

Starting Your Own Business

Part IV -- Raising Capital

Doing It on Your Own

This is the fourth article in a series of articles that look at the issues that arise when a new business is started. The first article dealt with developing a business plan, the second with choosing the form of organization, and the third, published last month, dealt with organizational agreements among multiple owners of a business. This article will focus on the issues that should be considered in soliciting and accepting investments or borrowed capital to fund a new business.

New businesses must have capital to successfully operate. When businesses get started, they usually have a period that expenses are incurred before revenues begin to roll in. Eventually, the owners of the business expect that revenues will exceed expenses, and the business will then be able to pay salaries or dividends to the owners. As part of any business plan, the owners must project how much capital will be needed before the business can finance its own operations out of income. In addition, if a business discovers that it must expand, acquire new facilities or equipment, hire more employees, conduct research and development activities, or make greater investment in inventory to meet customer demand, then more capital will be needed to finance the business.

In most circumstances, a business will develop a budget (or a projected cash flow statement) to understand and project its capital needs. Once these needs are identified, the owners must raise the funds necessary to satisfy the business's cash requirements.

Finance 101 -- Where Does the Money Come From?

People go to business school and get degrees in finance, and MBA's spend additional years in grad school doing fancy math to understand and choose among financing alternatives. The basics, however, are pretty simple. The following is an extremely simplified version of how business finance works.

The idea of a capital structure of a business is based on understanding the sources of capital used in a business, and the cost of that capital. While profitability can be measured by the absolute amount of dollars earned, to take into account the different size of companies profitability is often measured by the percentage return that is earned on the assets employed or capital invested in the business.

The cheapest form of capital is equity capital. No interest needs to be paid on that capital (although in some cases equity investors may get a right to a preference return, assuming sufficient cash is available to pay the preference amount), and the owners of the business give up a portion of future distributable profits as the cost of this capital. If the business does not have profits, or more accurately, distributable cash, the equity capital receives no income or return on its investment -- in this situation the "cost" of the capital is zero. The equity investor is betting on getting future dividends and capital appreciation to justify making the investment. Of course, if the company becomes very successful, this capital can be very costly.

Preferred stock is equity, but usually carries a payment obligation based on some stated interest rate. This stock has a preference on liquidation of the company, which means that if the company were to go out of business and be liquidated, any cash left over after paying all debt would be paid to the holders of the preferred stock until they received the liquidation preference they are legally entitled to receive under the terms of the preferred stock. Usually, preferred stock is not entitled to be paid its interest component or dividend if there is not sufficient cash available to make such payments. The upside potential of preferred stock is limited, unless the preferred stock is convertible into common stock.

Another source of capital is borrowed money. Money may be borrowed from financial institutions in the form of loans, either short term or long term, and secured or unsecured. Money may also be borrowed in the form of negotiable debt instruments (notes, bonds) that are sold to individuals, financial institutions or others. The more secure (from the lender's perspective) the repayment of the debt is, the lower the cost of borrowing. In other words, interest rates will be less as risk for the lender goes down. Rates on borrowed funds may be based on the prime rate charged by banks (or sometimes on the rate paid by the U.S. government on treasury securities of like maturity), usually expressed as percentage "points" (or fractions of a point) over the prime rate or the treasury rate. In the finance world, a "point" usually means one percent, but confusion may be created by the term "basis points", where a basis point is one hundredth of a percent (there are 100 basis points in one percent). Rates may be fixed at the time of the loan, or may float up and down during the loan term, based on movements in the prime rate. Floating loans carry lower interest rates, because the lender is protected against loss of value resulting from increases in the market rate of interest.

Some debt instruments are hybrids, and have equity features, such as being convertible into stock at some date in the future at the option of the debt holder. By adding this equity feature, the interest rate on the debt will be lower, because the lender has the opportunity to achieve additional return through capital appreciation of the stock. On the other hand, if the equity feature is exercised by the lender, the owners will end up with a smaller ownership percentage in the business.

There are many different types and classes of debt and equity financing available to companies. The game is to get the needed capital at the lowest cost, and the smallest give-up of equity ownership in the business. A large, mature business tends to view these alternatives as a relatively sophisticated mathematical game, where the goal is to lower the cost of capital and achieve a spread between the percentage return on capital used in the business and the cost of that capital. The greater the positive spread, the more leverage advantage to the equity owners of the business -- the spread drops to the bottom line and is available for distribution to the owners of the business (the holders of the equity securities) in the form of higher salaries for the owners or increased dividends.

