

Counseling the Small Business Client in Georgia:

How to Finance the Small Business

**National Business Institute
Atlanta, Georgia
May 5, 1999**

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HOW TO FINANCE THE SMALL BUSINESS

Introduction

The vast majority of businesses in the United States are small, closely held businesses. Small businesses have provided a great proportion of net new jobs in the last decade as large corporations have downsized and streamlined their operations. Technology is also having a positive impact on the ability of small businesses to compete with much larger enterprises.

Small businesses have strategic advantages over large, publicly held corporations which provide small businesses with the competitive strength to overcome the benefits of size enjoyed by much larger businesses. Many large corporations recognize these strategic advantages and attempt to emulate the characteristics of entrepreneurial businesses. Attorneys should appreciate the strategic advantages enjoyed by small businesses and attempt to preserve these advantages in structuring organizational and financing relationships for these entities.

This paper will review the market of small businesses and the strategic advantages of such businesses. The paper will then discuss some traditional and other more innovative means of financing small businesses, and the relative effects of each financing method on the strategic

advantages of small businesses.

Understanding the Market of Small Businesses

Roughly 22 million businesses exist in the United States: 16 million without employees (largely sole proprietorships) and 6 million with employees (including some under common control). Based on 1993 U.S. Bureau of Census Data and after adjusting for separate establishments under common control, a total of 5.2 million firms had employees. Of these 5.2 million firms, 5.1 million had less than 100 employees (over 98%) and only 15,000 firms employ more than 500 employees. The 15,000 firms that employ more than 500 employees are behemoths, employing a total of 45 million employees, or 53% of all U.S. employees (excluding government). But small businesses (fewer than 500 employees) are providing a great proportion of net new jobs, as demonstrated by Small Business Administration data for 1992-1996:

Firm Size in 1992

<u>by Number of Employees</u>	<u>Net Number of New Jobs</u>
<20 employees	8,084,000
20-99 employees	1,417,000
100-499 employees	2,326,000
500+ employees	(645,000)

The Internal Revenue Service publishes information about corporate tax returns which evidences the increasing importance of small corporations. Of the more than 5.4 million corporate tax returns the IRS projects will be filed for 1999 (including corporations with no employees), 50% will be filed by Subchapter S corporations, up from 20% in 1980. S corporations have accounted for virtually all the new growth in number of corporations from 1980-1999, while C corporations have remained flat. In 1995, 98% of all S corporations had 10 or fewer shareholders and 82% of all S corporations had only one or two shareholders. With the adoption of the "check-the-box" regulations, some of this growth may shift from S corporations to partnerships (including LLCs).

Recent developments in technology have dramatically lowered barriers to entry for new businesses and enabled small businesses to perform like large entities. Technological innovations in microelectronics, personal computers, telecommunications and most recently the Internet have spawned increasing rates of entrepreneurship, particularly in the state of Georgia. While new business incorporations for the period 1987-97 increased by 16.5% nationally, incorporations over the same period grew a whopping 62.2% in the state of Georgia to nearly 30,000 per year. Being an entrepreneur has also become fashionable in American culture. While the 1950's American Dream

was to own your own house and loyally work for a single employer until retirement, the 1990's American Dream is to own your own business and be your own boss. Small businesses are the driving force behind the current expansion in the American economy and are becoming an increasingly important factor in the global economy.

Creative Destruction

While small businesses are being formed at an increasing rate, the relative share of small business (<500 employees) to large business (500+ employees) in terms of employees and gross national product has remained roughly stable over the past 40 years. The reason is that many small firms fail and those that do succeed (for example, Microsoft) become large enterprises themselves. But underlying the statistics is a dynamic process whereby small businesses are continuously innovating and experimenting to achieve entrepreneurial success. According to the Small Business Administration, about 10-16 percent of firms are new each year and about 9-14 percent exit each year. The economist Schumpeter some 50 years ago described this as the process of creative destruction, in which entrepreneurs create new successful methods of employing resources and destroy the old and unsuccessful methods. The attorney must be cognizant that many entrepreneurial ventures will not succeed and should counsel the entrepreneur about the downside of obtaining financing, particularly the individual financial exposure assumed through personal guaranties.

Strategic Advantages of Small Businesses

Small businesses have strategic advantages over large, publicly held corporations. Four of these advantages will be discussed below:

Entrepreneurial nature.

1. Entrepreneurial nature
2. Confluence of management and ownership
3. Long-term orientations
4. Lower costs

Entrepreneurial nature - An entrepreneur is defined as one who organizes, manages and assumes the risks of a business or enterprise. While many people may have one or two of the attributes of an entrepreneur (organize, manage and take risk), a much smaller number of people have all three attributes and are willing to undertake all three functions at once. The successful entrepreneur has the vision to see market niches and the willingness to take the risks necessary to capitalize on the opportunities.

Studies of entrepreneurship have identified both tangible and intangible characteristics of entrepreneurial ability. The tangible characteristics include education, work experience, and interpersonal skills. The intangible characteristics, which are probably more important in determining successful entrepreneurial ability, include internal motivation, behavior patterns, self-confidence, integrity and maturity. Internal motivation is a particularly crucial characteristic of a successful entrepreneur.

