

Chapter 2

Sources of Company Funding

Abstract An early-stage or startup business will transform and morph as it escalates through the different stages of growth, from a fledgling startup to a successful large company. The stages of development that a business goes through during its life cycle include startup and early-stage development, growth and expansion, and maturity. As the new company moves from the design and conceptualization stages, through product development and finally to commercialization, there are many stages of growth which all require financing in some capacity. Securing funding is important at every stage of a company's development. Funding can come from a variety of different sources, which are discussed in this chapter.

2.1 Seed Capital and Early-Stage Funding

Seed funding is early-stage funding that a startup uses to launch an idea. The difference between seed funding and early-stage funding is that seed funding is generally when the business is prerevenue and it may still be developing a working model of the product or technology. Early-stage funding normally represents when the business is close to having or already has some revenues but remains unprofitable. The purpose of seed funding is to fund more research than development and sustain the startup until further infusions of cash can be obtained, such as funds from venture capital (VC) investors or cash flows generated by the startup itself. Seed funding is typically used to cover the initial costs of starting the business and research and early development costs of a product.

Seed and early-stage funding can come from a number of different sources, which are identified and discussed in more detail in this chapter. Seed funding can be difficult to obtain since the startup may only be in the idea stage—the founders have an idea of what their startup will be and what it will do, but they need initial seed capital to begin converting that idea into a reality. The amount of uncertainty that surrounds a startup at the outset can be a deterrent for investors, so startups often rely upon their own investment capital, investments made by family members and friends, grants, and crowdfunding as the main sources of early funding.

2.1.1 Personal Investment/Bootstrapping

One of the earliest sources of funding comes from personal investments made by entrepreneurs and company founders. This is sometimes also referred to as bootstrapping or self-financing. Making a personal investment in your burgeoning company demonstrates to potential investors your confidence and dedication to your business ventures. Investors are often more inclined to make an investment in a startup where the startup founders believe in their own cause so strongly that the founders themselves are willing to financially back their own business endeavor. This is called having “skin in the game.”

There are a number of ways that company founders and entrepreneurs can personally back their own business venture.

- **Investments from savings.** Many entrepreneurs and company founders will use their personal savings as a source of initial seed capital for their startup endeavor. Serial entrepreneurs who have had prior business successes have the ability to provide significant seed funding.
- **Borrowing against real estate assets.** If you own a home or other real property, it may be possible for you to get a home equity loan based on the equity you have in your home.
- **Liquidating personal assets.** Company founders and entrepreneurs can always liquidate their own personal assets and use the funds as seed capital for their business venture.
- **Using personal assets as collateral for a loan.** If company founders have good credit, they can try to obtain a bank loan for seed capital by using personal assets as collateral.

2.1.2 Friends and Family Funding

Many startups and early-stage companies obtain seed funding through investments or loans made by family members and close friends. The amount of funding that can be obtained from these sources depends greatly on the financial resources available to your friends and family, and the confidence your friends and family have in you and the business concept. It can also be difficult to manage seed funding from these sources as entrepreneurs and company founders tend to treat friends and family differently than they would third-party investors (e.g., they do not already have a pre-existing personal relationship with when they accept the third-party investor’s capital funding).

While there are many horror stories about investments and loans from family and friends, a lot of pitfalls can be avoided and many potential conflicts can be reduced or eliminated by handling the loan or investment in a professional way. For instance, many friend and family investors sometimes mistakenly believe that their

investment buys them a say in how the business is run. By treating loans and investments from friends and family the same way you would treat a loan or investment from a third party who is unfamiliar to you, you afford your friends and family investors the respect that they deserve and you can keep them from trying to manage the startup. This will provide both parties full disclosure as to the terms of the financing and mitigate the likelihood of future disagreements.

It could be helpful to have a third party educate and explain the terms of the investment. By having a third party act as an intermediary, the investment takes on a more serious and professional air. The terms of an equity investment can include common equity or preferred equity, accrued dividends, preferences, and other rights. Equity investments are discussed later in this chapter. Debt instruments tend to be more straightforward and include terms such as term of loan, interest rate, conversion features, and collateral. A third party can explain these terms, so the investors understand their rights and what they are getting for their money. Debt instruments are discussed later in this chapter. A proper financing agreement identifies exactly what friend and family investors can expect to get.

2.1.3 Private or Governmental Grant Funding Options

One source of early-stage funding that new businesses should consider is grants. Unlike loans, grant money does not have to be paid back in the future and thus is not dilutive to the current equity holders. Grants usually carry stipulations as to how the grant money can be spent over a specific time period. Grants can take many forms, and which type of grant is best for your particular company's needs is something that needs to be considered.

Eligibility for certain grants is quite strict, and applying for grants is time-consuming. For many early-stage companies, pursuing grants might not be worth the effort and would ultimately be a waste of time as the process is slow, tedious, and often fruitless. But for early-stage companies that are in eligible industries, such as technology startups, or startups that have targeted causes, the efforts associated with applying for a grant can be well worth it if the grant is awarded.

If you believe that pursuing grants is a good idea for your particular business, it is beneficial to have a plan for how to approach the grant application process. Early-stage companies should target a few grant options that seem like a good fit and are in alignment with the business objectives of the startup. Next, it is important to establish a relationship with the grant-sponsoring entity. A company can greatly benefit from a relationship with someone who works for, or is involved with, the grant funding entity. Ask around for advice, either from people who work for the entity sponsoring the grant or from people you may know who have successfully obtained a grant, for tips on the application process. Make sure that your application is complete, and hope for the best.

