of the insurance. In one recent study, Professor Tom Baker found that the “amount and structure of D&O insurance” significantly influences securities settlements based on his interviews with plaintiff and defense attorneys, D&O insurance claims managers, brokers, mediators, and testifying experts.\(^{130}\) Because of the “virtual absence of adjudication,” every securities class action that survives past the motions stage usually results in payment to the plaintiffs’ class.\(^{131}\) Even though parties may structure settlements by reference to other settlements, the lack of publicly available D&O insurance and settlement terms\(^{132}\) pressures D&O insurers to settle on terms that may not reflect the merits of the claims at issue.\(^{133}\) Similarly, the existence of crowdfunding insurance could lead to increased filings of strike suits.\(^{134}\) In these strike suits, “[o]pportunistic plaintiffs’ attorneys continuously monitor securities prices, probing for recent offerings that perform poorly in the aftermarket.”\(^{135}\)

One way to discourage strike suits could be partial or complete cost-shifting. Cost-shifting could make it expensive for plaintiffs’ attorneys who file frivolous suits because they could be responsible for the defense costs for the suits. Thus, plaintiffs’ attorneys would need to do proper research before automatically filing suit after every instance of crowdfunding loss.

Another way to discourage strike suits could be to require judges to impose sanctions for frivolous suits under Federal Rule of Civil Procedure 11.\(^{136}\) This issue previously arose in securities class action litigation, which led to the Private Securities Litigation Reform Act of


\(^{131}\) Id.

\(^{132}\) Baker & Griffith, supra note 109, at 508–09 (noting that not only do insurance companies price D&O insurance policies based on each issuer’s individual risk, but they also keep secret their underwriting methods and formulas).

\(^{133}\) Baker & Griffith, supra note 130, at 756.


\(^{135}\) See id.

PSLRA was a response to plaintiffs’ firms filing frivolous securities strike suits, and the defendants’ tendency to settle the suits to avoid the high costs of litigation. Prior to PSLRA, courts seldom exercised their discretion to sanction plaintiffs who filed frivolous complaints, but after PSLRA, Congress mandated that courts make specific findings concerning the requirements of Rule 11 and impose sanctions on attorneys who do not meet Rule 11.

In sum, the proposed D&O liability insurance model would spread the costs of fraud in crowdfunding across issuers because each issuer would obtain at least $1 million in insurance. Issuers unable to obtain insurance would not be permitted to crowdfund. To reduce litigation costs, the SEC could establish an administrative proceeding to resolve complaints before an ALJ. To reduce moral hazard, the insurance could exclude deliberate fraud, but it would include material misrepresentations or omissions within the meaning of Section 4A(c). To reduce the risk of strike suits, the courts could impose cost-shifting or sanctions in appropriate cases.

Conclusion

The SEC should require crowdfunding issuers to obtain private insurance against liability under Section 4A(c) of the Securities Act, based on D&O liability insurance. Antifraud concerns could be a major reason for SEC holdup on rulemaking because the SEC must balance investor protection against the costs of disclosure. To address these concerns, a private insurance model could spread the costs of fraud in crowdfunding across the issuers. The maximum recovery would be capped by the amount of the crowdfunding offering, and any recovery under the proposed insurance plan would require proof of a cause of action under Section 4A(c).

139 Id. at 1047.
140 For the elements of a Section 4A(c) claim, see supra Part I.B. For a definition of materiality, see supra note 33.
141 See supra note 16 and accompanying text.