Confluence of ownership and management - When an entity is managed by professional managers for the benefit of disinterested shareholders, resources are wasted by management seeking personal security and power, and by shareholders monitoring management. Dilbert cartoons provide great examples of this wasteful behavior in large American corporations. Recent research shows family-controlled firms have better financial performance than comparable non-family firms. Many large corporations have adopted compensation structures to provide owner-like incentives to its professional managers. Still, small corporations typically have a greater confluence of ownership and management, and therefore less wasteful behavior.

Long-term orientations - Public corporations are driven by very short-term (sometimes quarterly) goals. Small businesses generally have a small number of patient investors who can ignore short term fluctuations and make decisions based on long-term benefit. This can be a huge advantage for small businesses, particularly in their willingness to invest in new products or customer service which may have long-term paybacks.

Lower costs - In an industrial-based economy, large size generally resulted in lowered costs of manufacturing. In today's information-based economy, the personal computer revolution enables small enterprises to improve productivity without the need for large size. The Internet allows entities of any size to operate on a global basis from a single site. Economies of scale have reversed so that small businesses can operate with lower costs than large businesses in many service areas. In addition, people are increasingly willing to accept reduced income in exchange for control over their own destinies, often resulting in lower labor costs for small businesses.

Large entities do retain a distinct advantage of size in marketing. Brand recognition is a major benefit in the increasingly global economy. Notwithstanding the Internet, personal contact remains the best marketing technique, which favors large organizations with broad reach. As discussed more fully below, small businesses can tap into these marketing benefits through strategic alliances. The big firm gets entrepreneurial ideas and products to market and the small firm gains the marketing benefits without the other disadvantages of bulk.

Can Large Firms Be Entrepreneurial?

Many large firms recognize the competitive disadvantages of size and have attempted to emulate smaller firms, particularly with respect to entrepreneurial nature. The following excerpts from actual advertisements in *The Wall Street Journal* illustrate such attempts:

Example #1 Microsoft Corporation (\$14+ billion in revenues, 27,000+ employees):

"Corporate careers for entrepreneurial minds. One reason Microsoft Corporation attracts some of the greatest entrepreneurial thinkers is because we don't act like a corporation. We actually encourage things like creativity and opinion, thinking for yourself, and taking matters into your own hands."

Example #2 - Orrick, Herrington & Sutcliffe LLP (Top 50 law firm with 300+ attorneys):

"Orrick, Herrington & Sutcliffe LLP is looking for leading practitioners "with entrepreneurial drive to help us meet our goals and client needs."

Can large entities be entrepreneurial? They can employ people with at least some entrepreneurial characteristics. Entrepreneurial characteristics that are desirable in organizations of any size include:

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- **Achievement-oriented**
 - **Hard-working**
 - **Resourceful/creative**
 - **Flexible**
 - **Enthusiastic**
 - **Tough minded**

Other important entrepreneurial characteristics that typically exist in small entities, but that are more difficult to tolerate and nurture in a large enterprise, including:

- **Risk-taker**

- **Strong leader and organizer**

- **Independent**

- **Goal-setter**

- **Self-confident**

- **Non-conformist**

While large enterprises can attempt to emulate some practices, small businesses are, by their nature, more entrepreneurial than large organizations. Small businesses enjoy streamlined management with typically a single individual willing and able to organize, manage and take risk. They are generally quicker to take risk and seize opportunities. Significantly, the entrepreneurial characteristic of non-conformity often cannot be tolerated in large organizations. The non-conformist may be compelled to run his/her own business.

The need for capital can compromise some of the above described advantages of small businesses. The entrepreneurial characteristics of risk-taking and non-conformity can be seriously restricted once bankers, venture capitalists and outside shareholders become involved in the business. Indeed, it is the capitalist, not the entrepreneur, who assumes the ultimate risk of financial loss. An important task of the attorney is to maintain to the fullest extent possible the strategic advantages of the small business while obtaining the financing necessary for the success of the business.

Starting Capital Requirements and Resources

Roughly one-half of new businesses start with \$10,000 or less. The biggest capital contribution is frequently the opportunity cost for foregone salary in quitting a job and starting a small business. The business must quickly generate revenues and finance growth internally. Minimizing capital requirements at start-up has the great benefit of avoiding equity dilution and the involvement of outside lenders and shareholders. On the other hand, lack of adequate start-up capital is a commonly cited cause of small business failures.