2.1.3.1 Federal/State/Regional/Local Government Grants

Government grants for early-stage companies are available at the federal, state, regional, and local levels. Government grants are usually awarded to early-stage companies that are involved in certain lines of business that further the goals of the government entity sponsoring the grant. For example, at the federal level, grants for small businesses are generally very rare, but in certain business sectors, such as high technology, medical research, or scientific research and development, federal grants are made available to small companies and startups with the right potential and business objectives. At the local government level, local governments may be inclined to award grants to companies if a company's business would bring tourism or additional jobs to the area or would further some aspect of the local government entity's public agenda. State and local economic development authorities are good possible sources for these types of grants.

Government-sponsored grants often carry a number of strict eligibility requirements. Many of these grants are reserved for non-commercial entities, such as nonprofit organizations or educational institutes that are focused on developing certain industries. However, other grants, particularly at the local or regional levels, may be available that are meant to further economic development in certain geographic areas.

Small Business Grants

Small Business Innovation Research Grants

The Small Business Innovation Research (SBIR) grant program is a federal program coordinated by the Small Business Administration that offers startups and small businesses grants in an effort to stimulate high-technology innovation. These grants are limited to startups and small businesses working on targeted causes, such as scientific research and development, since the grant is funded by federal research funds. The grants are meant to allow small businesses to engage in federally sponsored research and development of products and innovations that have the potential for commercialization. These grants are funded by taxpayer dollars through SBIR participating agencies, a few of which include:

- The National Science Foundation.
- The National Institute of Health.
- The National Aeronautics and Space Administration.
- The Environmental Protection Agency.
- The Department of Transportation.
- The Department of Homeland Security.
- The Department of Health and Human Services.
- The Department of Energy.
- The Department of Education.
- The Department of Defense.

- The National Oceanic and Atmospheric Administration.
- The National Institute of Standards and Technology.
- The Department of Agriculture.

Each of the SBIR participating agencies administers its own grant program. The SBIR program is a three-phase program where small businesses and startups conduct research and development of an innovation. Funding is broken down based on the three phases and the phases build on one another, i.e., you can only obtain Phase II funding if you have successfully completed Phase I.

- **Phase I.** The first phase of the program is dedicated to establishing whether the innovation has technical merit, whether it is feasible, and whether there is any commercial potential. Funds for Phase I are generally limited to no more than \$150,000 for one year.
- **Phase II.** The second phase focuses on further research and development efforts that expand upon the results obtained during Phase I. Funds for Phase II are generally limited to no more than \$1,000,000 for two years.
- **Phase III.** The third phase is where the startup or small business pursues commercialization objectives based on the results of the research and development efforts of the first two phases of the SBIR program. No funds are generally available for Phase III, although some specific grant awardees may be eligible for additional funding from other sources.

Not many SBIR grants are awarded each year, and competition for these grants is very high. For instance, in 2014 only three hundred SBIR grants were awarded. However, the average funding amount of these grants was more than \$600,000.

Small Business Technology Transfer Grants

The Small Business Technology Transfer (STTR) program is another federal program coordinated by the Small Business Administration focused on providing funding for technology innovation. The STTR program also promotes technology transfer by requiring collaborative research and development efforts between research institutions and small businesses.

Several government agencies participate in the STTR program, including:

- The National Science Foundation.
- The National Institute of Health.
- The National Aeronautics and Space Administration.
- The Department of Health and Human Services.
- The Department of Energy.
- The Department of Defense.

Each STTR participating agency administers its own grant program. Similar to the SBIR program, the STTR program is a three-phase program where small businesses and startups formally partner with research institutions during the first two phases. Funding is broken down based on the three phases and the phases build

on one another, i.e., you can only obtain phase II funding if you have successfully completed Phase I.

Private and Foundation Grants

There are a number of privately funded grants that are made available by established businesses and other organizations. Private grants generally have specific qualification requirements and are usually awarded to startups or small businesses with targeted causes. By way of example, private grants exist for women owned startups, minority owned startups, startups operated by veterans, etc.

Finding private grants for startups and small businesses can take some effort, and identifying ones that your particular startup qualifies for can be time-consuming. However, the payout can be significant as grants are basically free money that has stipulations on how it can be spent.

There are also many grants that are funded by private foundations. Foundations look for grant applicants whose business activities are in alignment with the goals of a foundation or what the foundation stands for.

2.1.4 Crowdfunding

Crowdfunding is a relatively new way to raise early-stage capital by the collective efforts and cooperation of a network of many individuals or backers, which involves pooling money to help support the company's business plan. Crowdfunding is usually done through an online platform, which enables early-stage companies to engage investors from all over the world. Each individual invested amount is usually small, but the sum total of investments accrued on a crowdfunding platform provides large sums of funding. There are two main types of crowdfunding: rewards crowdfunding and regulation or securities crowdfunding.

With a reward crowdfunding model, early-stage companies generally reward their crowdfunding investors with an incentive for making a small investment in the company. This could include offering the company's product or services to crowdfunding investors for free or at a reduced rate in exchange for the investment that is made. Sometimes companies that engage in crowdfunding utilize a tiered incentive system to encourage investors. Different levels of rewards are offered based on the amount of the investment that is made.

Example If a startup company specializes in providing matchmaking services through a subscription-based smartphone app, the startup might offer the following incentives for crowdfunding investors:

- (1) A three (3)-month subscription of the services for free to crowdfunding investors who invest one thousand dollars (\$1000),
- (2) A six (6)-month subscription of the services for free to crowdfunding investors who invest two thousand dollars (\$2000), and
- (3) A twelve (12)-month subscription of the services for free to crowdfunding investors who invest three thousand dollars (\$3000).

