

***EX ANTE* CROWDFUNDING AND THE RECORDING INDUSTRY: A MODEL FOR THE U.S.?**

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Notwithstanding the recession, Barack Obama's campaign was able to raise nearly three-quarters of a billion dollars largely in small amounts over the Internet.¹ The campaign's ability to mobilize and monetize supporters using the Internet is often cited by pundits of all political stripes as a principal factor in Obama's victory. If nothing else, Obama's fundraising figures are evidence of people's willingness to give financial support to someone they believe in—sometimes referred to as “crowdfunding.” This article distinguishes “*ex post facto* crowdfunding” where financial support is offered in exchange for a completed product, from “*ex ante* crowdfunding” where, as in the Obama example, financial support is given on the front end to assist in achieving a mutually desired result.

Although commonplace in politics, crowdfunding is by no means limited to the political realm. Indeed, the concept of crowdfunding has been expansively described as “the act of informally generating and distributing funds, usually online, by groups of people for social, personal, entertainment or other purposes”² The *ex ante* crowdfunding method of capital formation has been increasingly used in the entertainment industry by independent filmmakers, artists, writers, and performers to bypass traditional keepers of the purse.³ In return, financial contributors typically receive “patronage perks” such as their name in the film credits or album liner notes, advanced autographed copies of the work, or backstage access at a performer's show.⁴ In the recording industry, more complex forms of *ex ante* crowdfunding are beginning to emerge as a handful of European companies experiment with financing models that do not rely solely upon patronage perks. The basic premise is the same: fans assume the traditional financier role of a record label for artists they believe in by funding the recording process. In addition to patronage perks, these models offer fans an opportunity to earn a monetary return on their contribution based on sales of the future recordings. Thus, there is a crucial difference between this form of “patronage-plus” *ex ante* crowdfunding and the “pure patronage” model previously mentioned.

¹ Tahman Bradley, *Final Fundraising Figure: Obama's \$750M*, ABC NEWS, Dec. 5, 2008, <http://www.abcnews.go.com/Politics/Vote2008/Story?id=6397572&page=1>.

² Peter Spellman, *Crowdfunding – Arts Patronage for the Masses*, KNOWTHEMUSICBIZ.COM, Feb. 25, 2008, <http://www.knowthemusicbiz.com/index.php/BIZ-BLOG/CROWDFUNDINGARTS-PATRONAGE-FOR-THE-MASSESby-Peter-Spellman.html>.

³ See Dan Ilet, *The Stock Market for Songwriters*, TELEGRAPH, Jan. 25, 2008, <http://www.telegraph.co.uk/scienceandtechnology/3356052/The-stock-market-for-songwriters.html>.

⁴ See Eliot Van Buskirk, *Put Your Money Where Your Indie Rock Is*, WIRED, Mar. 3, 2008, http://www.wired.com/entertainment/music/commentary/listeningpost/2008/03/listeningpost_0303.

Some view patronage-plus *ex ante* crowdfunding models as more sustainable than those based on pure patronage because fans are literally invested in the success of their artists.⁵ In fact, if successful, these models may go beyond simply giving artists an alternative to traditional record financing; fan investment could also work to counteract the devaluation of all recorded music in a system where many consumers treat recordings as a free commodity. Bringing consumers into the financial mix of the industry will—at the very least—expose them to the marketplace realities illegal downloading helped to create. It might also blur the “Us vs. Them” mentality that pits consumers against labels and vice versa.

Whatever promise patronage-plus *ex ante* crowdfunding models hold, without a presence in the U.S. market, their prospects for growth are severely limited.⁶ Unfortunately, the U.S. market poses unique and significant legal obstacles—mainly laws governing gambling and the sale of securities—that could derail any effort to import a patronage-plus *ex ante* crowdfunding system for the recording industry. This article examines the developing utilization of *ex ante* crowdfunding in the recording industry and explores the legal impediments that have thus far prevented patronage-plus models in the United States. Section I introduces the economics of record production and explains the continued need for outside capital even in an otherwise “Do It Yourself” environment. Next, Section II focuses on the recent growth of patronage-plus *ex ante* crowdfunding in the European market. Finally, Section III presents the legal obstacles to establishing similar models in the United States and considers several ways to address these challenges.