Based on U.S. Bureau of Census studies, the sources of equity capital for start-up businesses are as follows:

- **•50% - None used**

- **•30% - Self (personal savings)**

- **•20% - External Sources (in order)**
 - **Family**

 - **Partners/investors**

 - **Former owner**

- **Friends**



The sources of borrowed capital are as follows:

- **•60% - None used**

- **•20% - Credit cards/home equity**

- **•20% - External sources (in order)**
 - **Commercial bank loan**

 - **Family**

 - **Former owner**

■ Friends

Most businesses are started without debt or equity financing from outside the founder's family. In addition, technology has reduced the capital requirements of starting a business. Microsoft Corporation itself is an example of a business started without outside capital. Bill Gates and Paul Allen completed BASIC, the first language for a personal computer, in 1975. "From the start, Paul [Allen] and I funded everything ourselves. Each of us had saved some money. Paul had been well paid at Honeywell, and some of the money I had came from late-night poker games in the dorm. Fortunately, our company didn't require massive funding." Bill Gates, *The Road Ahead*, page 18.

In 1976, Bill Gates dropped out of Harvard to devote full attention to his start-up venture. Bill Gates and Paul Allen signed a partnership agreement in 1977 and by year end Microsoft had nine employees in its Albuquerque office. Microsoft began 1981 with 60 employees, all younger than age 40. The partnership also graduated to a privately held corporation during 1981. Microsoft did not go public until 1986, eleven years after formation. By 1998, Microsoft had revenues of \$14+ billion and 27,000+ employees. Bill Gates still owns 18.50% of the stock, with a market value in excess of \$75 billion. The moral of the story: hang on to the equity and don't get financing unless you really need it.

Stock Offerings

Public offerings are next to impossible for start-ups, even with the possibility of Internet offerings. The old adage applies: stocks are not bought, they are sold. Putting an offering up on the Internet is not an effective way to sell securities. Underwriters earn their fees by providing the sales force and clientele necessary for a successful stock offering. At least two years of audited financial statements are required by federal securities laws and reputable underwriters generally require 3-5 years of steadily improving business performance before agreeing to take a company public (although these guidelines are presently being violated by the Internet frenzy in the stock market). The fees of going public are also substantial and can only be justified for large offerings (more than \$5 million as a rule of thumb).

Private offerings to individuals are difficult for start-up businesses as well. While federal securities exemptions are usually available for stock offerings by small businesses, the attorney must watch out for state (blue sky) problems. The National Securities Markets Improvement Act of 1996 amended Section 18 of the Securities Act of 1933 ("Securities Act") to preempt state blue-sky registration and review of securities offerings of "covered securities" (federally registered securities traded on national stock exchanges). Securities which do not fall within the definition of covered securities remain subject to state registration and review requirements. Applicable state securities exemptions must be found for all private offerings of securities which are not federally registered and traded on a national exchange. The domicile of each individual investor determines the applicable state securities laws, not the state of incorporation or principal business office of the offeror.

Even if both federal and state securities exemptions are available, the securities must still be sold. Close personal relationships with qualified individual investors are necessary for a successful private offering to individuals. Otherwise, the venture capitalists are the only real option for serious start-up equity capital.

The basic federal securities exemptions are summarized below. Remember that all securities transactions, even exempt transactions, are subject to the antifraud provisions of the federal securities laws. In addition, offerings that are exempt from provisions of the federal securities laws may still be subject to the notice and filing obligations of various state laws. Be sure to get residency representations from all offerees and check appropriate state securities laws for applicable exemptions and other requirements (such as notice filings and legends).

Intrastate Offering Exemption. Section 3(a)(11) of the Securities Act is generally known as the "intrastate offering exemption." This exemption facilitates the financing of local business operations. To qualify for the intrastate offering exemption, the offeror must be incorporated in the state where it is offering the securities, carry out a significant amount of its business in that state, and make offers and sales only to residents of that state. There is no fixed limit on the size of the offering or the number of purchasers. The offeror must determine the residence of each purchaser. If any of the securities are offered or sold to even one out-of-state person, the exemption may be lost.

Private Offering Exemption. Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." To qualify for this exemption, the purchasers of the securities must have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (the "sophisticated investor") or be able to bear the investment's economic risk, have access to the type of information normally provided in a prospectus, and agree not to resell or distribute the securities to the public. In addition, the securities must not be offered by means of any form of public solicitation or general advertising.

The precise limits of this private offering exemption are uncertain. As the number of purchasers increases and their relationship to the company and its management becomes more remote, it is more difficult to show that the transaction qualifies for the exemption. Rule 506 of Regulation D (discussed below) provides objective standards for meeting the requirements of the Section 4(2) exemption.

Regulation A. Section 3(b) of the Securities Act authorizes the SEC to exempt from registration small securities offerings. By this authority, the SEC created Regulation A, an exemption for public offerings not exceeding \$5 million in any 12-month period. While technically an exemption from registration, the offeror must file an offering statement (consisting of a notification, offering circular, and exhibits) with the SEC for review before the Regulation A exemption may be utilized.

Under Regulation A, the required financial statements can be unaudited and there are no Exchange

Act reporting obligations after the offering unless the company has more than \$10 million in total assets and more than 500 shareholders. The offeror may "test the waters" to determine if there is adequate interest in the securities before going through the expense of filing with the SEC. "Test the waters" means the offeror can use general solicitation and advertising prior to filing an offering statement with the SEC to determine whether there is enough market interest in the securities before incurring the full range of legal, accounting, and other costs associated with filing an offering statement. The offeror may not solicit or accept money until the SEC staff completes its review of the filed offering statement and offering materials are delivered to investors.