Regulation, or securities crowdfunding, is where the company sells securities in the company in exchange for capital from investors. Because investors are getting securities in the company in exchange for their investment, there are many regulations imposed by the Securities and Exchange Commission (SEC) on this type of crowdfunding.

New SEC rules¹ governing regulation crowdfunding activities came into effect on May 16, 2016, that enabled unaccredited investors, i.e., “typical” people without large amounts of wealth, to invest in ways that had only previously been available to accredited investors, such as those on Wall Street. Under the new regulations, anyone can invest up to \$2000 (two thousand) dollars in startups using SEC-registered online crowdfunding platforms. For investments over \$2000 (two thousand dollars), investment caps, or limits, are put in place based on the annual income or net worth of the investor.

The new SEC rules also place limitations on how much money an early-stage company can raise through regulation crowdfunding. Specifically, a company can raise no more than \$1 million dollars totally through regulation crowdfunding efforts per year.

There are also stringent rules regarding how the company can advertise the regulation crowdfunding and what the company must disclose. Limitations have been placed on the company to only raise funds via a single platform. There are also strict compliance rules that must be followed by the company or else the company can face penalties. Another downside to crowdfunding is the fact that the entrepreneur will need to manage many more equity holders, which can have its own challenges.

Crowdfunding can be beneficial to early-stage companies in a number of ways:

- Crowdfunding generates a strong support network for the startup and raises awareness about the goods or services being offered by the company.
- Crowdfunding investors are often potential customers; so successful crowdfunding can produce lifelong customers.
- Crowdfunding can be an opportunity to get the company’s business idea or product out to the market, where people could talk about it and generate buzz. In essence, crowdfunding can be a marketing opportunity as well as an opportunity to raise early-stage capital.

¹15 USC 77d(a)(6).

Companies that use crowdfunding as a way to raise early-stage capital should start about six months before the money is actually needed by the company.

2.1.4.1 Case Study: Kickstarter

One of the most well-known rewards-based crowdfunding platforms on the Internet is Kickstarter. Kickstarter brings millions of potential backers into contact with thousands of creative projects and startups in an effort to secure funding for these projects through a pledging system. Projects are made available for pledges for a set amount of time referred to as a campaign. Kickstarter is an all-or-nothing crowdfunding platform: If too few pledges are made and the startup does not reach its funding goal in the limited amount of time provided for the Kickstarter campaign, the startup loses all the funds that had been raised with Kickstarter. If the funding goal is not reached, investors get their investments returned to them and the startup walks away with nothing. Through Kickstarter, only projects that gather enough support and interest from investors and reach their funding goal are actually funded.

The idea behind Kickstarter is that backers and creators work together hand in hand. The creative party could not make the project a success without funding, and the backers are the ones providing the necessary capital to make the project a reality. Kickstarter is an apt name for the crowdfunding platform to say the least.

Kickstarter, and other crowdfunding platforms, can be a good way for a startup to gauge the public's reception of the startup's product or business. When a project is posted to Kickstarter, backers need to be lured into making a pledge for the project. If no one is interested in the project, the startup needs to take this information into consideration when deciding to move forward with the product, project, or business. It needs to be determined whether the lack of interest was in the communication of the project or the project itself. As such, Kickstarter can be a good way to test out whether the startup's marketing strategy is a good one for a particular product.

If no one is willing to back the product or project on Kickstarter, the failed campaign could be a lean way for the startup to validate whether further investment of time, money, and energy on a particular project is a good idea.

When a company uses a Kickstarter campaign, they post a video of their product or project on their company's Kickstarter page. This is effectively the company's "elevator pitch" (i.e., a short description of the product or service) for their project, and it is the main vehicle by which companies can entice backers into supporting their project. Once the campaign is up and running, companies should go out and market their Kickstarter campaign as aggressively as possible, in an effort to drive Internet traffic to the company's Kickstarter page. Page views result in potential backers watching the company's video. Video views result in backers making pledges. Pledges result in achieving the company's crowdfunding goals.

2.1.4.2 Case Study: Crowdfunder

Crowdfunder is the most well-known equity crowdfunding Internet platform in the USA. Crowdfunder puts startups and small businesses into contact with investors to raise early-stage funds for growing and expanding the startup. Startups and small companies can raise capital through one of, or a combination of, debt, equity, revenue sharing arrangements, and convertible notes. The terms that a company offers investors through an equity crowdfunding platform, like Crowdfunder, largely depend on the startup. For some companies, a debt offering to investors makes more sense. For other companies, an equity offering is the most logical choice.

Similar to other crowdfunding platforms, companies create a pitch that they post to their startup's Crowdfunder page. Companies must also provide a term sheet, investor pitch deck, and an executive summary for potential investors to review. The Crowdfunder campaign lasts for a predetermined period of time during which the company must raise enough funds to meet its funding goal. The deals that are made between investors and the company must comply with the SEC regulations governing equity crowdfunding.

2.2 Equity Funding

Raising capital is one of the biggest struggles a startup or early-stage company can face. Equity funding is the most common source of funding for early-stage companies. Equity funding, or equity financing, is the exchange of partial ownership of the company for an amount of funding. While equity funding offers advantages over debt funding (to be discussed later in this chapter), such as eliminating or reducing the risk associated with cash flow problems for debt interest payments, equity funding requires the dilution of ownership of the company for the company's founders. When limited cash flows are anticipated, or are a concern for a startup, serious consideration should be given to the advantages and disadvantages associated with using equity funding to grow a startup.

