Caution before you crowdfund (part one)

by John F. O'Rourke and Patrick Soon

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Crowdfunding represents nothing less than a paradigm shift in technology development. This alternative to traditional fundraising allows an entrepreneur to pitch an idea directly to the public, test the market's response, and independently gather seed money. Thanks to the power of social networking, innovations that may have otherwise been rejected by CEOs, or big-name venture capitalists, can now raise thousands (or even millions) of dollars. Never before has the public had such a voice in deciding what products will be developed, and never before have consumers played such a major role in the birth of invention. But while crowdfunding success stories abound, there have also been plenty of tales of heartache and headaches. This two-part article discusses some of the important concerns that we at WHGC believe should be addressed before any inventor attempts to crowdfund.

Kickstarter is an excellent example of a crowdfunding platform. It is the largest of the 450 or so crowdfunding websites, having helped raise over $925 million for over 54,000 projects. This 70-person company, located in Brooklyn, N.Y., was named as one of the best inventions of 2010 by Time Magazine. Virtually any idea that has a clear end (i.e. a project that can be definitively completed) and fits into one of Kickstarter's 13 categories (such as technology, art, or film) can be posted on their website. And there are no upfront costs! A fee is only applied if the project successfully reaches its funding target by the deadline chosen by the project creator, at which time Kickstarter will apply a 5 percent fee and Amazon will charge another 3-5 percent for payment processing. However, if the funding goal is not met, then the funds are not released and no fees are applied since Kickstarter is what is referred to as an "All-or-Nothing" site. Indiegogo, on the other hand, uses a "Keep-It-All" model that allows creators the option of keeping whatever amount is raised even if the funding goal is not met.

Kickstarter employs the "donation-based" model of crowdfunding wherein entrepreneurs retain 100 percent ownership and control of their projects (equity-based crowdfunding, as covered by the Jumpstart Our Business Startups Act [the JOBS Act], will be the topic of later articles). Project backers generally give money in small increments (which can add up quickly), but they do not acquire equity, so there are no shareholders. Instead, a tangible reward or special experience is offered in exchange for a "donation" (which is often a unit of the product, a T-shirt, etc.).

This simple funding model has led to some amazing Kickstarter successes:

1 Eric Migicovsky, a young Canadian engineer, hoped to receive 1000 pre-orders on Kickstarter (for a total of $100,000) to fund the development of his invention – the Pebble wristwatch. This "smart" watch not only tells time, it can receive messages from one's smartphone via a Bluetooth link. An additional feature, the device's e-paper display, allows wearers to read messages even in bright sunlight. The campaign results far surpassed expectations. In just 37 days, Migicovsky received *75,000 pre-orders* and raised *over $10 million* (100 times the initial target amount)!

2 Australia native Phil Bosua, a college dropout, wanted to raise capital to fund the production of his invention – an $89 light bulb he named LIFX. This LED device is wi-fi enabled and can be controlled with an app on a smartphone. Users can completely control the intensity of the light, and choose any one of 16 million different colors. Bosua posted his invention on Kickstarter with a goal

of obtaining $100,000 in pledges within sixty days. Instead, Bosua raised over $1.3 million . . . *in just three days!*

And there are many other examples of entrepreneurs circumventing (or at least supplementing) traditional fundraising methods on Kickstarter. For example, the Oculus Rift, a lightweight virtual reality headset, met its $250,000 target *in just four hours* – ultimately going on to raise *$2.4 million!* Then there is the Ouya game console, which completely obliterated its initial $950,000 funding goal by raising *$8,596,475 in just 30 days!*

Such success stories might lead one to believe that there is everything to gain and nothing to lose by crowdfunding, especially since posting doesn't cost a dime unless a project is first successfully funded. But, beware! While crowdfunding may not require any up-front costs, it is certainly not risk free! Here are a few examples of successfully funded projects that now have huge obstacles to overcome:

Form 1, a 3-D printer by creator Formlabs, succeeded in its campaign by raising $2,945,885. Unfortunately for Formlabs, its crowdfunding success was followed by a lawsuit. Just one month after the completion of its Kickstarter campaign, Formlabs (and Kickstarter itself) was sued by 3D Labs for patent infringement. Thus, despite successfully raising almost $3 million on Kickstarter (plus an additional $19 million that Formlabs raised in Series A Financing), the future of the Form 1 3-D printer is far from certain.

Hanfree, by creator Seth Quest, was described as a kind of stand that could hold a tablet or other electronic device in place (in front of one's face) while the user is reclined on their back. Quest's Kickstarter campaign was a success and he raised $35,000. However, due to complications, the Hanfree never made it to the production stage. Quest was sued by a disgruntled backer who expected to receive one of the devices as a reward for his pledge. And because Quest did not form a business entity for his project, the liabilities he faced were all his personally. Quest was eventually forced to file for bankruptcy protection.

RoboRoach, a kit made by Backyard Brains, is a successfully-funded Kickstarter project that allows one to turn a cockroach into a remote-controlled cyborg. Apparently, People for the Ethical Treatment of Animals (PETA) was not happy with the fact that the instructions for creating this living robot involve surgically implanting a little control board onto the insect's back, and that it also requires cutting off part of the cockroach's antennae so that little electrodes can be attached. PETA has filed a complaint with the Michigan Attorney General to halt production, claiming RoboRoach is cruel and constitutes the unauthorized practice of veterinary medicine.

These examples illustrate the fact that an inventor should not attempt to crowdfund their technology until: 1) they generally understand the rules and obligations of crowdfunding, 2) they are certain that they are complying with the laws and regulations that may pertain to the production and/or distribution of their invention, 3) they have a business plan for how to fulfill their obligations if they reach their funding target and, 4) they have taken the necessary precautions to protect their intellectual property rights.

Part two of this article will discuss these concerns in more detail, and it will examine the benefits of consulting with an attorney prior to launching any crowdfunding campaign.

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