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# NON-PROFIT CROWDFUNDING: RISK OF FRAUD

Швидке розповсюдження останнім часом по усьому світу краудфандингу – збору коштів від багатьох людей через онлайн-платформи - не могло залишити осторонь кримінальний світ. Шахраї з багатьох країн зацікавились можливостями фінансування тероризму, відмивання грошей, шахрайства та простої крадіжки грошей та / або ідей за допомогою IT-платформ. Метою статті є аналіз можливих ризиків шахраювання та реальних злочинних дій, вчинених з використанням краудфандингових платформ, в основі яких закладені не пов'язані з інвестуванням бізнес-моделі.

Спонсори/донори неприбуткового краудфандингу (моделей, базованих на пожертвах або на майбутній винагороді) надають гроші на благодійні цілі або підтримують виробництво певного товару чи послуги в обмін на якусь винагороду. Вони не набувають жодного права власності або прав на проект та не стають кредиторами проекту. Законослухняні донори отримують нематеріальні цінності або матеріальні цінності значно меншої вартості, ніж пожертвування; модель, що базується на винагороді, пропонує інвесторам негрошову винагороду, наприклад, майбутню продукцію. Усі сторони, що приймають участь у краудфандингу, можуть стати ініціатором або жертвою шахрайської фінансової схеми. Ризик шахрайства, вчиненого власниками платформи (що може бути як навмисним так і  ненавмисним), обумовлюється джерелом їх доходу - комісійними платежами за будь-які гроші, зібрані на їх платформах. Потенційний прибуток не стимулює власників платформ проводити ретельний аналіз отримувачів коштів та / або їх бізнес-планів; він також не заважає злодіям витрачати зібрані гроші на цілі інші, ніж декларовані - у статті наведено численні приклади неадекватного використання пожертвуваних коштів. Аналіз відомих випадків шахрайства шляхом краудфандингу дає підставу для висновку про те, що незважаючи на ризики шахрайства, притаманні краудфандингу, висування вимог щодо проведення перевірки даних про отримувача коштів або перевірки бізнес-планів рівнозначно зростанню вартості капіталу та / або вилученню більшості стартапів зі списку шукачів коштів – що викривить саме поняття краудфандингу як швидкого та дешевого способу фінансування.

Recent worldwide rise of crowdfunding – raising capital from many people through the online platforms – could not but leave behind criminal world. Criminals all over the world concern themselves with the possibilities of terrorism financing, money laundering, fraud and simple theft of money and/or ideas using IT platforms. The paper is aimed at the analysis of the potential risks of fraudulent activities and real cases of deceitful acts committed via crowdfunding platform based on non-for-profit business models.

Backers of non-for profit crowdfunding (donation-based and reward-based models) give money for philanthropic purposes, or support production of specific product or service in exchange for some reward. They do not obtain any ownership or rights to the project—nor do they become creditors to the project. Law-abiding donors receive non-tangible assets or a tangible asset of much lower value than the donation; reward-based model provides funders with a non-monetary return, such as would-be products. All the parties, engaged in crowdfunding, can become the generator or the victim of fraudulent financial scheme. The risk of fraud committed by the owners of the platform (which can be premeditated or inadvertent) is stipulated by the source of their income - fees charged on any money raised on their platforms. Potential profits do not stimulate owners of the platforms to carry out thorough analysis of the initiators and/or their business plans; nor do they prevent perpetrators from spending raised money on other than declared purposes – the paper provides numerous examples of inappropriate use of donated funds. Analysis of the known cases of fraud via crowdfunding provide basis for the conclusion that in spite of risks of fraud, inherent to crowdfunding, to set up claims of conducting a background check on the issuer or on business plans checking is equal to raising costs of capital and/or excluding majority of startups from the list of fund-seekers - thus laying away the very notion of a crowdfunding as a quick and cheap way of funding.

Ключові слова: краудфандинг, на основі винагороди, на основі пожертв, шахрайство, неналежне використання пожертвуваних коштів.

Keywords: Crowdfunding, reward-based, donation-based, fraud, inappropriate use of donated funds.

**Problem statement.** The motto of nowadays is 'Digitalization' – digitalization of all spheres of life, work, fun and economy as a whole. One of its most known manifestation of it in the financial sphere is crowdfunding, which provides a means for funding projects, connecting inventors and entrepreneurs with a multitude of supporters outside of banking system. These quite new form of financing, being a fast and comparatively inexpensive way to raise finance with no forthright expenses, appeared also to be an efficient form of marketing, providing entrepreneurs with valuable feedback and expert guidance.