Due to the risky nature of lending money to a startup or small company, banks will typically hold off on providing financing to a small business venture until it has successfully entered the growth phase of its development. In the interim, smaller businesses and startup companies need alternative financing sources. Equity financing is a good, and may be the only, option for raising early-stage capital. Venture capitalists, angel investors, and private equity partners are important sources of financing for small ventures. These types of financiers are often individuals, but can also be institutional investors that are interested in investing in small entities that have great potential for growth. These investors, as part of their financing negotiations, often bargain for a stake in the company's success by providing the company with up-front capital in exchange for an ownership interest in the company, i.e., common or preferred stocks issued to the financier. Business incubators and business accelerators can be sources of equity financing as well.

One of the benefits of equity financing is that the business raises funds without incurring debt and the business is under no obligation to repay specific sums to the investors at specific intervals of time. One of the main disadvantages to this type of financing is that it dilutes the equity of the company.

Since the valuation of early-stage companies can be difficult to determine, investors will many times require financing using convertible debentures. A convertible debenture is a debt financial instrument whereby the investor converts the debt to equity based on a discount to the company value at the next round financing. This eliminates the need to have the entrepreneur and the investor group to agree on the company value at the timing of the financing.

2.2.1 Angel Investors

There are some affluent individuals, often referred to as angel investors, who are interested in investing privately in small businesses or startups during the early stage and growth and expansion stage of the company's growth—the stages of a business' development which are least certain and have the highest risk. Because the risk is so high, angel investors often require a return on their investment at a higher rate than venture capitalists (which are discussed in the next section of this book). It is common for angels to invest in industries that they have past experience in and will generally invest in businesses that are local to the angel since the angel often relies on his or her established network of professional service providers, such as accountants/tax specialists, legal counsel, and lenders, when assisting the investment venture's growth.

Angel investors provide funding to companies in exchange for convertible debt or ownership equity and contribute anywhere from \$100,000 to \$500,000 in private equity funds. Angels prefer businesses with a working prototype of the product, although some are persuaded to invest based on a proof of concept. Angels often look for at least the beginning steps toward IP protection of the product, such as pending or provisional patent applications, when deciding to make an investment.

2.2.2 Venture Capital

Venture capital (VC) is a form of funding for new business venture that is often conditional—meaning the funds usually come with strings attached. A few examples include instances where VC funds are granted in exchange for an interest stake in the company (i.e., equity), a seat on the board of directors, the right to approve loans on behalf of the business, authority over the hiring/firing process, or various promises that the VC will be included in all major business decisions. VC funds are typically derived from a pool of professionally managed funds contributed by either individual venture capitalists or institutional investors. When VC

funds are administered to a business, they typically range between \$500,000 and \$10 million.

Venture capitalists often have certain criteria that must be met or demonstrated by the business venture before the VCs will consider it a viable and worthwhile investment. For instance, VCs are typically looking to invest in companies with (i) potentially large and lucrative markets, (ii) strong management/advisor team, and (iii) a business model they feel can be executed. This will meet the VCs' primary interest, which is to ultimately obtain a high return on its investment.

VC funding is often limited to established technologies that are beyond the proof of concept stage; VCs are more inclined to invest in entities that are at the product development stage or at the production and marketing stages of commercialization since the technology is well developed by that point. Also, there are many VCs that prefer to invest only in companies that have an IP portfolio.

2.2.3 Rounds of Venture Capital Financing—Series A, Series B, Series C, etc.

Equity funding can be obtained as a series of funding, and each round in the series is given a corresponding letter based on how many rounds of funding the company has participated in Series A, Series B, Series C, etc. Professional investors often choose to participate in Series funding rounds since the company has gained some traction in the market and is a lower investment risk. Investors get shares of the company, or stock, in exchange for their lump sum investment capital.

At the outset of each round of funding, the company undergoes a valuation, i.e., a current assessment of how much the company is worth. Valuations are based on a number of factors, including market size, the company's risk profile at a particular stage of development, and the company's track record for success up to the time of the valuation. From this valuation, investors for Series A, for example, can determine how much funding to offer the company in exchange for a certain amount of equity in the company.

- Series A funding is generally used to finalize the product or service offered by the company and to optimize the target consumer base through initial marketing strategies.
- Series B funding is generally used for building the company, growing the workforce, and expanding their market share.
- Series C funding is generally used to scale up the business, which could involve acquiring other companies or intellectual property rights from competitors, expanding product lines, or broadening the customer base or market (e.g., entering into international markets).
- Series A, Series B, Series C, etc., designations often correspond to stock issuances.

In a typical round of equity financing, the premoney valuation is negotiated between the company and the new investors. Premoney represents the company's equity value prior to the new funding. Post-money valuation is the company's equity value after the new funding. The premoney value plus the new funding that will stay in the company for growth determines the post-money value. The new funding versus the post-money value will drive the amount of dilution to the existing shareholders.

Most larger rounds of equity financing will be funded in tranches, which are smaller pieces or slices of the total round of equity financing divided up over a period of time, rather than paid out as an up-front lump sum. Evergreen investment funds are an example of VC funds that are funded in tranches. Capital influxes are made into a company as incremental funding during a company's growth and expansion development stage. The evergreen funding arrangement is beneficial to both the company and the investor. The company gets small, manageable infusions of capital over time, as opposed to a large lump sum up-front. This arrangement ensures that the company is consistently fueled by a source of capital and eliminates the risk that the company could waste its funds simply by having too much money at the start. Investors similarly benefit from evergreen funding structures by holding onto their investment capital and providing only small dispersion to the company at a time. This way, the investor is in control of the funds, rather than the company. If the company fails, the investor has not lost all of their investment capital since they retained control of the money in the first place.

