Life Sciences Crowdfunding Considerations

In recent years, equity (or investment-based) crowdfunding has been growing as an alternative source of funding for early stage biotech companies. This is due to the increasing availability of capital and willingness of the general public to invest in innovative companies, the potential speed and efficiency gains for companies compared to other sources of funding and the positive marketing and media exposure associated with a successful crowdfunding campaign, which can then generate more follow-on funding for companies.

Although early stage biotech companies will often need many millions before a product can be launched to the market, equity crowdfunding can be (and has been for some) an important source of capital at the start of that journey, when venture capital or other institutional investors may otherwise be less inclined to participate in that stage of funding.

According to a recent report tracking equity crowdfunding campaigns in the UK, whilst there was a slight decline in the number of campaigns and amount raised during Q2 2020 (with the market uncertainty resulting from Covid-19 likely having an impact), more investors are backing crowdfunding campaigns than in previous quarters, the crowdfunding market remains strong and there is an expectation that investors and companies will continue to utilise this source of funding. In addition, an interesting market trend is the growing number of purpose-driven companies, including those that qualify as "Certified B Corps" and actively commit to balancing profit with social and environmental impacts. Such companies can generate additional public interest, and this can be particularly relevant for life sciences companies which are often engaged in activities that have the potential to benefit the public in general.

This article explores 5 key considerations relevant to any equity crowdfunding campaign, including those in the life sciences sector.

Size of the crowd

Equity crowdfunding involves a high number of individual 'crowd investors' investing into a company through an online platform, such as Crowdcube or Seedrs, which continue to dominate the overall equity crowdfunding market – according to a recent report, during Q2 2020, approximately 95% of all campaigns took place, and money was raised, on Crowdcube and Seedrs. There are also specialist life sciences equity crowdfunding platforms, such as Capital Cell, which was the first of its kind in Europe and launched in Barcelona, Spain and Cambridge, UK.

There can be hundreds or thousands of crowd investors (and potentially more if multiple campaigns are completed over time). Individually, each crowd investor will hold a very small proportion of the company's share capital, but together, the crowd investors may hold a more meaningful proportion. As a result, companies should consider how the crowd investors will align with its existing shareholder base and, if necessary, what protective wording needs to be included in the company's equity documents (including those set out below).

Transactions on crowdfunding platforms are also generally structured for compliance with UK financial promotion regulations. Companies should ensure, and potentially seek confirmations from the platform, that all necessary financial promotion regulations have been complied with by the platform in respect of the offer to the new crowd investors.

Nominee structure

Crowdfunding platforms often use a nominee structure, whereby the nominee holds the legal title (including the right to vote) and the underlying crowd investors hold the beneficial title (the economic interest) to the crowd shares. This can provide enhanced protection to investors, simplify the administrative burden on the company and make it easier to manage the equity going forward on both sides.

Crowd investor rights

Deal terms will vary but, generally, although crowd investors will receive the same economic rights as other investors that hold the same class of shares, the non-economic rights afforded to crowd investors will not be the same as those typically given to institutional investors in the company. For example, it is normally the case that crowd investors do not: (a) conduct extensive due diligence into the company; (b) receive business warranties or extensive information rights from the company; or (c) participate in consent matters or receive other contractual rights, such as the benefit of restrictive covenants from the founders of companies. Companies should evaluate if, and to what extent, crowd investors should receive pre-emption rights on new issues of shares, rights of first refusal over transfers of existing shares and / or co-sale rights. Crowd investors and the nominee will also not typically become a party to a company’s shareholders’ agreement and so their rights will be set out in the company’s articles of association.

Decision-making

Companies should consider how decisions in respect of the shares are made by the crowd investors and/or the nominee and reflect this in the investor terms and conditions that will apply between them and the company’s articles of association. In some cases, a decision is effective if approved by the majority of the crowd investors that respond to a request from the nominee. In other cases, the nominee can act in its discretion (without any vote), so long as it acts in the best interests of the crowd investors. Given the number of crowd investors, companies should try to avoid having to obtain consent from each crowd investor.

The articles of association should also clarify how shareholder offers, notices and communications are shared with crowd investors. It is customary to allow them to be sent to the nominee only, to avoid the company having to also distribute the same to each crowd investor.

Share transfers and exits

Companies may consider restricting the ability of the nominee and each crowd investor to transfer the legal or beneficial title (respectively) in shares to limited scenarios, such as permitted transfers, board approved transfers, tag-along transfers and compulsory transfers. These restrictions would be set out in the articles of association and referenced in the investor terms and conditions entered into between the nominee and the crowd investors. This will help avoid a secondary market in the shares, given the size of the crowd and the known split in the legal and beneficial title to the shares. It is important that, wherever beneficial ownership is transferred, the nominee remains the legal owner of the shares.

It is also important that companies understand how an exit can be implemented in respect of the crowd shares. Companies will want to avoid relying on the consent of each crowd investor to implement the exit, given how many there may be. This can be achieved by relying instead on nominee consent (subject to various protections) and ensuring the nominee and the crowd investors are capable of being ‘dragged’ with other shareholders under the drag-along provision in the articles of association.

Conclusion

Equity crowdfunding is distinct from other forms of crowdfunding, such as reward-based crowdfunding on Kickstarter, donation crowdfunding on Crowdfunder or loan-based crowdfunding on Funding Circle. It is also distinct from other sources of capital from angel investors, venture capital funds, corporate venture companies or sovereign wealth funds. It presents a unique set of issues and challenges that should be evaluated to facilitate the effective management of the crowdfunding investment, beyond the initial campaign. It can, however, provide an important source of capital for life sciences startups, particularly at the start of their journey.