But as the evidence shows, criminals use the fruits of IT in general, and engineered capabilities of crowdfunding platforms in particular, as craftily as any other accomplishments of civilization. Alongside with the growth of number of crowdfunding platforms and volumes of funds raised via them, we are witnessing the increase of cases of fraud, money laundering and terrorism financing, committed by the parties involved in crowdfunding. So the analysis of such cases and detection of the risks of fraud, money laundering and terrorism financing via crowdfunding platforms are of vital importance for all of us and especially for key parties of crowdfunding, law-makers and law-enforcement bodies.

**Literature Review.** Crowdfunding itself is rather a novel concept and thereof lacks adequate academic research, to say nothing about profound scientific research of criminal aspects of this newly-minted way of funding. The majority of the publications focuses on such areas as the analysis of the economics [1] and legal aspects [2] of crowdfunding, while other authors limit themselves to the analysis of success factors for crowdfunding campaigns that is, what factors determine that a project will fail, attain or surpass its funding goal [3]. Other researchers fix their attention on the motivations that drive people to fund projects [4]. Much less attention is paid to the criminal aspects of crowdfunding – one of the very sparse thorough papers on this topic was published by the Association of Certified Anti-Money Laundering Specialists [5]; legal aspects of fraud prevention in the USA are researched by Steven Bradford [6] and Christopher Moores [7]. Not a single paper on this topic was published in Ukrainian academic literature.

**The aim** of this empirical research is to trace potential risks and to analyze real cases of fraud committed via non-for-profit crowdfunding platform.

**Results.** To analyze criminal patterns in crowdfunding it is necessary to start with definition of crowdfunding and different modes of it, determination of participants of the process and their primary rightful objectives.

Among the numerous definition of crowdfunding, the one coined by international research team (including scientists from Belgium, Germany and the Netherlands) seems the most appropriate: "a collective effort of many individuals who network and pool their resources to support efforts initiated by other people or organizations. This is usually done via or with the help of the Internet. Individual projects and businesses are financed with small contributions from a large number of individuals, allowing innovators, entrepreneurs and business owners to utilize their social networks to raise capital" [8].

Croudfunding is an umbrella term that encompasses different forms of funds collection. By their economic essence they should be differentiated based on what backers receive in return for their money and appropriately divided into two major groups: for-profit and non-for profit.

The first group of investment oriented forms of crowdfunding includes debt- based (aka peer-to-peer lending) and equity-based models.

Both of these models presuppose that 'the crowd' invests money expecting to make profit in the future - either to earn interest when receiving their money back (debt-based model) or to become a co-owner of the growing business (equity-based model). In both cases the crowd provides entrepreneurs (initiators, who come up with the campaign project) with a feedback, demonstrating likeability of the project product.

Contrary to this in the framework of the non-for profit crowdfunding funders give money for philanthropic purposes, or support production of specific product or service in exchange for some reward. Thus this group of crowdfunding includes donation-based and reward-based models.

In donation-based model individuals give up money for philanthropic purposes: to a charity, event, project, person or community, expecting in return only the satisfaction of having contributed towards something they feel is worthwhile. The backers do not obtain any ownership or rights to the project—nor do they become creditors to the project. As a rule the donors receive non-tangible assets (if any), such as tokens, or recognition or a tangible asset of much lower value than the donation.

Reward-based model provides funders with a non-monetary return, such as would-be products; in many aspects such transactions resembles pre-sale. In this model, entrepreneurs invite potential customers to pre-order (and to pre-pay) their products offering, sometimes at a lower-than-usual price. Founders may also offer gifts and other non-monetary rewards to their funders, but they never pay interest or a share of their future earnings.

Specifically the risk of fraud in the framework of two last business models of crowdfunding is the subject of this research.

In order to detect identified patterns of fraud it is useful to distinguish all the parties, engaged in crowdfunding. They are:

Seeker of funding (aka Initiators): physical or juridical persons in an effort to raise money;

Providers of funding: physical or juridical persons (crowd or backers) donating or investing in a project;

Platforms owners or moderator (aka the 'funding portal' or a 'traditional broker-dealer') who brings everyone together to launch the campaign **and mediate the transaction** on their own conditions.