Example JumpStart is an Ohio-based regional economic development organization that manages an evergreen fund for startups and small businesses. JumpStart chooses to work with and fund startups in the information technology, healthcare business and consumer products and clean technology areas. JumpStart offers evergreen funding in two forms: equity-based capital and debt-based capital.

2.2.4 Business Incubators and Accelerators as a Source of Equity Financing

Business incubators are designed to nurture small, fledgling businesses during the startup and early development stage by providing business development support, some initial financing, and encouraging the business to flourish and grow at its own pace. Participation in the incubator is permitted in exchange for an equity stake in the company.

Incubators and accelerators share similar characteristics, such as offering business development services and professional advice and guidance to startup

participants in exchange for an equity stake in the company. Also, businesses that participate in an accelerator, like an incubator, have a myriad of opportunities to network with others in the field. The major difference between incubators and accelerators is time and the amount of pressure that the company is put under. Business accelerators are intense, time-compressed programs designed to assist companies in getting up and running in a matter of months.

2.3 Debt Funding

Debt funding can be used by businesses that are in the early stage, the growth and expansion stage, or the mature stage of the business life cycle. Debt funding, or debt financing, is a more attractive means of financing for larger business entities that are more established, such as companies in the growth and expansion stage, or the mature stage, than for startups. But some startups find debt financing to be useful, and possible, at the early stage of development as well.

In debt financing, money is borrowed with the intent that it is to be repaid over a fixed period of time, with interest. Interest paid on the loan is tax deductible for the borrower. Debt financing may further be distinguished as short-term and long-term debt financing.

- Short-term financing will be repaid in full within one year of borrowing.
- Long-term financing will be repaid in full more than one year after borrowing.

Debt financing is essentially a loan whereby the lender retains no ownership interest in the business in exchange for the loan. The lender earns interest on the amount borrowed. It is common for the lender to require a personal guarantee based on the business owner's assets and credit history as an individual when making the loan in order to protect the lender's investment.

2.3.1 *Loans*

When the founders of the company have good credit and own real estate or other valuable assets, it may be possible to obtain financing for the company through private loans made to the founder personally. However, mixing the debts of the company with the personal finances of any individual founder is often an unappealing financing option because if things do not work out with the company, the individual founder is stuck dealing with the consequences and the loan.

Some banks will permit the use of IP as collateral when obtaining a loan or for establishing a line of credit for a business. IP-backed lending is a fairly straightforward debt instrument, and in fact, the use of IP as collateral may allow the business to get better financing rates. IP-backed loans can be personal, i.e., made

out to an individual, such as a founder of a company, or can be business loans, which are made to the business as an entity. As a borrower, it is important to establish title to the collateral IP as a preliminary matter. No lender is comfortable making a loan in reliance on collateral when it is uncertain who exactly owns the rights to the IP being used as collateral, even if the borrower purports to own the rights. It is highly recommended that a filing be made with the USPTO regarding any collateral assignments of patents or trademarks.

After ownership is confirmed, a lender will be concerned with “perfection” of the security interests in the IP. Perfection is a notification process whereby the secured parties’ rights become fully enforceable. Two sets of laws govern perfection of IP collateralization: federal law and Article 9 of the Uniform Commercial Code. Based on the type of IP used as collateral, perfection may require compliance with one or both. To perfect the security interests in patents and trademarks, compliance with the filing requirements of Article 9 is required. Perfection of copyright interests, on the other hand, may only require federal registration with the Copyrights Office. However, if the securities interest in the copyright also grants an interest in related receivables derived from the copyright, then compliance with Article 9 is also required.

2.3.1.1 Small Business Loans

Small businesses have a lot of options when it comes to small business loans. Some options are better than others, and which small business loans a business entity can take advantage of depends on the specific circumstances of the business.

Some banks offer special small business loans. However, banks are often hesitant and reluctant to issue these loans to unestablished startups and instead prefer to lend to businesses with a proven financial track record and proven success in the marketplace, such as companies that are in the growth and expansion stage, or the mature stage of development. Obtaining a small business loan is something that a startup or small growing business should consider once it has become more established.

When a small business has difficulty obtaining a traditional bank loan, other loan options may still be available, for instance through the Small Business Administration (SBA). The SBA is a government entity that works with small businesses and startups to obtain access to financing through a number of different government programs. The SBA does not make direct loans to startups or small businesses, but rather places eligible business entities into contact with third-party lenders. When a startup or small business is eligible for a loan through one of the SBA loan programs, the SBA will guarantee the loan will be repaid, which alleviates some of the risk that lenders would shoulder by granting a loan to a small business or startup. There are several SBA loan programs that startups can apply for:

- (1) **Basic 7(a) Loan Program.** The 7(a) loan program is available to eligible borrowers who are beginning, acquiring, or expanding their small business or startup. Funds obtained through this loan program can be used for real estate purchases, equipment purchases, and working capital. It is the most popular SBA loan program, and the program must be applied for through a lender institution that is a participant in the SBA Basic 7(a) Loan Program.
- (2) **Certified Development Company 504 Loan Program.** The Certified Development Company 504 Loan Program is available for small businesses that are experiencing growth. The loan is a long-term, fixed-rate loan that can be used for major fixed asset purchases for the business, such as buildings, land, or equipment.
- (3) **Microloan Program.** The Microloan Program is true to its name. Small loans are granted to eligible borrowers who are trying to establish or grow a brand new startup or small business. The loan amounts offered under this program are less than \$50,000. Funds obtained through this loan program can be used for real estate purchases, equipment purchases, and working capital.

