Initial Funding Sources

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§1 Introduction

One significant challenge for the founders of a new company is obtaining the funding that will be required to bring the company’s initial product or service to the marketplace. At the very beginning the founder will typically be seeking a relatively modest amount of initial capital, so-called “seed financing,” to get the business up and running and finance completion of the initial development work on the new products or technology that the company intends to sell or use in the future. While it is possible for a portion of the seed financing to underwrite some of the costs associated with actually launching production and distribution of the new products the more likely situation is that further capital will need to be raised in order to support full-blown commercialization activities including the purchase or lease of manufacturing equipment and recruitment of a sales and marketing team. The amount of capital required will depend on the company’s business plan and the goals and objectives over the first few months while products and services are launched and promotional activities begin. If the business of the company is seasonal working capital will be required to continue operations during the off season and additional funds may also be needed in order to continue expansion of operations and begin development of a second generation of products and services.

In many cases the founders may be able to bootstrap their way through the initial product development and create a working prototype that can be evaluated and beta-tested by prospective customers using funds from their personal savings and available credit. However, if the founders are not independently wealthy, and perhaps even if they are, they will eventually need to obtain some outside capital for the business. Founders generally have a variety of financing sources to choose from; however, the practical availability of capital from specific sources varies substantially from country-to-country. For illustrative purposes the discussion in this chapter focuses on initial funding sources in the US and includes references to funding from relatives, friends and business associates of the founders; venture capital financing; private individuals otherwise unaffiliated with the founders; corporate partners; loans from banks and other commercial lenders; government financing; lease financing; and trade creditors. A good summary of various sources of startup funding is provided in P. Graham, How to Fund a Startup (November 2005), http://paulgraham.com/startupfunding.html

Bootstrapping

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While it is widely believed that startups need outside capital in order to grow and survive, many of the fastest growing new businesses in the country—60% of the companies on the Inc. 500 list in 2015—have been launched using “bootstrapping” techniques with less than $10,000 in capital. In contrast, only 7% of the companies on the Inc. 500 list that year were fueled with funding from venture capitalists. Joel Spolsky, writing in Inc. about his own experiences with bootstrapping, said that “our goal has always been to grow slowly, organically, steadily and profitably”. This approach contrasts sharply to the “big bang” model that involves rapid growth fueled by significant amounts of capital from outside investors such as venture capitalists.

Spolsky explained that companies that bootstrap correctly move slowly and four important pillars of organic growth—revenue, head count, public relations (“PR”) and quality—are always synchronized. In other words, revenue grows only as fast as the company can hire and train skilled employees and awareness of the company’s products never gets ahead of the quality of the goods and services that the company is able to provide to customers. When the only capital available comes from actual revenues from sales of products or services, as opposed to outside investors, the company must build its workforce slowly, which means there is more time to train new employees and make sure they understand and embrace the desired culture of the company. Working on a shoestring also means there is no money for big advertising campaigns, which makes the company rely on natural growth of the marketplace and be selective about how it prospects for customers. Product development is more simplistic for bootstrapped companies; however, while initial product offerings are limited in the scope of their features they generally are enough to convince customers that the company is able to offer quality and value.

Several problems can arise when raising large amounts of outside money causes the company to get out of synch with its pillars of organic growth:

- When capital is used for advertising that produces a service in revenues from sales to customers, companies often struggle to keep up because they are unable to hire skilled employees and train them fast enough to keep up with the demands of existing customers and the intense interest of prospective customers. Employees become overworked and demoralized and the failure to keep up with prospects means they lose patience and move on to competitors—generally for good.
- When the company hires employees faster than it can reasonably expect the quality of its product to improve the new employee won’t have a chance to learn and absorb the culture of the company because there simply are not enough experienced mentors available to conduct the necessary training. If this continues for too long, the quality of work and service will begin to decline as more and more of the workforce consists of inexperienced employees who haven’t had the time to learn about the business and their specific roles.
- When the company uses the money collected from investors to jump start demand through PR campaigns, it often isn’t ready for the explosion of interest in the new product or service, which often still lacks all of the features that prospects believe they have been promised in the marketing blitz. The company may find itself handling more customers, but turning them into paying customers is difficult and they may ultimately decide that the product or service is too simple or lacks the necessary quality and never return, even when the company has substantially increased the quality of its offerings. A related risk of misalignment is that the time frame for developing high quality technology-based products is generally quite long, which means that quality has a hard time keeping pace with interest generated from high spending on PR.

Spolsky argued that “raising too much money—whether it is venture capital or private equity or from a strategic investor—is often the key deciding factor in whether a company grows at a natural pace or gets misaligned”. His advice was that sometimes it makes sense, however difficult, to say “no” to investors willing to fund a “great leap forward” if the founders know that it will likely become too difficult to manage growth and satisfy customers to the point where they will forge long-term relationships with the company. Having too much money may also lead to waste and a lack of discipline about finding smart solutions to problems in the most efficient manner.