I. THE ECONOMICS OF RECORD PRODUCTION

While other aspects of the traditional recording industry structure are questioned and challenged with DIY alternatives, the mechanisms by which recordings are financed have remained relatively conventional. Even though advances in technology have reduced the costs associated with making a professional recording, the funding for full-length albums is still largely within the purview of record labels.⁷ The economics are fairly simple: even independent artists with some level of local or regional success are unlikely to have the requisite liquidity—typically \$20,000-\$60,000—for recording costs absent some outside capital.⁸ Most often this outside capital comes in the form of an “advance” from a record label,⁹ although more recently, corporations outside of the

⁵ See John Tozzi, *Scoring Money from an Online Crowd*, BUSINESSWEEK, Sept. 10, 2007, http://www.businessweek.com/smallbiz/content/sep2007/sb20070910_540342.htm.

⁶ See Gavin Haycock, *Online Music Site Sellaband Gets \$5 mln Investor*, REUTERS, Apr. 8, 2008, http://uk.reuters.com/article/UK_SMALLCAPSRPT/idUKL0851208720080408.

⁷ Telephone Interview with Michael Latterell, Grammy-winning engineer, in Nashville, Tn. (Nov. 17, 2008).

⁸ Telephone Interview with Michael Latterell, *supra* note 7..

⁹ See generally M. WILLIAM KRASILOVSKY ET AL., THIS BUSINESS OF MUSIC 22-23 (10th ed. 2007).

recording industry have assumed this initial financing role.¹⁰ True, there are some exceptions to this general rule; for example, Radiohead was able to independently fund the recording of *In Rainbows* and utilize *ex post facto* crowdfunding to recoup its costs.¹¹ However, this “digital tip-jar” approach has limited potential for artists who lack the up-front capital to make a recording in the first place. Without some form of outside financing to facilitate quality content, most artists are unable to take full advantage of the increased DIY opportunities afforded by low-cost marketing and digital distribution. Recognizing this financial paradigm is the first step in understanding the importance of *ex ante* crowdfunding for recording artists.

II. EX ANTE CROWDFUNDING MODELS

Some U.S. artists have already successfully financed their recording costs through pure patronage *ex ante* crowdfunding.¹² A number of European companies have taken the next step and are now using patronage-plus models to attract potential contributors. In general, these models can be broken down further into two categories: betting (“Betting Model”) and investing (“Investing Model”).

The Betting Model is best demonstrated by the U.K. company Slicethepie which is a licensed bookmaker under U.K. gambling laws.¹³ Slicethepie utilizes crowdfunding in two ways. First, through a pure patronage model called the “Arena” process, artists compete to secure financing by selling “Backstage Passes” for £5.¹⁴ A “Backstage Pass” is essentially an investment for which the fan receives a copy of the album upon completion and a few other perks.¹⁵ Second, through the “Exchange” system, fans can buy, sell, or trade what are known as “Contracts.”¹⁶ A maximum of 15,000 Contracts are issued for each album financed through the Arena process.¹⁷ After an artist begins recording, fans can purchase Contracts for approximately £1.50.¹⁸ Investors who purchased Backstage Passes during the Arena process can purchase Contracts at a reduced price.¹⁹ These Contracts are good for two years at which time

¹⁰ See Paul Bonanos, *Bandstocks Appears as Rival to Sellaband*, Slicethepie, THEDEAL.COM, Aug. 29, 2008, <http://www.thedeal.com/techconfidential/the-note/the-note/bandstocks-appears-as-rival-to.php>.

¹¹ Press Release, ComScore, For Radiohead Fans, Does “Free” + “Download” = “Freeload”? (Nov. 5, 2007), available at <http://www.comscore.com/press/release.asp?press=1883>.

¹² Eric Danton, *Independent Music Artists Appeal to Fans to Underwrite Recording Costs*, DALLASNEWS.COM, Aug. 3, 2008, http://www.dallasnews.com/sharedcontent/dws/ent/stories/DN-independent_0803gl.ART.State.Bulldog.4d9e50e.html.