New businesses do not have the opportunity in most instances to choose among many different sources of capital. The problem is attracting or obtaining the needed capital, and secondarily obtaining that capital at a reasonable cost. When the question is whether you starve to death or not, you are not in much of a position to haggle over the price of the bread.

For new businesses, the usual accessible source of capital is investment from the existing owners. The owners finance the business out of personal resources, and obtain either equity for the investment, or treat the investment as a loan. The advantage to loan treatment (for a corporation which is not an S corporation) is that money can be taken out of the business and not be taxed as a dividend. It is difficult to treat all money as loans, as this will leave the business undercapitalized for financial statement

purposes. Additionally, where a business is undercapitalized, the owners face the risk of creditors trying to assert claims directly against the owners and to get around the limited liability afforded to corporations. The IRS may treat the loans as equity if the business does not have sufficient equity investment by the owners, and when the loans are repaid they will be treated as if a taxable dividend had been distributed by the corporation to the owners.

Raising Capital by Selling Securities

Struggling new businesses often find it difficult or impossible to borrow funds from outside lenders. In some cases funds may be borrowed through special federal and state government programs, designed to assist small businesses, minority owned businesses or businesses that create new jobs. Some of these programs directly provide funds, and others guarantee borrowings from banks. In most cases, such borrowings will have to be personally guaranteed by the owners of the business, which exposes the owners to risks that they may not want to take.

If the owners of a business need capital and do not want to put any more of their own money into the business (or the owners are out of money), and cannot borrow the needed funds on acceptable terms, they usually will seek outside equity investors.

In the technology area, there are some publicly funded or supported entities that will invest (both equity and debt) in new technology businesses. In Pennsylvania, the Benjamin Franklin Partnership is one such entity.

Companies may seek to raise funds by selling stock to private investors in a private offering of stock or other securities. These offerings are called private placements, and they are regulated under both federal and state law. A common mistake of entrepreneurs is to sell securities (stock, options, warrants, limited partnership interests, limited liability company membership interests, notes, bonds or other type of investment contract) in a new venture without complying with the regulatory requirements. This may lead to federal or state legal proceedings against the persons conducting the illegal offering, and also provides the investor with a claim against the company and its principals for fraudulent or illegal sale of securities. The investor in such cases is usually entitled to a judgment for the return of all money invested, even if the business has failed. In addition, failure to comply with the regulations in one offering may make it difficult for a company to conduct a later (and usually larger) offering of securities legitimately. Investments promoted through advertisements in the Wall Street Journal or on the internet frequently will be in violation of these regulatory requirements.

The Regulatory Requirements in a Nutshell

The regulatory requirements to sell securities are very complex and require legal advice from securities law specialists. In a nutshell, any sale of a security must be registered or exempt from such registration under both federal and state securities laws, and it is deemed fraudulent to offer any security where the information provided is materially misleading, or where information is omitted that causes the information provided by the offering entity to be materially misleading.

Securities may be sold by the principals of the company directly, or through registered broker dealers or agents who specialize in the sale of securities. Initial organization of a new company, with a few securities holders, will be exempt as a private offering under federal law, and also will be exempt

under most state securities laws, without any special filing or disclosure requirements (but the offering company must still meet the anti-fraud requirements imposed by state and federal law, as discussed above).

Registration is used when a company goes public, and is very expensive and time consuming. New businesses rarely raise funds through registered public offerings. The cost of registration is typically in the hundreds of thousands of dollars.

Exemptions from registration include offerings to limited numbers of investors, where the investors, before committing to the investment, have been provided with sufficient information to fully understand the investment. The information that must be provided varies in accordance with the federal "safe harbor" exemption from registration relied upon (discussed below), the state securities laws that must be complied with, and the nature and sophistication of the investors. In cases where the investors meet certain minimum net worth or income requirements, and have sufficient resources to invest and lose their investment (accredited investors), the law may permit the company to provide less information to the investor because the investor has the sophistication and resources to protect itself. The decision as to the information to be provided in any situation should be made by a lawyer experienced in private placements.

