Attracting Investors

"It takes money to make money." This might be a cliché, but your business is going to need some startup capital to pay the bills before you start to see financial returns. Loans, selling equity, and issuing convertible notes are the most common options to get that startup capital.

Loans

Loans allow upfront capital without giving up any equity in the business, which means the company's founders can retain full ownership of the company. However, loans are subject to the terms and conditions of a loan agreement, especially interest payments, and loan repayments have priority before dividends and other company profits.

The terms and conditions of a loan will depend on the negotiations between the lender and the company, as borrower. For example, the interest rate, the term of the loan, payment terms (interest-only, principal and interest, balloon payment), and whether early payoff is permitted are terms negotiated between the borrower and lender and can have a substantial effect on the business. An institutional lender (like a bank) may be less flexible when negotiating the terms of a loan, in contrast to a private lender (like an individual). A lender may also require a personal guarantee from the owner of the business and/or security for the loan, such as a mortgage.

Interest and principal payments on a loan are treated as expenses of the business. That is, the business must make any such loan payments before the business pays out any profits to the business owners.

Equity

The other option available for attracting capital is to offer ownership in the business. Investors buy ownership units in a corporation or limited liability company and become entitled to a share of the company's profits. The company can offer different classes of shares that have different rights with respect to payment of profits and voting. For example, the company founders may have class A shares that allow them to vote, while investors may have class B shares that do not allow them to vote, but do allow them a greater share of the company's profits. The rights that go with certain ownership units are negotiated between the company and the investors.

One of the primary issues with offering equity to investors while the company is just beginning to develop is determining the value the company itself. That is, the company and investor need to agree on the value of the company before they can agree on a price for the company's equity. If the company does not have a long financial history but needs upfront capital, investors may be able to purchase equity at a price that undervalues the company.

Convertible Notes

This valuation issue leads many companies to issue convertible notes instead of equity at the company's early stages. Convertible notes begin as loans, under which the company must make interest payments, and then at the maturity date any outstanding amount on the note is converted into equity in the company on the same general terms that shares are issued to other investors. This additional time before the loan converts into equity provides a longer time frame for the company and the convertible note holders to value the company.

Gary R. Pannone
Managing Principal

Joshua J. Butera
Associate

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PANNONE LOPES DEVEREAUX & O'GARA LLC
counselors at law