¹³ Slicethepie, <http://www.slicethepie.com/About/FAQ.aspx> (last visited Dec. 6, 2008).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Slicethepie, <http://www.slicethepie.com/About/FAQ.aspx> (last visited Dec. 6, 2008).

they are recalled at a price determined by how well the album sold.²⁰ Each Contract holder receives £1 for every 10,000 digital album sales.²¹ Consequently, if a fan buys a contract at the initial offering price of £1.50 and the record sells 15,000 digital copies, the fan breaks even. If it sells more, the fan makes money. If it tanks, the fan loses money. By tying the rate of return to album sales, the Exchange system encourages fans to market and promote the albums for which they hold Contracts.

Slicethepie obtains exclusive digital distribution rights for the album for two years.²² The company takes a £2 royalty for each album sale and the rest goes to the artist.²³ The artist also retains all other rights and is free to sign with a label at any time.²⁴ If a label wants to obtain the digital distribution rights from Slicethepie, the label must pay the Contract holders a 50% premium on their individual purchase price.²⁵ Otherwise, the label must continue to pay the £2 royalty until the expiration of the two year digital distribution agreement.²⁶

The Investment Model is best explored through the companies Sellaband and Bandstocks. Sellaband is a German company that was formed in 2006 and is considered the “granddaddy” of these *ex ante* crowdfunding models.²⁷ Artists seek to raise \$50,000 by selling 5,000 “Parts” at \$10.²⁸ During the initial fundraising stage, all investor money is held in an escrow account managed by a third party and regulated under German law.²⁹ Individual investments can be withdrawn by the investor up until the \$50,000 goal is reached, at which time the money is transferred to Sellaband to fund the artist’s recording project.³⁰ Sellaband retains the master recording rights exclusively for 12 months, and non-exclusively for another 12 months.³¹ During that time, Sellaband, the investors, and the artist share equally in any profits derived from sales and advertising revenues.³² Additionally, Sellaband requires that the artist enter into a publishing agreement for all songs recorded. Profits from the exploitation of the compositions are split between the artist (60%), Sellaband (30%), and the producers of the album (10%).³³

²⁰ *Id.*

²¹ *Id.*

²² Slicethepie, <http://www.slicethepie.com/Assets/Pdf/ArtistTerms.pdf> (last visited Dec. 30, 2008).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ See generally Tozzi, *supra* note 5.

²⁸ *Id.*

²⁹ Sellaband, http://www.sellaband.com/site/faq_believer.html (last visited Dec. 30, 2008).

³⁰ *Id.*

³¹ Sellaband, http://www.sellaband.com/site/faq_artist.html (last visited Dec. 30, 2008).

³² *Id.*

³³ *Id.*

Bandstocks.com is owned and operated in the U.K. by Civilian Industries PLC (“Civilian”).³⁴ Bandstocks is also the name for the securities—loan stocks—offered to investors on terms approved by the Financial Services Authority.³⁵ Artists submit their songs to Bandstocks.com where they undergo a basic screening process.³⁶ Every artist must also set a “Target Amount” between £25,000- £100,000 that the artist would like to raise from the sale of Bandstocks.³⁷ The artists then compete for the chance to seek that amount from fans. The number of fan votes needed to move on to the investment stage is directly tied to the artist’s target amount.³⁸ For example, if the artist has a target amount of £50,000, Civilian would have to issue 5,000 Bandstocks priced at £10 to fund the project. To move on to the investment stage, that artist would have to receive 2,500 votes (half the required issuance).