The major drawback to Regulation A is the lack of corresponding state securities exemptions for the quasi-public offering and the "test the waters" provisions of federal law. As a result, state-level registration is often required and the associated time and expense of state-level registration undercuts the benefits of the Regulation A exemption.

Regulation D. Regulation D establishes three exemptions from Securities Act registration. Each exemption is addressed separately. Exemptions from state securities laws must again be found, but unlike Regulation A, many states have adopted exemptions which generally conform to the requirements of Regulation D.

Rule 504. Rule 504 provides an exemption for the offer and sale of up to \$1 million of securities in a 12-month period. Any offeror may use this exemption so long as it is not a blank check company and is not subject to Exchange Act reporting requirements. Under Rule 504, the offeror can sell securities to an unlimited number of persons and may use general solicitation or advertising to market the securities if registered under state securities laws or limited to accredited investors. Purchasers receive securities that are "restricted" from resale for one year. This means that they hold for at least one year before they may sell their securities in the open market without registration or other sales limits imposed on privately placed securities. Rule 504 does not require issuers to give disclosure documents to investors. Nonetheless, the offeror should take care to provide sufficient information to investors to avoid violating the antifraud provisions of the securities laws.

Rule 505. Rule 505 provides an exemption for offers and sales of securities totaling up to \$5 million in any 12-month period. Under this exemption, the offeror may sell to an unlimited number of "accredited investors" and up to 35 other persons (who do not need to satisfy the sophistication or wealth standards associated with other exemptions). Purchasers must buy for investment only, and not for resale. The issued securities are "restricted" and may not be sold without satisfying the applicable holding periods set forth in Rule 144 or the requirements of another applicable exemption. The offeror may not use general solicitation or advertising to sell the securities.

An "accredited investor" is:

- **a bank, insurance company, registered investment company, business development**

company, or small business investment company;

- **•an employee benefit plan (within the meaning of the Employee Retirement Income Security Act) if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;**
- **•a charitable organization, corporation or partnership with assets exceeding \$5 million;**
- **•a director, executive officer, or general partner of the company selling the securities;**
- **•a business in which all of the equity owners are accredited investors;**
- **•a natural person with a net worth of at least \$1 million;**
- **•a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or**
- **•a trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.**

If the Rule 505 offering is made to only accredited investors, no disclosure is required to meet the safe harbor, although antifraud disclosure is generally advisable. If the Rule 505 offering includes any non-accredited investor, all investors must receive disclosure documents (including audited financial statements) that generally are the same as those used in registered offerings. Thus, if preparation of a federal disclosure document is to be avoided, the offering should not exceed \$1,000,000, or if greater, the offering must be restricted to accredited investors only.

Rule 506. As discussed above, Rule 506 is a "safe harbor" for the private offering exemption under the Section 4(2) exemption; in contrast, Rules 504 and 505 are issued pursuant to Section 3(b). Rule 506 is much like Rule 505, without the \$5 million offering limit. Under Rule 506, the offeror can raise an unlimited amount of capital from an unlimited number of accredited investors (the same group we identified in the Rule 505 discussion) and up to 35 unaccredited purchasers. Unlike Rule 505, all non-accredited investors (either alone or with a purchaser representative) must be sophisticated - that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

Accredited Investor Exemption - Section 4(6). Section 4(6) of the Securities Act exempts from registration offers and sales of securities to accredited investors when the total offering price is less than \$5 million. The definition of accredited investors is the same as that used in Regulation D. Like the exemptions in Rules 505 and 506, this exemption does not permit any form of advertising or public solicitation. There are no document delivery requirements. Of course, all transactions are subject to the antifraud provisions of the securities laws.

Exemption for Sales of Securities through Employee Benefit Plans - Rule 701. The SEC adopted Rule 701 to exempt offers and sales of securities if made to compensate employees. This exemption is available only to companies that are not subject to Exchange Act reporting requirements, and is limited to offers and sales of the greatest of \$1 million, 15% of the issuer's total assets or 15% of the outstanding securities of that class. The amount that a company may offer or sell under this exemption may be limited further depending on factors such as the amount of company assets, the number of the company's outstanding securities and previous securities sales. Employees receive "restricted securities" in these transactions and may not freely offer or sell them to the public.

Angel Capital Electronic Network (ACE-Net). The Office of Advocacy of SBA has established an Internet site where small companies may list their Regulation A and Regulation D stock offerings. ACE-Net is a cooperative effort among SBA and nine universities, state-based entities, and other non-profit organizations to provide a listing service where small companies may list their stock offering for review by high net worth investors (accredited investors). In addition, ACE-Net anticipates providing mentoring and educational services for small companies needing business planning and securities information. ACE-Net has obtained SEC No-Action Letters to ensure it will not be considered a broker-dealer under the Securities Exchange Act of 1934 or an investment adviser under the Investment Advisors Act of 1940. The URL for the ACE-Net Internet site is: <http://www.sbaonline.sba.gov/ADVO/acenet.html>.