The SBA also offers a number of additional loans, but these loans carry specific eligibility requirements or use requirements. Some examples include disaster loans, export assistance loans, veteran and military community loans, and special-purpose loans.

Obtaining SBA loans can be challenging as the eligibility requirements are very specific and are strictly adhered to, meaning there is no flexibility in the lending application process. Additionally, since SBA loans are obtained through a government program, processing of the loan application and then obtaining the loan itself can take considerably more time to accomplish than a startup can reasonably afford. While SBA loan programs are an option that is available to early-stage companies, these programs may not be the best option for the company to pursue.

Microloans may also be available through nonprofit lending organizations, for which startups can apply. Specific terms generally apply to these types of loans, such that borrowers must immediately begin repayment or that the borrower must have positive cash flows above a certain amount in order to qualify.

2.3.1.2 Peer-to-Peer Loans

Startups and small businesses that are growing can also take advantage of peer-to-peer (P2P) lending. A P2P loan is made available through an online platform where people can make loans to other people or entities. In P2P lending, borrowers are held personally liable for the debt, and P2P loans carry high interest rates. However, when a startup is having difficulties obtaining financing, a P2P loan may be another good alternative. Prospective borrowers need to have good credit in order to seek P2P financing.

2.3.2 *Lines of Credit*

2.3.2.1 Use of Credit Cards

Startups and other businesses also have the option of obtaining lines of credit by having a credit card issued to the business, although banks are more likely to grant credit cards to more established businesses than to startups. When a business has a business credit card, the business can begin to develop its own credit rating. However, the owner of the card must back the credit cards, meaning they are liable for the debts accrued on those company cards.

Startups and small businesses should carefully consider their options and review the terms and conditions for which credit card company they are planning on securing a line of credit. State laws may require a guarantee on the line of credit by those individuals who have significant ownership of the startup. Many credit card companies offer special business credit cards, with special terms and conditions and reward programs. Startups and small businesses that are considering obtaining a separate credit card for business expenses need to consider:

- Maximum limits on the card.
- Fees associated with the card.
- Interest rate on borrowing, which can be rather high.

2.3.2.2 Asset-Based Lines of Credit

Another creative IP-based financing solution is an asset-based line of credit. These lines of credit are designed to provide a company with the capital necessary to bridge the gap between cash flows from receivables and its business expenses. The line of credit offers a 0 % interest rate for a set period of time after the line of credit is established (for instance, balances carried on the line of credit have a 0 % interest rate for the first six months or year that you have the credit line) and can be used for an assortment of business expenses from operating costs to working capital used to promote company growth, or as capital for turnarounds, buyouts, mergers, or acquisitions. Where traditional lines of credit are based primarily on the credit-worthiness of the borrower, asset-based lines of credit are based on the value of certain assets, such as accounts receivables, inventory, and IP assets. Typically, only IP assets with demonstrated market value are factored into the credit assessment of the assets. These could be IP assets that have previously been bought and sold, or those IP assets with licensing agreements in place, which are known to generate revenue.

2.3.3 Securitization with Intellectual Property

IP-backed securitization is quickly becoming a popular means of debt financing. For instance, an IP-holder's future cash flows, or royalty payments, from future IP licensing agreements can be exchanged for an up-front, lump sum payment by an investor. Essentially, the IP-holder receives cash in hand and trades its right to royalty payments on future licensing deals, or a portion of the royalty payments, which may result from its IP for a set number of years. Securitization in this fashion puts the risk on the investor because the investor pays out a set amount to the IP-holder, which it may or may not recover as a result of future licensing deals.

Securitization can be a mutually beneficial form of debt financing for both the investor and the IP-holder. There are two main models for securitization of future royalties: royalty interest transactions and the revenue interest model.

In a royalty interest transaction, the transaction gives the IP-holder an up-front payment for its IP rights, while the investor attempts to buy the future revenue stream from the IP at a discounted rate, with the hope that the IP turns out to be worth more than its purchase price over the duration of royalty payments. The discount rate is dependent on the required return the investor is seeking based on the perceived risks of the investment. The riskier the investment, the higher the discount rate and the lower the value of the future royalty payments. If the investor is correct, the purchase could be well worth the risk.

A revenue interest model is similarly structured but is executed before the IP rights have generated any revenue whatsoever. Due to the lack of established earning potential of the IP rights and the greater level of risk associated with the IP, the investor can typically negotiate a lower value and more investor-friendly terms for the transaction. The investor is effectively paying for the future benefits of all prospective royalty generation from the IP rights prior to any history of actual royalty payments.

2.3.3.1 Case Study: Debt Financing with Bowie Bonds

In 1997, Bowie bonds, named after rock musician, actor, and record producer David Bowie, were asset-backed securities based on current and future royalty revenues that would be generated on songs recorded by Bowie prior to 1990. By that time, Bowie had amassed 25 albums, consisting of 287 songs, which he collateralized in a unique and pioneering securitization scheme. David Bowie was the first musician ever to securitize his IP rights in his music as collateral for a loan.