The flip side of the argument is that venture capitalists not only provide money that can be used to
accelerate growth, they also provide expertise that can be tapped to improve the business model and connections that are not otherwise available to the founders that can be used to find talent for the business and forge key partnerships. Money from venture capitalists can also be used to make investments ahead of revenues, such as hiring and training employees who are best suited to the particular business and conditioning the market through selective PR campaigns. Venture capital is also seen as a “Good Housekeeping Seal of Approval” for the company, its management team and proposed business model. Finally, founders with money in the bank can spend more time on building their product and business rather than continuously looking for and pitching new investors or assuaging the concerns of employees and/or vendors worried about whether they will be paid. However, venture capitalists are under their own pressures to produce results for their investors and will want to see their invested funds deployed quickly in order to generate value that can be turned into an “exit event” (i.e., a sale of the company or initial public offering) within a relatively short period of time, say five to eight years. Venture capitalists also want to be involved in the steering the business, something that many founders are not totally prepared for. In some cases, investors demand that companies move their offices, install elaborate tracking and reporting processes and adhere to tight milestones to ensure that progress, as defined by the investors, is being made.

In an article in *The Wall Street Journal*, John Roa, the founder and CEO of ÄKTA, observed that bootstrapping wasn’t for everyone or every business and that the answers to the following three questions would provide a founder with insight on whether it makes sense for him or her:

- **How well do you know your business and industry?** The founder needs to have a solid understanding of the proposed business and the applicable industry in order to determine the cost structure and price points for the proposed product or service. If launch is not possible without investing in substantial R&D, inventory, etc., the founder may have little choice but to bring in outside investors. If it looks like the business can be launched without such an investment, the founder must nonetheless be prepared to operate “lean” and make sure that the key functions for the business can be operated and talent can be recruited without substantial cash outlays (e.g., by offering equity).

- **What’s your comfort level with different kinds of risks?** Bootstrapping is risky business and it is likely that the founder will find himself or herself on the edge of a cliff, with a declining bank balance and no reserves, more than once during the time it takes for the company to gain traction. If the founder is uncomfortable with this, and the accompanying stress, seeking a cushion from outside investors may be the preferred route. Even if the founder is willing to take on such a risk, he or she must have a plan for dealing with unexpected downturns to make sure the business can survive rough patches.

- **Do you want the buck to stop with you?** Founders who want, and enjoy, have full control over the management of the business will be attracted to bootstrapping, since money from outside investors generally comes with demands for sharing in decision making. In many cases, however, founders will benefit from having others who have “skin in the game” and can serve as sounding boards and bring different perspectives and experiences to the table.

Only certain types of companies can realistically look to bootstrapping as a viable strategy: companies that can generate revenue from the very beginning, usually firms that can quickly find a market for their product or service among other businesses. The inherent ability to generate revenues quickly tends to lower the risk for properly-synched bootstrapped companies and the chances of “success” are enhanced by not having to meet the ambitious valuation goals of outside investors and instead concentrate on methodically building a sustainable business with the right amount of growth and marketing to support building a loyal workforce and customer base impressed by the quality and service offered by the company.

The reality is that “bootstrapping” and “big bang” funding are not necessarily incompatible and the ideal may be to use the two strategies sequentially, an approach that is at the heart of the popular “lean startup” methodology. This path begins with self-funding until the point where the business model has been validated and profitability has been achieved. Once that milestone has been reached, outside funding can be used for “company building” and fueling a proven growth model without the founders having to absorb too much dilution to their ownership stake.

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In the course of identifying sources of financing founders must also determine whether to raise funds through debt or equity. Debt, of course, means borrowing money and loans are often made by family members and friends, banks or other financial institutions or private investors. Equity financing involves selling an ownership interest in the business. Such a sale can take many forms such as admitting of a new owner or, in the case of a corporate business, issuing additional stock, options or warrants to investors. There are positive and negative aspects to each type of financing. The cost to the company of each type of funding is different, as is the way they are treated for tax purposes. The interest on borrowed money is deductible by a business for tax purposes, which reduces the effective cost to the company. Dividends that might be paid on the same investment in stock would typically not be tax deductible by the company. In selling stock there usually is no firm commitment to pay the money back but the stockholder will want and generally will have a legal right to have a voice in the management of the company. Depending upon the nature of the business the financing may be a combination of debt and equity and may be tailored to fit the specific needs of the company.

Timing is important, since it also provides clues as to the type of security the business can offer to prospective investors and lenders. For example, if capital is required to develop a new product or service or build a customer base from scratch, commercial lenders may shy away due to the lack of an established base of fixed assets and receivables. In such cases, venture capitalists or angel investors may be the only ones willing to take on what is essentially an unsecured risk. But, they will typically demand compensation for the risk undertaking by asking for a larger piece of ownership in the company. On the other hand, once the business is established, commercial lenders may be more willing to provide the company with secured debt financing that will not dilute equity ownership. Of course, bank financing may be available at an earlier stage if the founders have good credit records and personal assets that they are willing to put forward as security for loans to the company.