Venture Capital

"Venture capital" refers to capital typically provided by professional investors to fund early stage, more risk oriented business endeavors. The investment is usually in the form of stock or an instrument which can be converted into stock at some future date. Venture capitalists typically expect a 20% to 50% annual return on their investment at the time they are bought out. Some will invest as little as \$50,000 and as much as \$20 million in any one company, but typical investments range from between \$500,000 and \$5 million. Venture capitalists look for companies with solid management, strong market niches and high growth prospects.

Venture capital has increased dramatically in the last six years. According to the Price WaterhouseCoopers Money Tree Survey for the fourth quarter of 1998, total venture investments for 1998 was \$14.3 billion. This compares to \$11.5 billion for 1997, and less than \$3 billion in 1992. In addition, venture capitalists have become more willing to provide seed capital to fund early-stage

and even true start-up businesses. Venture capitalists had traditionally avoided start-up investments in favor of later-stage investments to fund rapid growth of companies with developed products. With an increased supply of available funds, venture capitalists are now actively seeking start-up investments in hot areas, such as telecommunications and the Internet.

A venture capital funding arrangement will typically entail relinquishing some level of ownership and control of the business. The small business must compromise some of its strategic advantages over public companies and will suffer some of the inefficiencies resulting from the divergence of ownership and management. [Appendix A](#) contains a form of Shareholders' Agreement that was adapted from one used on a venture capital deal with a start-up physician practice management company. In the deal, the venture capitalist ("VC") received notes, warrants and convertible preferred stock in exchange for an initial investment of \$5,000,000 and a commitment (albeit a weak one) to provide another \$10,000,000 in two subsequent stages. The form provides a point of reference for analyzing the nature and extent of the compromises that venture capitalists may ask of the small business.

Impact on Pass-Through Tax Treatment. Creating a second class of stock will disqualify the small company from maintaining any election to be taxed under Subchapter S. In addition, the venture capitalist in [Appendix A](#) included several foreign entities that would not be qualified S shareholders. The small corporation would have to convert to an LLC in order to maintain pass-through tax treatment. The company in the [Appendix A](#) example accepted C corporation status. If the business must be organized before but in anticipation of a venture capital investment, the need to accommodate a second class of stock and/or foreign entities may argue for choosing an LLC over an S corporation.

Board of Directors. Section 3 of [Appendix A](#) sets forth the structure of the Board of Directors after the venture capital investment. In this case, the venture capitalist had the right to elect 70% of the Board prior to an initial public offering (IPO), or five of the seven directors. The non-VC shareholders had the right to designate the balance of the directors, only two in this case. With the initial investment, the venture capitalists seize complete control of the corporation. The founders of the business have immediately lost the legal power to act as entrepreneurs in organizing, managing and taking risks. The founders must now convince the venture capitalists of the need and wisdom of their proposed actions. The venture capitalists will, of course, promise not to interfere or micro-manage (so long as their financial expectations are being met). Even if such promises are kept, the legal structure will force management to incur additional time, expense and delays in reporting to, and receiving approval of, a majority of outside directors.

The deal in [Appendix A](#) involved a start-up without established ownership and management. If the business is established, the non-VC shareholders can often successfully negotiate to retain majority control of the Board of Directors, subject to specific areas of VC veto power as discussed below.

Special Transfer Restrictions on Management Shareholders. Section 5 of [Appendix A](#) contains

special transfer restrictions on management shareholders in addition to the normal transfer restrictions contained in a typical shareholders agreement (compare Section 4). For a four year period, each management shareholder can sell no more than 15% of his/her aggregate stock ownership in the company. The venture capitalist wants to be sure that management remains invested in, and therefore committed to, the success of the business. This requirement maintains the situation of the typical entrepreneur, disproportionately invested in his/her employer. Both the time period and percentage may be negotiable items in different deals.

Rights of First Offer vs. Rights of First Refusal. Section 6 of [Appendix A](#), while captioned "Rights of First Offer," really provides for rights of first refusal. The management shareholders must notify the company and the venture capitalists of any offer to buy their stock, including the purchase price and other material terms. The company and the venture capitalists then have successive periods of time to buy the stock from the selling management shareholder on the same terms and conditions as set forth in the offer.

A true right of first offer procedure would simply require any management shareholder intending to sell to notify the company and the venture capitalists of such intention without specific terms of sale stated in the notification. Then the company and the venture capitalists would have successive periods of time to negotiate mutually acceptable terms of sale with the selling management shareholder. If a mutually acceptable sales agreement is not reached after good faith negotiations, then the management shareholder has some reasonable period of time (like six months) to solicit and accept offers from outside shareholders. The procedure may stipulate that any outside offers must be a minimum percentage of any prior offers by the company or venture capitalists (like 95% to 105%). If the price is lower than the minimum, the stock must be re-offered to the company and the venture capitalists.