Each of the mentioned participants of crowdfunding can become the generator or the victim of fraudulent financial scheme. The most active in the role of shady deals procreator are platform owners and initiators.

According to Investopedia 'Financial fraud occurs when someone takes money or other assets from you through deception or criminal activity'. And according to Financial Dictionary, the term fraud refers to 'any attempt to deceive another for financial gain' and 'deception carried out for the purpose of achieving personal gain while causing injury to another party'.

In crowdfunding types of fraud are conditional upon the business model and the party engaged in the process. The only exception is the owners of the platform: their motivations and possibilities to carry out crooked operations are the same for all models and are stipulated by the common for them source of income – fees charged on other participants of the process. Before everything else, almost all of the platforms' activities are aimed at profit making.

Vast majority of crowdfunding platforms make money taking a percentage fee from any money raised on their platform, average rate being 5-10%. French platform WiSeed, for example, collect 10% of_amount raised (if_successful) from entrepreneurs while investors are simultaneously paying_5% of_amount invested. US WeFunder takes 10% of the return on investment (profit) from a successful exit, plus $1,000-$3,000 in administrative fees. Belguim platform MyMicroInvest charges 12% of_amount raised and US CrowdFunder charges issuer fee for listing of $299 for less than $500k, $999 for more than $500k, in addition to 7,9% of successful raise and 1,9% – 5% of transaction fee.

Potential profits do not stimulate owners of the platforms to carry out thorough analysis of the potential entrepreneurs and/or their business plans. The latter was outspokenly declared by the owners of Kickstarter - the platform whose name had become synonymous with crowdfunding: in 2014 its owners has simplified their own monitoring rules. Up till then «creators» had to submit their projects for approval to Kicksarter's «community managers»; the vetting procedure caused delays and drove some projects to Kicksarter's competitors, which had more relaxed rules. Thus in 2014 Kickstarter relaxed its vetting rules, driving home the idea that it's not a store but a place where the craziest ideas are bandied about and supported or thrown away. Nowadays Kickstarter, taking a 5% cut of each funded project, makes clear in its service terms that the platform isn't responsible for anything that happens after fundraising. So owners of the platform chose to 'Trusts Wisdom of the Crowd' [9].

As a rule, as professor Steven Bradford states, vast majority of crowdfunding sites do not independently generate reports on the companies listed. They merely post funding requests and other information produced by the entrepreneurs themselves [6]. Transparency about funding and willingness to share data is far from being core task of platform owners.

From the side of platform owners, fraud can be premeditated or inadvertent.

While the abovementioned example demonstrates only provisions for deceitful practices, the public is already aware of the real cases of premeditated fraudulent activities of the owners and top-management of some platforms, which were caught red-handed while breaking rules or even law.

In 2016, for instance, an internal review in LendingClub showed that *the founder and first CEO of* the company *Renaud Laplanche* had taken out loans on the platform for himself and family members without being transparent about them. Laplanche reportedly also did not disclose a personal stake in an investment firm in which LendingClub had considered making an investment. In 2018 the US Securities and Exchange Commission charged him and the whole company with fraud, stating that they caused one of the private funds they managed to purchase interests in certain loans that were at risk of going unfunded, to benefit LendingClub, not the fund, in breach of fiduciary duty. For these misdeeds *Renaud Laplanche, considered to be* a pioneer of the online lending industry in the US*,* was fined and barred from the securities industry for three years [10].

While such facilities for fraud and real cases of rules breaches can be found on all types of platforms, there are some kinds of fraud that are specific for non-profit business models of crowdfunding.

For example, *for* donation-based crowdfunding, where funders are driven mainly by philanthropic or social motives, there is serious risk in terms of moral obligations and the transparent handling of funds. The most impressive example of the donation-based scam seems to be the story of Johnny Bobbitt, a homeless man who spent his last $20 to help fill the gas tank of a stranded motorist in Philadelphia. That motorist, Kate McClure, started on the most known donation-based platform GoFundMe a campaign to help Bobbitt, raising more than $400 000 from more than 14 000 people. Nearly a year later Johnny Bobbitt was suing McClure and her boyfriend for the funds. His pro bono lawyer claimed that the couple committed fraud by spending the fundraising money on themselves for lavish vacations and a luxury car [11].

Numerous similar cases prompted Kate Knibbs to publish an article titled "GoFundMe Is a Great Way to Scam People"[12]; they also attracted hawk eyed attention of CharityWatch (a nonprofit charity watchdog and information service).