Once in the investment stage the artist enters into to a formal recording agreement with Civilian obligating the artist to record an album if funded based on a mutually accepted budget.³⁹ Civilian then creates a different class Bandstocks for each album project and offers them to fans who, upon purchase, become investors.⁴⁰ If enough £10 Bandstocks are sold to reach the artist’s target amount, Civilian creates a subsidiary company (Albumco) specific to the recording project.⁴¹ The artist then records the album with almost total creative freedom and Albumco owns the copyrights in the recording for five years.⁴² The remaining funds are used to market the album which is done through Civilian’s partners.⁴³ Each Albumco has its own bank account for any expenditures or income generated by the project.⁴⁴ Income from the sale of physical CDs, digital downloads, licensing fees and royalties, advances, and performance income is split between the Albumco subsidiary (20%), the artist (50%), and the investors (30%).⁴⁵ In addition to their percentage of net receipts, investors also receive a copy of the album and

³⁴ Bandstocks, <http://www.bandstocks.com> (last visited Dec. 30, 2008).

³⁵ Bandstocks, <http://www.bandstocks.com/Help.htm#faqs> (last visited Dec. 30, 2008). Technically, Civilian Industries is not regulated by the Financial Services Authority, but it has a partnership with Fisher Corporate PLC which is regulated under the FSA. *Id.* Civilian Industries issues loan stocks instead of shares because it allows the company to pay returns based on a particular recording—rather than the overall earnings of the company. *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *See* Bandstocks, <http://www.bandstocks.com/Help.htm#artistcontract> (last visited Dec. 30, 2008).

⁴⁰ Bandstocks, <http://www.bandstocks.com/Help.htm#faqs> (last visited Dec. 30, 2008).

⁴¹ *Id.*

⁴² *See* Bandstocks, <http://www.bandstocks.com/Help.htm#artistcontract> (last visited Dec. 30, 2008).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Bandstocks, <http://www.bandstocks.com/Help.htm#faqs> (last visited Dec. 30, 2008).

a few additional patronage perks.⁴⁶ The artist is free to sign with another label during the five year window of exploitation under pre-agreed terms that ensure Civilian and the investors are appropriately compensated.⁴⁷

III. LEGAL ISSUES AND POSSIBLE SOLUTIONS

Unlike pure patronage models, there are significant challenges facing patronage-plus *ex ante* crowdfunding in the United States. This section introduces the legal impediments posed by both Internet gambling and securities laws that could prevent the use of such models. Admittedly, circumventing these obstacles may not be easy or cheap. Therefore, the solutions proffered are aimed at firms—not individual artists—seeking to utilize either the Betting or Investment Model. Artists wishing to act totally independent of a larger collective effort are likely better served by less-problematic funding mechanisms such as pure patronage crowdfunding or private contribution from a wealthy investor.

A. INTERNET GAMBLING LAWS

Any Betting Model *ex ante* crowdfunding would be subject to domestic Internet gambling laws. Most legitimate online gambling in the U.S. was effectively terminated in 2006 with passage of the Unlawful Internet Gambling Enforcement Act (“UIGEA”).⁴⁸ The UIGEA is an enforcement statute that targets unlawful Internet gambling by prohibiting the transfer of funds necessary for gamblers to bet or wager online.⁴⁹ Such bets and wagers include “staking or risking . . . something of value upon the outcome of . . . a game *subject to chance*, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome.”⁵⁰ Since picking “winners” in the recording industry almost always involves a mix of both skill and chance, a Betting Model could be considered “subject to chance” and consequently prohibited under the UIGEA.

There are three potential solutions to this quandary. First, since the UIGEA is only an enforcement statute, it generally requires an independent violation of federal law—usually the Wire Act⁵¹—for its provisions to be triggered. Previously, the Wire Act was thought to apply only to certain sports-related betting.⁵² Since 2001, however, the Department of Justice has taken the position that the Wire Act applies to *all* forms of

⁴⁶ *Id.*

⁴⁷ See Bandstocks, <http://www.bandstocks.com/Help.htm#artistcontract> (last visited Dec. 30, 2008).

⁴⁸ Gerd Alexander, *The U.S. on Tilt: Why the Unlawful Internet Gambling Enforcement Act is a Bad Bet*, 2008 DUKE L. & TECH. REV. 6, *1-2 (2008).

⁴⁹ Michael D. Schmitt, *Prohibition Reincarnated? The Uncertain Future of Online Gambling Following the Unlawful Internet Gambling Enforcement Act of 2006*, 17 S. CAL. INTERDISC. L. J. 381, 381-82 (2008).