It can be very difficult to induce a third party to make a good faith offer to buy stock when the stock is encumbered by a right of first refusal and the third party knows its offer will likely be futile. Under the true right of first offer procedure, the third party will get to buy the stock as long as the minimum price is met. The right of first offer procedure is less of an encumbrance on transfer than the right of first refusal procedure, and is therefore more favorable to the management shareholder.

Bring-Along (a/k/a Drag-Along) Rights. Section 7 of [Appendix A](#) establishes bring-along or drag-along rights which require all shareholders to sell their stock upon certain conditions. In the example, the bring-along rights may be invoked by at least 66% of the outstanding shares at any time after two years but before an IPO. The bring-along rights are important to the venture capitalist because prospective purchasers generally want to acquire 100% control of their targets. While the venture capitalist with majority control of the Board of Directors has the corporate power to sell 100% of the assets (subject to dissenters rights), the venture capitalist could not force a 100% stock sale absent the bring-along rights. C corporations generally must sell stock rather than assets to avoid double taxation on the sale of assets, once at the corporate level and again at the shareholder level as liquidating distributions are made.

The founders of the business are concerned about the power of the venture capitalist to prematurely force liquidation of the founders' equity interest before the full value of the enterprise is realized. As a result, the founders negotiate for a period of time (two years in the example) to give them a chance to develop the venture. Note that the management shareholders must first offer to sell to the venture capitalists (Section 6) before dragging the venture capitalists along using Section 7. The converse does not apply and the venture capitalists can drag along the founders at any time after two years without first offering to sell to the founders.

Tag-Along Rights. Section 8 of [Appendix A](#) sets forth the rights of shareholders to participate, or tag-along, on a pro rata basis, in any sale of at least 50% of the outstanding common stock. Tag-along rights are a minority shareholder protection. Such rights effectively negate any control premium that might be realized by sellers of a controlling block of stock because the minority shareholders can participate in the sale on a pro rata basis. In the example where the management shareholders have already relinquished control of the Board of Directors, tag-along rights actually protect their interests by ensuring that the venture capitalists do not attempt to realize a control premium upon the sale of their stock interests without offering the management shareholders a chance to participate.

Holdback Agreement. Section 9 of [Appendix A](#) adds to the shareholders agreement a requirement that each shareholder not sell, or holdback, any shares of the company for a period up to 180 days after the IPO and up to 90 days after any other public offering. The underwriter will typically require such a holdback agreement from all major shareholders as a condition to an underwritten stock offering. It is advantageous to include such a holdback provision at the venture capital stage to ensure that no dissident shareholder can interfere with the plan to go public via an underwritten offering.

Major Corporate Transactions. Section 10 of [Appendix A](#) contains a lengthy list of "Significant Transactions" that require the prior written consent of the venture capitalist. In the example, the extent of this list was not negotiated because control of the Board of Directors was already conceded to the venture capitalists. In other deals where the founders successfully negotiate to retain control of the board of directors, the list of "Significant Transactions" will be heavily negotiated. Even so, the list will often include a number of actions normally within the sole discretion of the entrepreneur. Examples of this in Section 10 of [Appendix A](#) would include: (iv) management agreements with physicians; (vii) incurrence of debt greater than \$25,000; (xxi) budgeting; and (xxiv) entering into employment agreements.

Other Documents. The venture capital deal will generally include a number of other documents which are not included in [Appendix A](#). A Securities Purchase Agreement will contain full blown representations and warranties by the founding shareholders similar to what would be required in a stock or asset purchase. A Registration Rights Agreement would lay out the procedure whereby the venture capitalists could require the company to register its securities for public trading. The

commitment to register is a significant financial obligation of the company. In addition, sophisticated articles and bylaws of the company will be required to provide for the new preferred and convertible securities and the various control arrangements.

Damage to the Small Business. A venture capital deal will impair several strategic advantages of the small business. The requirements for venture capitalist approval at the director level (Section 3) and for a long list of so-called "Significant Transactions" (Section 10) deprive the company of much of its entrepreneurial nature. No longer can a single entrepreneur quickly assume risk in order to seize opportunities, instead the company must report to and receive the approval of its venture capitalist. The separation between the founding shareholders and the venture capitalists introduces some of the wasteful efforts relating to power and oversight that are present in large, public companies. Involvement of the venture capitalists will also shorten the decision-making horizon for the business as venture capitalists are not patient investors. The posturing to go public will also likely increase costs in the form of more managers, financial accounting and audit expenses, and maybe even flashier office space.

Accepting venture capital often leads the company down a one way street toward going public. While some venture capitalists do market their services to small businesses to finance special needs (such as succession planning and liquidity) with the understanding that the business intends to remain private, any venture money carries with it the requirement for high financial returns. Achieving the stock premium enjoyed in the public markets may be the only way to satisfy the financial expectations of the venture capitalists.

Small businesses should carefully consider their strategic advantages and motivations before accepting venture capital. The necessary concessions in management and equity may outweigh the benefits of receiving the venture money. Less intrusive financing alternatives may be available.