The David Bowie Class A Royalty-Backed Notes were given an A3 rating by Moody's Investors Services, based on a 7.9 % annual return, which at the time was a better rate of return than US Treasury bonds. The Prudential Insurance Co. was eager to buy the bonds and purchase the entire bond issue. Bowie had to forfeit his

rights to all royalties for a 10-year period in exchange for an up-front lump sum payment of \$55 million. This transaction took the form of a loan. Over the 10-year period, the bondholder would get an annual principal payment plus interest. In the event that the contractually stipulated debt obligation was not satisfied by the royalties generated over the life of the bonds, Bowie would sacrifice his IP rights in his music to the bondholder. Prudential held on to the bonds and did not make them available for repurchase by individual investors on the secondary market.

Bowie bonds met the market with such initial success that other artists also opted to securitize their IP rights in their musical creations. The individual responsible for structuring the Bowie bond debt vehicle was a banker named David Pullman. Pullman assisted other artists securitizing their music with debt structures called Pullman bonds, which were similar to the Bowie bonds. Some notable artists include James Brown, the Isley Brothers, Ashford & Simpson, heavy-metal band Iron Maiden, Marvin Gaye, and Rod Stewart.

Bowie bonds were downgraded to Baa3—near-junk status—in 2004, citing lower-than-expected revenues due to a slowdown in sales of recorded music. Illegal downloading was largely to blame for the slowdown, as file-sharing was rampant in the early 2000s. Apple helped to legitimize the downloadable music and media content industry with the popularization of Apple's iTunes and iPod products. Instead of having to buy an entire record just to own and listen to one or two songs, consumers could instead purchase the rights to individual songs. This change in the way people purchase music generated a revival of the music industry.

2.3.4 Collateralization of IP

Intellectual property assets represent important, valuable business assets that can be used as a source of debt capital. Many traditional lenders are uncomfortable lending capital to unstable borrowers or borrowers without any credit history, such as new startup companies and small businesses, without some sort of collateral to support the loan.

IP-based collateralization allows an IP rights holder to derive value from their intangible assets by securing financing that would otherwise be unavailable to them. In certain circumstances, a lender will provide a loan to the IP rights holder in exchange for a security right in the IP. In the event that the loan is defaulted on, the lender will assume the rights to the collateral IP.

The collateralization process is relatively simple to understand, but challenging to execute because the IP assets must be valued prior to lending. Intangible asset valuation for the purposes of collateralization is often a difficult undertaking for an IP appraiser because not only it requires an accurate determination of the fair market value of the IP and an accurate forecast of future revenues that could be generated by the IP being valued in the current context, but also it requires a

prediction as to the theoretical future liquidation value of the IP in the event that the loan is defaulted on. Where normally IP assets are typically appraised at fair market value, which is the value that two willing parties would negotiate in an arms-length transaction to purchase the rights, those IP assets that have been seized in the event of default will be liquidated by the lender under distressed circumstances and will likely be worth less than fair market value.

The future liquidation value is challenging to determine since it is unclear what the worth of the IP will be at the time of default. If, for instance, the company's default on the loan is a result of the technology being a failure, the liquidation value of the collateral IP assets will be worth less than the liquidation value of the IP assets seized if the default is a result of poor company management. The challenge for the business is being able to support the value of the IP through sales of similar IP or historical data and to show that the IP is appropriately protected.

There are many benefits to using IP assets as collateral for a loan. Loans provide a source of capital that does not dilute the company's equity structure. Risk management is another benefit to IP collateralization. In non-recourse financing, the lender is only entitled to repayment from the profits resulting from the investment loan; the lender may not collect repayment from any other assets owned by the borrower. The risk associated with licensing royalty payments is transferred to the collateral holder because royalties generated from the collateral IP are paid to the lender for the duration of the loan, until repayment is completed. If a licensee fails to pay its due royalties on collateralized IP, the lender has a cause of action to pursue the licensee for failure to pay, instead of the borrower/IP rights owner. It is important to note that this is an incredibly rare situation, as most lenders require personal guarantees from the loan recipient.

2.3.4.1 Case Study: Levi Strauss Borrows Against Trademarks and Other Assets

When an established company has valuable intangible assets, the company can leverage that value to generate sources of capital. The Levi Strauss Company and a number of its subsidiaries and sister businesses have a highly valuable IP portfolio. The company holds intellectual property in the form of patents, design patents, trademarks, copyrights, and trade dress. The company also has other valuable intangible assets such as a strong brand and goodwill.

In the early 2000s, Levi Strauss sought to use some of its IP as collateral for a few significant loans. Bank of America, and its various subsidiaries, underwrote a \$350 million dollar loan to Levi Strauss collateralized by Levi's trademarks, copyrights, and other IP rights. In exchange for the loan amount, Bank of America was granted an interest in all of the following intangible assets belonging to Levi Strauss under trademark:

- Trademarks
- Service marks

- Designs
- Logos
- Indicia
- Trade dress
- Company name
- Corporate name
- Business names
- Trade style

Bank of America was also granted an interest in all of the following intangible assets belonging to Levi Strauss under copyright:

- Copyrights
- Software
- Designs
- Computer programs
- Computer databases
- Layouts
- Drawings
- Writings
- Formulas

Bank of America's ownership interest in Levi's IP terminated upon the repayment of the loan in full.

2.3.4.2 Case Study: Ford Leverages Trademarks and Patents for Loan

In 2006, Ford Motor Company was struggling and in desperate need of capital to finance a restructuring of the company and had some near-term and medium-term negative operations-related cash flow issues to address. A deal was arranged between Ford and Citigroup, J.P. Morgan Chase, and Goldman Sachs to finance the loan. Ford set out to secure the money it needed, a whopping \$18 billion dollars, by mortgaging a number of its business assets. Assets that were pledged as collateral for the loan included equipment, factories, buildings, along with stakes in some of Ford's subsidiaries, and intellectual property assets, including patents and trademarks.