⁵⁰ 31 U.S.C. 5363 (2006)(emphasis added).

⁵¹ See 18 U.S.C. § 1804 (2006).

⁵² Alexander, *supra* note 48, at *10-14.

online gambling despite a Fifth Circuit ruling to the contrary.⁵³ The matter remains unresolved, thus it is not clear that a Betting Model for the recording industry would violate the Wire Act—triggering the UIGEA. Second, there remains significant disagreement as to what “subject to chance” means.⁵⁴ Some commentators argue that the UIGEA is only broad enough to include those hybrid games where chance is the predominate factor.⁵⁵ Because predicting future record sales arguably involves significantly more skill than chance, there is a legitimate argument that the Betting Model should fall outside the scope of the UIGEA. This position is akin to that of the online poker community, but the issue remains live.⁵⁶ Finally, proponents of the Betting Model could vocally support current legislation that would to repeal or limit the effect of the UIGEA.⁵⁷ Regarding future policy, many commentators cite the U.K. Gambling Act of 2005⁵⁸—under which Slicethepie operates—as a potential regulatory model for the United States.⁵⁹

B. DOMESTIC SECURITIES LAWS

Investment Model *ex ante* crowdfunding faces similarly tumultuous terrain in the U.S. because of securities laws.⁶⁰ In this context, a security is sold any time a fan gives money for a recording project expecting to share in the profits but does not actively participate in the management of the funds or the operation of the business.⁶¹ Thus, offering investors a return based on sales generated from an album over which they have no control would be considered selling securities.

Though the sale of securities is governed by both state and federal law, the main obstacle facing an Investment Model is likely the significant legal fees associated with federal registration.⁶² Federal law sets disclosure requirements for all public offerings

⁵³ See *In re Mastercard Int'l Inc.*, 313 F.3d 257 (5th Cir. 2002).

⁵⁴ Benjamin C. Wickert, *All In, But Left Out: How the Unlawful Internet Gambling Enforcement Act Seeks to Eradicate Online Gambling in the United States*, 10 VAND. J. ENT. & TECH. L. 215, 228-29 (2007).

⁵⁵ *Id.* See also Alexander, *supra* note 48, at *26-28.

⁵⁶ Wickert, *supra* note 54, at 229-30.

⁵⁷ See, e.g., Internet Gambling Regulation and Enforcement Act H.R. 2046, 110th Cong. (2007); Skill Game Protection Act H.R. 2610, 110th Cong. (2007); Internet Gambling Regulation and Tax Enforcement Act H.R. 2607, 110th Cong. (2007); Skill Game Licensing and Control Act S.3616, 110th Cong. (2008).

⁵⁸ Gambling Act, 2005 (Eng.), available at http://www.opsi.gov.uk/Acts/acts2005/ukpga_20050019_en_1.

⁵⁹ See, e.g., Matthew W. Mauldin, *The European Union, State Sponsored Gambling, and Private Gambling Services: Time for Harmonization?*, 36 GA. J. INT'L & COMP. L. 413 (2008); Katherine A. Valasek, *Winning the Jackpot: A Framework for Successful International Regulation of Online Gambling and the Value of the Self-Regulating Entities*, 2007 MICH. ST. L. REV. 753 (2007).

⁶⁰ See Tozzi, *supra* note 5 (noting that SEC laws make crowdfunding very difficult).

⁶¹ See MARK HALLORAN, ESQ., *THE MUSICIAN'S BUSINESS AND LEGAL GUIDE* 28 (4th ed. 2008).