While majority of fraud on donation-based crowdfunding platforms is intentional, funders on the reward-based crowdfunding platforms are often misled without malicious intent. One of the ludicrous case history is Kickstarter helping one man raise over $55 000 so he could make potato salad [13].

Notoriously known example of failure to fulfill promise when due is "Pebble" campaign of Eric Migicovsky on Kickstarter. This campaign started on April 11, 2012, when Mr. Migicovsky turned to crowdfunding, with the goal of raising $100k, promising contributors a watch for every $120 they pledged. After 37 days, he closed his campaign, having raised more than $10M from 68,929 people and committed to producing 85,000 smartwatches the same year (shipping 15 000 watches per week). But he was not able to fill all of his crowdfunded orders until May 2013 [14].

Pebble project was not unique: according to CNNMoney investigation, 84% of Kickstarter's 50 top-funded projects missed their estimated delivery dates. As Julianne Pepitone explains, usually the same pattern emerged: a team of ambitious but inexperienced creators launched a project that they expected would attract a few hundred backers. It took off, raising vastly more money than they anticipated -- and obliterating the original production plans and timeline [15]. Other reasons for delay in shipping include all the hindrances facing startups (the failure rate of startups in their first year is estimated to be 55%).

Additional, specific for crowdfunded projects reasons of failure were disclosed by the researches of the US national bureau of economic research [14]: in reward-based crowdfunding, more investors are needed to raise the required funding goal as funders typically fund in smaller amounts. Hence, the number of investors that need to be managed can make investor management more costly. A project creator goes from the idea or prototype phase to production and full customer support in about 4 weeks or less. This typically involves providing regular updates, replying numerous comments and emails. The level of communication/refunds requested by funders typically increases when a project fails to meet the delivery date or expectations. For instance, Brook Drumm, project creator of Printrbot, had to issue refunds of about $20 000 to funders who complained about the delay.

In contrast to the case of Pebble and Printrbot deliveries, which were delayed without malicious intent, some campaigns are intentionally fraudulent.

As more and more cases of scams are detected, special sites for their uncovering are being created. One of them is kickscammed.com, a platform that serves as a sort of watchdog for these platforms. It gives users a place to report Kickstarter and IndieGogo campaigns they believe to be illegitimate and allows would-be investors to search for campaigns they are considering putting money toward. According to the site, it has uncovered over $3 million in crowdfunding scams. The latest projects, considered to be fake, include

Heart Forth, Alicia,

TWINZ STUDIO CHOPSTICKS

AVALON Playing Cards

BLIP — Turn Teadphones Wireless for $10!

fem -A Japan-made Multifunctional bag for Minimalists

The last one, for example, has 142 backers, who invested $12 000 (Ґеn1 286 460 ). 16 months later there was not one meaningful update and not one progress report about the actual project. Conclusion: Absolute scam [16].

Dealing with the risks of crowdfunding, visiting Professor of Entrepreneurship & Innovation Dr. Christopher-John Cornell and Director of Crowdfund Insider Charles Luzar proposed the following taxonomy of crowdfunding fraud [17]:

• **Preempted Fraud** — refers to a campaign with suspicious qualities being shut down by the platform before any funds are exchanged.

• **Stillborn Fraud** — refers to a campaign filtered out and dismissed by the platform before it's ever launched.

• **Attempted Fraud** — refers to a campaign utilizing an IP address, among other information, not belonging to it.

• **Perceived Fraud** —genesis of which begins when the promised perks and rewards from contributing to a campaign are drastically delayed or not delivered at all.

• **Backer fraud** — occurs when a contributor, donor or investor who has committed to funding a campaign deliberately does so with the intent of withholding those funds or filing a claim to have their funds returned.

• **Broker/Portal Fraud** — occurs when the crowdfunding platform operators are involved with fraud or enable the fraud.

It is interesting to mention that until 2014, when the abovementioned articles were published, all of them offered warnings about crowdfunding fraud risks, explaining threat or the potential of fraud, while none of them cited any successful cases of fraud. But in the following years not only the cases of fraud were detected, but also several legal actions took place:

On April 30, 2014, Washington State Attorney General brought the first enforcement action in the nation against Altius Management. This was to pay for irregularities arising from the 2012 *Asylum Playing Cards* Kickstarter campaign. Attorney General won his case, and the defense had to pay $54 851, according to the attorney general's office.