Disclosure of required information about the investment is usually accomplished through a private placement memorandum ("PPM"), which is made available to a limited number of prospective purchasers. The PPM is a specialized document which should be prepared by an attorney. The PPM will describe the business of the company, the securities being sold, the management of the company, and how the proceeds of the offering will be used by the company, and it also will provide financial statements for the company and highlight risk factors for investors. Under many state securities laws, the PPM must be filed with the state securities commission in order for an exemption to be available.

Certain offerings are deemed exempt from federal registration if they meet certain federal "safe harbor" requirements. Depending on the size of the offering, securities may be legally sold under exemptions available under Rule 504, 505 and 506 promulgated by the federal Securities and Exchange Commission ("SEC"). Rule 504 is available for offerings by a company under \$1 million in any twelve month period. Rule 505 covers offerings of up to \$5 million in any twelve month period to any number of "accredited investors" and up to 35 non-accredited investors. Rule 506 provides an exemption for offerings without dollar limit to any number of "accredited investors" and up to 35 non-accredited investors in any twelve month period. Rule 506 also requires that non-accredited investors meet certain sophistication requirements. States are very limited in how they may regulate offerings that qualify under Rule 506, which means that qualification under Rule 506 can save significant time and expense by avoiding the need to comply with state law exemption requirements. In order to rely on a federal safe harbor exemption, the company must file a Form D with the SEC, and satisfy all other requirements of the Rule. It is not necessary, however, to file the PPM with the SEC.

State securities laws (often referred to as "blue sky laws") are similar to federal law, but each state has its own unique requirements to obtain an exemption from registration. Each state typically requires an exemption from registration for sales to any resident of the state, or for sales made in the state. In offerings made to residents of many different states, the securities lawyers for the company must review and satisfy the requirements of each state's laws. If an offering does not qualify as exempt under federal Rule 506, many states will require the PPM to be filed and will review it. If an offering qualifies

under Rule 506, most states require only that a copy of the Form D be filed with the state securities commission.

In most private offerings the securities sold in an exempt offering are not "free trading", and they may not be resold by the purchaser unless an exemption from registration is available for the securities owned by that purchaser. The purchaser will be required in the purchase documents to represent that the purchaser is purchasing the securities for investment only, and not for resale. Free trading securities may be obtained by selling securities in a registered offering, or by selling under the federal exemption available under Rule 504. Even when Rule 504 is used, however, some states will not permit the securities sold in their states to be free trading.

In some cases, purchasers of exempt securities may require that the company agree to register their securities for sale on demand at some point in the future, or contingent upon certain events occurring. By engaging in a public offering, the company creates a market for its securities, and provides an "exit strategy" for the original owners and later private investors to make a profit on the sale of the securities.

Venture Capital Investors

As companies grow, and need additional capital, one potential source for that capital is venture capital investors. These investors have specialized in identifying companies that are likely to be successful, and they will provide funds on terms that are very favorable to the investor, and costly to the company. Some state blue sky laws provide special exemptions for investments by venture capital companies.

Venture capital investors ("VC's") usually extract very steep terms to put money into a company. They typically take a very high percentage of the company's equity, and in some cases provide for a "claw-back" where the company can reduce the VC investor's percentage stake by achieving early success. Some of the money put up by a VC may be loaned at very high interest rates, and have equity features, such as being convertible into stock. The goal of the VC investor is to get a very high rate of return on its investment, because it generally is investing in start-ups and very high risk situations.

Because of the high percentage give-up of equity demanded by VC's, and because many VC's will want to have a seat on the company's board of directors and may impose certain restrictions on management, most companies prefer to obtain capital in private placements from wealthy individual investors, or companies with synergistic reasons to invest, which usually will be less costly to the original owners.

Investment Bankers and Advisers

Because of the complexity of raising funds and evaluating different investment alternatives, many companies seek outside financial advice from investment bankers and other financial advisers. These advisers are experienced with evaluating the best financing alternatives for a company and the sources of capital available, and they have many contacts in the investment community to solicit regarding prospective investments in new or growing companies.

These investment advisers are paid fees for their financial advice, and are also compensated if they are successful in locating investment capital for their advisory clients. In many cases one or more of the principals of the advisory firm may serve as a member of the board of directors of a client company, and the advisory firm may have a right of first refusal to provide future financing required by the company.

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