⁶² Interview with Trey Drury, Professor of Law at Loyola University, in New Orleans (Nov. 2008).

and generally prohibits the offer and sale of securities that are not registered with the Securities and Exchange Commission (“SEC”).⁶³ Compared to many foreign jurisdictions, SEC registration is typically more burdensome and expensive.⁶⁴ In the U.K. for instance, a company like Bandstocks can create and offer a different class of stock for each recording project more economically than could be done here. Indeed, a standard SEC registration would cost much more in legal fees than an average recording project—nullifying much of the Investment Model’s value as an alternative funding mechanism.⁶⁵

However, there are a few possible exemptions to full-scale registration that may provide economically sound solutions for the Investment Model. The first is “Regulation A” which provides a less burdensome quasi-registration process.⁶⁶ Regulation A permits the securities seller to pre-advertise an offering to the general public.⁶⁷ This “testing the waters” provision may allow Investment Model sellers to gauge the interest in a particular artist before creating and offering securities to potential investors—thereby avoiding unnecessary legal fees spent on artists with no likelihood of raising sufficient capital to fund a recording. The second exemption is located in Rule 504 of “Regulation D” which does not require any federal registration for certain small business securities so long as the offering is compliant with state law in each state where the securities are sold.⁶⁸ Like Regulation A, Regulation D is very useful to online firms because it also permits testing the waters prior to sale.⁶⁹ However, the costs saved from the federal registration exemption are somewhat offset by the multitude of state law compliance requirements.⁷⁰ One final possibility would be to allow investors to become “active” in the management of the artists’ recording projects.⁷¹ If the investors had some significant participation in the process, their monetary contributions would not be considered purchasing securities at all.⁷² The obvious shortcoming of this solution is that many artists may not be willing to share creative control, making widespread acceptance of such a model uncertain.

⁶³ DAVID L. RATNER & THOMAS LEE HAZEN, *SECURITIES REGULATION* 11 (8th ed. 2005).

⁶⁴ Lisa A. Mondschein, *The Solicitation and Marketing of Securities Offerings Through the Internet*, 65 *BROOK. L. REV.* 185, 188 (1999).

⁶⁵ Interview with Trey Drury, *supra* note 62.

⁶⁶ Mondschein, *supra* note 64, at 193; *see also* Mark Anthony Jefferis, *Regulation A: Direct Public Offerings and the Internet*, 79 *DENV. U. L. REV.* 229, 230-33 (2001).

⁶⁷ Mondschein, *supra* note 64, at 194.

⁶⁸ *Id.* at 196-97.

⁶⁹ Mondschein, *supra* note 64, at 196.

⁷⁰ *Id.* at 197.

⁷¹ *See* HALLORAN, *supra* note 61, at 28-29 (describing Active Investors).

⁷² *See* RATNER & HAZEN, *supra* note 63, at 32-33 (explaining the requisite level of investor involvement).

IV. CONCLUSION

The Betting and Investment Models each pose unique problems in the U.S. market. In addition to the legal challenges addressed in this article, there are also social issues at play. In some circles, there is strong moral opposition to loosening gambling restrictions in the online environment.⁷³ Similarly, following the collapse of the financial system, there is a philosophical movement towards more regulatory oversight and investor protection in the securities market.⁷⁴ Clearly, establishing these models in the U.S. will not be easy, but perhaps the country is primed for a more fundamental shift in ethos: one where honest investment in creativity is not treated like betting on a football game or investing in the complex financial instruments that helped turn the securities market into a “legal pyramid scheme.”⁷⁵ These investments are not driven solely by the profit motive and are unlikely to bankrupt the moral character of fans or the global financial system. Instead, the country should have a system that allows fans to safely invest in the artists they love.

What is perhaps most exciting about the *ex ante* crowdfunding models is that—unlike *ex post fact* funding—they do not require an established track record to work. As innovative as the Radiohead *In Rainbows* experiment may have been, that style of *ex post fact* crowdfunding offers very little to lesser-known artists without a comparable pool of supporters. The *ex ante* models, on the other hand, allow unknown artists to simply let their music do the talking from the outset. In the end, the new model for the recording industry may be “no one model” at all. Artists will claw, scratch, bite, and kick their way into the industry any way they can, using all means available. *Ex ante* crowdfunding ensures that they are making music with value to others along the way.

⁷³ See Alexander, *supra* note 48, at *9.

⁷⁴ See Thomas L. Friedman, Op-Ed., *The Great Unraveling*, N.Y. TIMES, Dec. 17, 2008, at A39.

⁷⁵ Friedman, *supra* note 74.