Strategic Alliances

The strategic alliance has rapidly developed into a major structural alternative to joint ventures and a major financing alternative to traditional debt and equity offerings. While the strategic alliance can take a variety of forms, this paper will focus on the prototype in which an early stage, small business with some entrepreneurial technology or service capabilities establishes an alliance with a larger corporation with established marketing resources and contacts. The small business gains access to great marketing resources and the large entity gets entrepreneurial ideas which it may have difficulty developing within its corporate culture.

I have represented entrepreneurial clients in several very successful strategic alliances with larger entities, in one case with a Big 5 accounting firm and in another case with a major long distance phone company. Companies such as IBM and Microsoft are actively seeking to form strategic alliances which complement their existing products and services. The growth of the strategic alliance is largely due to the value of and dependence on technology in the current economy.

Simple Structure. As a legal structure, the strategic alliance is generally a simple sharing arrangement without the extensive negotiations over capital contributions, control and ownership normally associated with a joint venture, partnership or venture capital investment. A basic form of Strategic Alliance Agreement is attached as [Appendix B](#). The first observation to make, particularly for those of you with "page-counting" clients like me, is that the agreement is only six pages long. Simplicity is a major benefit of the strategic alliance.

The members of the alliance may contract with clients jointly, separately, or as contractor and subcontractor. Article I of [Appendix B](#) contemplates separate billing by each alliance member with an option for Large Corp. to assume the prime contractor role. The relationship may exist for a specified term or simply on a project-by-project basis. Article II of [Appendix B](#) states a five year term, but the agreement can be terminated early for any reason by either member upon 60 days notice.

Proprietary Property. The small company typically is sharing some of its proprietary property or information in the strategic alliance relationship. The main function of the agreement with respect to the small company is to protect this proprietary property or information from appropriation by the larger corporation. Article IV of [Appendix B](#) establishes confidentiality obligations between the parties and refers to a separate exhibit for the Non-Disclosure Agreement. The Non-Disclosure Agreement should, in turn, fill in the specifics concerning the proprietary property or information, particularly that of the small business. The contractual non-disclosure agreement will provide back-up protection to the extent the proprietary property or information is not already covered by patent, copyright, trademark, trade secret or other legal protection of intellectual property. In addition to non-disclosure, the small business may request an affirmative agreement by the larger corporation not to attempt to replicate its proprietary property or information.

No Partnership. Article V of [Appendix B](#) states that the members of the alliance are not partners or joint venturers for tax, property or liability purposes. This structure avoids the sticky tax issues arising in forming a partnership or joint venture, particularly between capital and service partners.

Indemnification. Notwithstanding the structural attempt to separate liability, Article VII of [Appendix B](#) provides a standard, mutual indemnity, excluding negligence and wrongful acts by the other party. The provision requires prompt written notice, the right of the indemnifying party to defend and select counsel, and the obligation of the indemnified party to cooperate in the defense.

Nonsolicitation of Employees. A concern in strategic alliance relationships is that one party will end up hiring the employees of the other. Article VIII provides a mutual non-solicitation of employees for six months following termination of the strategic alliance.

Nonsolicitation of Clients/Non-Compete. The form in [Appendix B](#) does not include provisions for nonsolicitation of clients or noncompetition that may be requested by the larger corporation with the marketing contacts. The decision to give such covenants, and the scope of such covenants, if

given, must be carefully considered by the small business on a case-by-case basis.

Other Considerations. One drawback of the strategic alliance structure is that the small business may become dependent on the marketing resources of the larger corporation without any rights of control. Ideally, small business should be developing its own marketing resources while it enjoys the benefits of the strategic alliance so it can survive on its own when the strategic alliance terminates.

During the actual management of the strategic alliance, the relationship between the parties is very important. The written agreement provides little in the way of management structure to govern the alliance. Commitment, chemistry and trust must exist and be maintained for a successful relationship. The development of such a relationship requires significant time and effort that must be considered in the pricing arrangements of the alliance. When the parties realize the importance of relationship issues and manage them appropriately, the strategic alliance can be a win-win situation for both sides.

Overall, the strategic alliance largely preserves the strategic advantages of the small business, and actually leverages these advantages with the marketing resources of a large enterprise. Entrepreneurial nature is maintained with a minimum of additional procedure. For technologically oriented businesses, the strategic alliance should be seriously considered as an alternative to traditional debt and equity financing.

Banks

Banks are financial institutions that accept deposits and make loans. They fall into several categories, such as savings and loans, thrift institutions and commercial banks. Knowing the category in which they include themselves can tell you a lot about the kinds of loans these banks are interested in making. Savings banks are more experienced in dealing with consumer loans, such as home mortgages and automobile loans. Commercial banks have more experience and interest in business loans. Probably the most important point to keep in mind when dealing with a bank is that bankers don't like risk. Their primary concern is always the safety of their funds, which can be in conflict with the need to assume risk in an entrepreneurial venture.

Banks come in all shapes and sizes and there are some real differences among them. Small community banks with two or three branches may operate quite differently from large commercial banks with hundreds of loan offices. A commercial bank may be more experienced and familiar with a business loan request, but a community bank may know the small business personally and have more confidence in its ability to repay the debt.