In June of 2015, the Federal Trade Commission intervened in a case involving a misuse of crowdfunding money, suing for $122 000. As court documents have shown, Erik Chevalier solicited funding through the popular platform Kickstarter, to back a board game called The Doom of Atlantic City. Nearly 1 250 backers pledged a minimum of $75 to get a replica of the game or one of its prized character figurines. All in all Erik Chevalier raised more than $122 000 for a game. For more 14 months he was providing intermittent updates on the progress, but then announced that he was cancelling the project; later he even sold backers' data to outside firms. The FTC settled with Chevalier for close to $112 000. The Commission also wanted him to repay backers, but he apparently spent all their money on rent, other personal expenses and licenses for an entirely different project, so the backers were left with nothing [5].

In September 2016, the Oregon Justice Department confirmed that it was investigating the Coolest Cooler. Although some backers had never received their perks, the product was being sold on Amazon. In 2017, the company settled with the Oregon Department of Justice, where they were required to deliver to over 800 people who still hadn't gotten coolers [18].

In 2018 FTC was back investigating the case of iBackPack: the backpack's creator, Doug Monahan, marketed the device as a Wi-Fi-enabled, battery-packed backpack that would power gadgets on the go and provide a local hot spot for wearers' friends. After campaigns on both Indiegogo (2015) and Kickstarter (2016), the iBackPack netted over $700 000. Despite a significant amount of funding that exceeded goals set by Monahan, the project missed its promised delivery date, initially set for September 2016. While Monahan assured backers the product was still in the works and that the setback was caused by an issue with the battery, updates on the project ceased in the spring of 2017. When complaints about the delays started piling up, Monahan allegedly started to threaten supporters. According to the FTC's complaint, he told one customer that he knew where they lived and had their personal information. In another case, he threated to sue a person and their employer for libel and slander.

But the backpacks haven't shipped yet, and iBackPack's website no longer works. In June 2019 the Federal Trade Commission announced that it would sue the company's founder for misusing funds provided by backers [19]. According to the agency, project creator Doug Monahan used much of the more than $800 000 raised via Indiegogo and Kickstarter for personal use, including the purchasing bitcoin, making withdrawals from ATMs and paying off credit cards.

As if predicting abovementioned cases of fraud, as early as in 2016 Sherrie Sessoms [5] proposed a summary of rough activities of seekers and providers of funds via crowdfunding platforms, stating that they occurs when:

A crowdfunding campaign solicits or accepts funding from backers while deliberately and deceptively concealing or misrepresenting the true nature of the project and the expected results.

Backers commit to financing a project, business or cause with all intents of canceling and backing out of the campaign or to extract returns not offered to other backers.

The scope of the paper does not provide for the research of other risks of crowdfunding (such, for instance, as risks of illiquidity, business failure, and entrepreneurial self-dealing) or analysis of fraud in ICO-based model or in the framework of investment-based crowdfunding in general; the same refers to the risk of money laundering or terrorism financing via crowdfunding platforms. They are to become the subject of other articles.

**Conclusion.** Findings of the paper reinforce the statement of some industry experts [7] that the typical crowdfunding investor is an ideal target for repeated crowdfunding frauds because he/she may not be able to discern legitimate offerings from scams or even recognize when he/she has been defrauded.

Fraudulent activities take place in all spheres of economy that involves money. But in based on trust crowdfunding they can be exacerbated due to core fabric of the process:

The investors' pool has no personal contact with the entrepreneur and can't have specific knowledge of the business idea. Anonymity offered by the web and its worldwide scope provide for efficient funding of venture projects as well as for scams.

Channeling of small amounts of uncollateralized funds from great amount of backers through a non-banking intermediary to fund a specific initiative offers little incentive to spend time and money investigating creators and/or projects. To the extent that the cost of due diligence is high and the individual stake (and, correspondingly, risk) of an investor is low, the crowdfunding community may desist from due diligence. Competition between platforms does not stimulate platform owners to perform thorough examination of creators and/or projects either.

Unlike banks, venture capital or private equity funds, crowdfunding platforms are not intermediators (in the sense that they are not required to assess partners of the transaction) – they serve only as match-makers. To set up claims of conducting a background check on the issuer and its personnel or on business plans checking is equal to raising costs of capital and/or excluding majority of startups from the list of fund-seekers - thus laying away the very notion of a crowdfunding as a quick and cheap way of funding.

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