The iconic blue oval with the Ford logo inside was just one example of the intellectual property that was pledged a collateral by Ford for capital in the loan arrangement. Ford eventually earned its marks back in 2012, when Moody's, which is one of the principal rating agencies on Wall Street, upgraded the outstanding debt Ford was holding to investment grade. The upgrade of Ford's debt satisfied the terms of the 2006 loan, which released Ford's trademarks back under Ford's control.

2.4 Mezzanine Financing

As a company becomes more established, additional forms of financing become available. For instance, companies that are in the late growth and expansion stage, and mature stage of development, may be eligible for mezzanine financing. Mezzanine capital is designed to bridge the gap between debt financing and equity financing. Mezzanine financing is a form of either debt with warrants or convertible debt, which begins as a loan and later converts to equity if the loan is not repaid or a certain return on investment has not been achieved, reducing the risk for all parties involved. Mezzanine capital is usually large sums, used to facilitate big changes or growth in the company. Not all companies use mezzanine financing, but it is important to know that mezzanine financing options exist and a company can use this type of financing to its benefit.

Mezzanine financing is another form of financing that is a combination of debt and equity financing. To think of this in another way, mezzanine financing is a form of convertible debt. The investment starts as a loan, which can later be converted into equity. Debt financing and equity financing are not mutually exclusive and are combined to allay some of the disadvantages of each. Ideally, the blend of debt to equity financing should maximize return on investment while minimizing risk. Typically, a company seeking mezzanine financing should have stable cash flow to pay the interest on the debt and show significant growth, so the warrants or equity increases in value.

A mezzanine loan can be either a secured debt requiring collateral, or an unsecured debt, meaning the investor does not require collateral in exchange for the loan. For the secured debt scenario, some mezzanine investors will permit the use of IP rights as collateral. In situations where the debt is unsecured, the investor holds a convertible note, which can be converted to equity in the company if the loan is not repaid. The result of a conversion is dilution of the ownership structure of the company, giving a stake in the company to former creditors. However, mezzanine financiers are not particularly interested in becoming shareholders in the company—they would prefer to be repaid on the loan. The convertible note is a fallback measure in the event that the loan is not repaid.

A benefit of mezzanine financing for late growth and expansion stage and mature stage companies is that if the mezzanine debt is unsecured and can be subordinated to senior bank debt, then the mezzanine debt can be leveraged to attain lower cost capital such as senior bank debt.

The terms of mezzanine financing are defined by an agreement, which include terms such as the type of instrument, the date of maturity, the interest rate on the mezzanine loan and any fees associated with the financing, ranking in the capital structure, and the rights of the parties in the event of a default.

One of the biggest benefits of obtaining mezzanine financing is that once mezzanine financing is secured, established and mature companies often find that other financing providers are more willing to also make investments in the company, since a mezzanine financier has backed the company.

Companies use mezzanine capital in a number of different ways, but one common theme is clear: Mezzanine capital is often used for funding a growth opportunity. Typical growth opportunities financed by mezzanine capital include the following:

- Real estate transactions for factory facilities or store fronts,
- Plant or factory expansion,
- Launching a new product line,
- Restructuring,
- Establishing a new distribution channel, or
- Facilitating a leveraged buyout or acquisition.

When financing a company, there are many layers of financing, and a hierarchy is created among the company's financiers. Debt holders have superior claims to equity holders (i.e., shareholders), and mezzanine financiers' claim to the company's assets fall somewhere in the middle of the hierarchy.

The structure of mezzanine financing often takes one of the two forms, subordinate notes with or without warrants or preferred stock. Both offer mezzanine investors a claim to the company's assets, but these claims are subordinate to the claims of senior debt holders, but are superior to the claims of common stockholders. Mezzanine investors often prefer one form of mezzanine capital structuring to the other.

2.4.1 Subordinate Notes

Mezzanine financing is often structured as a subordinate note, which is a loan note that is subordinate to other, senior debts held by the company. Senior debt holders (i.e., banks and other debt financiers) hold debt notes that are superior to mezzanine subordinate notes, and senior debt holders should be compensated fully before a mezzanine subordinate note holder is compensated. The note is subordinate because it is usually unsecured, but often carries a higher interest rate to reflect the increased level of risk associated with its unsecured status.

2.4.2 Preferred Stock

Mezzanine financing can also be structured as preferred shares of stock. Preferred stock is senior to common stock, but junior to debt holders' claims. Preferred stock holders are afforded special privileges, called preferences, when it comes to their shares of equity in the company. Preferences can include accrued dividends, anti-dilution rights, and drag-along and tag-along rights. For instance, preferred shareholders hold a claim that is superior to common stockholders and can be

granted an equity warrant, which is a conversion rate by which their preferred shares can be converted into common shares of stock at a set price within a set time period.

2.5 Anticipated Rate of Return for Investors

Typically, when investors agree to make an investment in a company, the investors expect a rate of return on their investment capital, or a return on investment (ROI). The below chart is a general guideline as to the expected rate of return organized by the type of investor. These rates are current rates as of the completion of this book, but these rates may fluctuate over time. As a reference point, the current bank rate as of the completion of this book was 0.5 %.

Source of funding	Investor required rate of return (%)
Bank loans	3.5–5.5
Asset-based loans	4–10
Mezzanine financing	8–16
Private equity	25–30
Venture capital	25–45
Angel funding	30–35

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