EQUITY CROWDFUNDING: OFFERING FANS A TRUE STAKE IN THEIR FAVORITE TEAMS

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Corporate Alert

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We've all been there—that incredible moment when our favorite team is driving down the field for the go-ahead touchdown, has runners in scoring position in the bottom of the ninth inning, or has a penalty kick in the 89th minute. The emotional connection between a fan and their favorite sports team is hard to describe, and certainly hard to replicate. For most fans, the connection to their sports team is a result of where they live, an affinity for a particular player, or even the result of allegiance inherited from a family member.

Now imagine the deep connection between a fan and a particular team or club if the fan actually owned even a small stake in the team. Equity crowdfunding provides a vehicle to make this happen. This alert provides (1) a brief conceptual overview of equity crowdfunding and Regulation Crowdfunding (Regulation CF) in the context of professional sports, and (2) a case study highlighting rewards and risks of equity crowdfunding using two real world examples: Chattanooga FC and Detroit City FC.

The economic ramifications of the COVID-19 pandemic have hit the sports industry particularly hard. Thousands of live sporting events have been cancelled or postponed, and many revenue streams throughout the industry have been reduced or, in some cases, completely vanished. At the same time, access to capital is becoming increasingly difficult for businesses of all sizes across all industries. To survive in this uncertain economic environment, many professional sports teams must get creative and seek alternative sources of capital in order to fund operations. One option is equity crowdfunding.

EQUITY CROWDFUNDING

Non-equity crowdfunding (e.g., Kickstarter and Indiegogo campaigns) is familiar to many people and is often confused with equity crowdfunding. Non-equity crowdfunding is a process through which companies seek donations to charities or engage in pre-sales for new products. Non-equity crowdfunding is not typically subject to U.S. securities laws and regulations. *Equity* crowdfunding, on the other hand, involves the sale of a security (e.g., stock, debt, or some other form of interest in the company) to investors that would be subject to registration under U.S. securities regulations unless an exemption from registration exists under the law.

Securities Exchange Commission (SEC) rules and regulations provide many registration exemptions that may be available to issuers (i.e., the entities selling securities) to avoid the costly and time-consuming registration and reporting requirements. In the most oft-relied upon exemptions, sales of securities can only be made to “accredited investors” who must have a net worth over US$1,000,000 or annual income over US$200,000 (which typically excludes 90 percent of Americans). However, Regulation CF allows for *non*-accredited investors to purchase securities if the issuer follows certain rules and guidance, thus greatly expanding the pool of potential investors for issuers (including sports teams) looking to raise capital.

REGULATION CF FOR SPORTS TEAMS

Fan Ownership

Sports teams across the world leverage public or "fan" ownership as a source of incoming capital with a view toward brand building and public relations. Soccer clubs FC Barcelona, Real Madrid C.F., Manchester United, and teams in the German Bundesliga all have partial fan ownership. Conversely, the Green Bay Packers of the NFL were, until recently, the only major professional sports team in the United States that was publicly owned. In the United States, professional team valuations range from US$1 million to multibillions for NFL, NBA, and MLB clubs. Even extremely high net worth individuals experience difficulties raising or arranging the funds to buy ownership interests in sports teams.

As supporters, fans contribute substantial time and money to their favorite teams. Savvy team owners ensure that many critical team decisions comport with the preferences of their fan bases. Through Regulation CF, controlling owners of every professional team have the opportunity to offer fans the meaningful benefit of *actual* ownership of their beloved teams.

Particularly, under Regulation CF, issuers can raise up to US$1,070,000 from non-accredited investors in a 12-month period. Once that Regulation CF limit is reached, an issuer would still be allowed to raise unlimited additional funds from accredited investors using the securities exemption under Regulation D, Rule 506(c).

Additional Benefits and Risks

Additional benefits of utilizing a Regulation CF offering include:

- **Positive Public Relations**: Teams compete in the marketplace for fan attention and are always seeking new, exciting propositions to offer fans. Instead of offering more premiums and gimmicks at games, teams could offer fans the chance of a lifetime: ownership of their favorite team. At least two National Independent Soccer Association clubs (Chattanooga FC and Detroit City FC) have created dozens of local and national media hits and millions of digital impressions by leveraging the equity crowdfunding tool to sell team ownership to their fans.
- **Increased Financial Resources**: Through equity crowdfunding, teams and their fans can jointly contribute to capital projects (new stadium and training facilities), daily operational cash flow requirements (player and employee salaries and benefits and overhead costs), and cash reserves for economic downturns (including the current economic environment resulting from the COVID-19 pandemic).
- **Fans Expectation of Return**: Fans will expect some level of pecuniary return on their investment in their favorite team. However, a combination of (i) the limited cash outlay from each fan (in most cases), (ii) the team's disclosure of certain risks associated with investing, and (iii) the fan's affinity toward the team, may lower expectations of a significant cash return on the investment.

As with any capital raising vehicle, there are risks inherent to issuing securities under Regulation CF. Risks include (among others):

- **Distinguishing from Non-Equity Crowdfunding**: Teams must be proactive to prevent the spread of misinformation about an equity crowdfunding campaign or confusion with non-equity crowdfunding. Wealthy controlling owners do not want to appear as if they are asking for a donation from fans when they are actually seeking new business partners and issuing ownership interests.

- **New Stakeholders**: Bringing in additional investors means that existing owners may give up some voting rights and other ownership privileges to additional people. However, a Regulation CF offering can be designed in a way that the securities sold have very specific and limited rights, preserving the material decision-making power for the controlling owners.
- **Increased Communications**: Investors may expect and deserve more information on the inner workings of the team than the average fan. A large pool of investors means there are more people to communicate with, broader reporting requirements, and additional administrative tasks for which the team is responsible. However, through timely and effective communications, team management can keep investors informed without disclosing proprietary and confidential information.
- **Disclosure and Reporting**: Regulation CF requires very specific, detailed disclosure to be made by the issuer, and issuances are subject to anti-fraud requirements. There are also ongoing reporting requirements with the SEC.

CONCLUSION

Equity crowdfunding as a tool to issue actual team ownership to fans is an innovative and exciting proposition for sports team owners in leagues across the country. The benefits to teams and their fans are clear. However, as with any issuance of securities, there are risks. The sports industry group at K&L Gates is uniquely positioned to assist sports team ownership groups with navigating the equity crowdfunding process for their teams. For more information please contact John Wilson or Francisco Olmedo.

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