Commercial Finance Companies

The primary purpose of a commercial finance company is to provide loans to purchase inventory and equipment. Loans from such companies can be useful for manufacturers or wholesalers.

Commercial finance companies generally charge higher rates of interest than banks. They also may be more willing than banks to approve a small business request. Commercial finance companies will require that the debt be fully collateralized.

Factoring

A factor company can be a useful source of funds for small businesses with substantial assets in accounts receivable. Factor companies purchase accounts receivable of the small business at a discount, thereby freeing cash for the small business sooner than if it had to collect the money itself. The factor company takes title to the accounts receivable in exchange for a cash payment.

Factor companies provide two types of financing alternatives: recourse factoring and nonrecourse factoring. In recourse factoring, the small business and its individual principals retain part of the risk for ultimately collecting the accounts receivable. If the customers do not pay, the factor company has recourse against the small business and its principals for the bad receivables. In nonrecourse factoring, the factor company has no recourse against the small business or its principals for bad receivables. Neither commercial finance companies nor factor companies are appropriate as a means of seed capital to start a business because of the need for collateral or accounts receivable to sell.

Leasing Companies

A leasing company is a business that rents various types of equipment to businesses and individuals. By renting rather than buying, the small business may obtain needed equipment without a large, front-end capital expenditure. Many leasing companies do require a down payment or several months' prepaid rent. The small amount of cash needed to secure the use of equipment for your business makes leasing very attractive to many business owners. Leasing may help the small business to avoid the expense of purchasing quickly outdated equipment if the industry experiences rapid changes in technology.

However, since the small business does not actually own the equipment, the leasing company may repossess it upon a default in payment.

Small Business Administration Loans - Lender of Last Resort?

SBA loans are a major source of financing for small businesses, providing over \$10 billion in 1997, both direct and guaranteed. Paperwork on SBA loans can be excruciating, although the recently adopted "low-doc" programs are an improvement. Typically SBA loans require fixed assets as collateral and guaranties of the principal owners and their spouses. SBA loans work well for "mom and pop" businesses and traditional industries. Another advantage of an SBA loan is that the entrepreneurial nature of the business is generally maintained as long as the monthly loan payments are made. SBA lenders do not require the control concessions that venture capitalists do.

SBA loans do not work well for technology oriented businesses with little fixed assets or for pure start-ups. Entrepreneurs with good credit may find it easier to obtain a straight commercial loan rather than SBA loan. Commercial bankers, like venture capitalists, are now aggressively pursuing small and even start-up businesses with good credit.

The SBA offers financing through the programs listed below.

7(a) Loan Guaranty Program. As the SBA's primary lending program, the 7(a) Loan Guaranty Program was designed to meet the majority of the small business lending community's financing needs. In addition to general financing, the 7(a) program also encompasses a number of specialized loan programs:

Low Doc. This program is designed to increase the availability of funds under \$100,000 and streamline or expedite the loan review process.

CAPLines. An umbrella program to help small businesses meet their short-term and cyclical working-capital needs with five separate programs.

International Trade. A program for a business which is preparing to engage in or is already engaged in international trade, or is adversely affected by competition from imports.

DELTA. Defense Loan and Technical Assistance is a joint SBA and Department of Defense effort to provide financial and technical assistance to defense-dependent small firms adversely affected by cutbacks in defense.

Microloan Program. This program works through intermediaries to provide small loans from as little as \$100 up to \$25,000.

Certified Development Company (504 Loan) Program. This program, commonly referred to as the 504 program, makes long term loans available for purchasing land, buildings, machinery and equipment, and for building, modernizing or renovating existing facilities and sites.

Small Business Investment Company Program. Small Business Investment Companies (SBICs), which the SBA licenses and regulates, are privately-owned and managed investment firms that provide venture capital and start-up financing to small businesses.

Summary

[Appendix C](#) summarizes the various financing options available to small business and their relative impacts on the control and tax structure of the small business.

RESOURCES ON THE INTERNET

1. SBA Small Business Administration Home Page - The mother lode for small businesses:

<http://www.sba.gov>

- **Small Business Advancement National Center - Great site with a wealth of information about small businesses:** <http://wwwsbanet.uca.edu> (no period after the www)
- **eWeb Resources of Entrepreneurship Education - Articles and links to topics on entrepreneurship:** <http://www.slu.edu/eweb/index.html>
- **NetMarquee - Excellent resources with a focus on family businesses:**
<http://www.fambiz.com>
- **Securities and Exchange Commission Home Page - Everything you ever wanted to know about the large competition, with some information directed to small businesses:**
<http://www.sec.gov>
- **WMO Atlanta Law Home Page - Current legal topics of interest to small businesses and more (from yours truly):** <http://www.wmolaw.com>

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NOTE: This site includes a summary of certain legal issues facing small businesses today. This site does not, and is not intended to, give legal advice. Reference should be made to full text of the statutes and regulations for complete analysis. Consultation with competent counsel is strongly recommended.