

## The Delaware Effect: Enabling Success in Equity Crowdfunding through Strategic Incorporation

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Over the last half-decade, the U.S. equity crowdfunding market has caught fire. Even the winning horse of the 2023 Kentucky Derby, Mage was funded in part by a fractional crowdfunding security offering.

Platforms like Wefunder, StartEngine, and SeedInvest have risen to prominence, aiding startups in raising substantial capital from individual investors. This surge in growth is mainly attributed to the implementation of Title III of the JOBS Act in 2016, which eased the limitations on securities offerings by small businesses. Essentially, it democratized investing, allowing any motivated investor to participate in early-stage funding rounds. Yet, as equity crowdfunding gains traction, the need for governance and investor protection has never been more crucial. Firms should recognize that success in this rapidly evolving market relies not only on opportunities but also on responsible management and safeguarding investor interests.

A crucial aspect of establishing sound governance for small firms engaging in equity crowdfunding is choosing the proper jurisdiction for incorporation. The state of Delaware, known for its business-friendly environment and expertise in corporate law, has long been a popular choice for both small businesses and Fortune 500 companies. Despite being home to just 0.3% of the US population, over 60% of Fortune 500 companies are incorporated in Delaware, showcasing the state's attractive corporate law for managers<sup>1</sup>.

Incorporating in Delaware offers several advantages that can especially benefit the smallest and most opaque crowdfunding firms.

1. Enabling exit: Delaware has a well-developed capital market and a strong corporate law framework, making it an attractive destination for companies looking to go public or be acquired. Crowdfunding investors and later-round venture capital (VC) appreciate a firm being incorporated in Delaware because it increases the likelihood of a successful exit for their investment.
2. Preventing self-serving management: Delaware's respected corporate law champions the rights of all involved, creating a balance between managers and shareholders. The law cultivates an environment where inefficient managers could see their firm acquired by a more proficient one, ensuring optimal resource management. Hence, the possibility of mergers and acquisitions keeps managers on their toes, making sure their interests align with those of shareholders.
3. Legal Efficiency: Delaware's Court of Chancery, a specialized court for business disputes, provides streamlined procedures and expert judges, resulting in quicker and more predictable outcomes in legal cases. This efficiency is particularly vital in the crowdfunding context where many firms are pre-revenue, as it saves time, resources, and

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<sup>1</sup> CNBC. (2023, March 13). *Why Big Corporations Love Delaware* [Video]. YouTube. <https://www.youtube.com/watch?v=ACEN0cqg7MY>

protects these small firms from potentially damaging financial consequences of prolonged disputes.

4. Legal familiarity: Many investors and legal professionals are well-versed in Delaware's corporate law, making evaluating and understanding the implications of a firm's incorporation in the state easier. This familiarity simplifies the due diligence process for potential investors.
5. Signaling: Delaware incorporation acts as a valuable signal for crowdfunding firms. It signals to investors that the firm is serious about its business and committed to complying with the law. These qualities can be particularly appealing to investors who value transparency and accountability.

In summary, investors often prefer companies incorporated in Delaware due to their familiarity with the state's corporate laws. They find navigating potential disputes in Delaware easier and anticipate how such conflicts might unfold. By incorporating in Delaware, the smallest and least transparent firms can signal quality, capturing investor interest and setting themselves apart in the highly competitive crowdfunding landscape. In fact, our recent study estimates that pre-revenue firms that choose to incorporate in Delaware raise on average 90% more capital and have a 5% better probability of a successful campaign<sup>2</sup>.

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<sup>2</sup> Cumming, Douglas J, Sofia Johan, and Robert S Reardon. 2021. "Governance and Success in U.S. Securities-Based Crowdfunding." Working Paper.