**Investment Criteria of Sustainable Investors**

Sustainable investors are concerned not only with what companies are striving to accomplish, but also with the way in which those companies intend to operate and the values and methods that will be used by the principals of the companies. Specifically, sustainable investors look for individuals and companies that value and exhibit transparency and honesty and candor in communications among stakeholders; define economic success by social and ecological impact, not just financial results; have an entrepreneurial spirit and culture that encourages and fosters innovation and continuous improvement; and which are truly pioneers in their areas interested in building the fields in which they operate through collaboration and “open sourcing” of methods and ideas. Sustainable investors also tend to be particularly interested in developing and maintaining close, long-term relationships with their investees and providing them with appropriate support and resources throughout the investment period. One way this is accomplished is by
matching entrepreneurs with local investors from the same community to develop a sense of shared responsibility and facilitate face-to-face interaction.

Enterprises seeking financing from social venture capital funds and other sustainable investors need to understand the criteria that these types of investors use when evaluating potential portfolio companies. A modest survey of the published investment criteria of various investors indicates that are looking for companies that:

- Have a primary, clear objective to achieve significant social change and a business model in which generating social impact is an essential and necessary part.
- Provide goods and services that meet human needs and have significant social impact (e.g., food, medicine, clothing, housing, heat and light, transportation, communication, recreation, renewable energy, and “green” products and services). These goods or services must be based on core technology that is economically better or create greater social impact than what is available currently through the market, aid, or charitable distribution. Sustainable investors prefer and expect evidence of customer feedback on the utility of the proposed goods or services.
- Have a clear business plan and model that demonstrates the potential for financial viability and sustainability within a five to seven year period, including the ability to cover operating expenses with operating revenues and generate a fair return for investors.
- Have a strong and experienced management team with the skills, will, and vision to execute the business plan, an unwavering commitment to achieving the desired social impact in an ethical manner.
- Demonstrate a clear path to scale for the number of end users over the anticipated investment period, and be positioned as one of the leaders in the market.
- Provide positive leadership in the areas of business operations and overall activities that are material to improving societal outcomes, including those that will affect future generations.
- Balance the needs of financial and nonfinancial stakeholders and demonstrate a commitment to the global commons as well as to the rights of individuals and communities.
- Advance environmental sustainability and resource efficiency by reducing the negative impact of business operations on the environment, managing water scarcity and ensuring efficient and equitable access to clean sources, mitigating impact on all types of natural capital, diminishing climate-related risks and reducing carbon emissions, and driving sustainability innovation and resource efficiency through business operations and products and services. Red flags for sustainable investors would include a record of poor environmental performance and failure to comply with applicable laws and regulations, activities that contribute significantly to local or global environmental problems, and/or risks related to the operation of nuclear power facilities.
- Establish an environmental management system with objectives and procedures for evaluating progress, minimizing negative impacts, training personnel and transferring best practices to customers, suppliers and other participants in the marketplace through trade associations and other collaborations.
- Contribute to the quality of human and animal life. Sustainable investors will not invest in companies that abuse animals, cause unnecessary suffering and death of animals, or whose operations involve the exploitation or mistreatment of animals.
- Contribute to the community through charitable giving, encouraging employee volunteering in the community, making products and services available free or at cost to community groups and supporting local suppliers and striving to hire locally.
- Respect consumers by marketing products and services in a fair and ethical manner, maintaining integrity in customer relations and ensuring the security of sensitive consumer data.
- Respect human rights, respect culture and tradition in local communities and economies and respect Indigenous Peoples’ Rights. Sustainable investors will not invest in companies that have exhibited a pattern and practice of human rights violations or have been directly complicit in human rights violations committed by governments or security forces.
- Promote diversity and gender equity across workplaces, marketplaces and communities. Sustainable investors look for diversity throughout the organization, beginning with the board and senior
management team, and will not invest in companies that discriminate on the basis of race, age, ethnicity, religion, gender, sexual orientation or perceived disability or support the discriminatory activities of others in their workplaces, marketplaces or communities. Red flags include a record of consistent violations of workplace-related laws and regulations and failure to adopt and enforce explicit policies against discrimination in hiring, salary, promotion, training or termination of employment.

- Demonstrate a commitment to employees by ensuring development, communication, appropriate economic opportunity and decent workplace standards. Sustainable investors will not invest in companies that have been singled out for serious labor-related actions or penalties by regulatory agencies or that have demonstrated a pattern of employing forced, compulsory or child labor. Sustainable investors seek confirmation that companies have implemented and follow personnel policies that promote the welfare of their employees, adhere to internationally recognized labor standards, value employee welfare and safety, pay a living wage to its employees and maintain a reasonable ratio of CEO earnings to average employee earnings, maintain cordial and professional relations with labor unions and bargain fairly with their employees, and follow sustainable employment practices.

- Save lives by guaranteeing product safety while promoting public health. Concerns for safety and public health caused sustainable investors to reject proposals from companies engaged in certain “prohibited business activities” such as the manufacture and/or sale of tobacco products; the manufacture of alcoholic beverages or gambling operations; the manufacture and/or sale firearms and/or ammunition; or the manufacture, design or sale of weapons or the critical components of weapons that violate international humanitarian law.

- Provide responsible stewardship of capital in shareholders’ best interests.

- Exhibit accountable governance and develop effective boards that reflect expertise and diversity of perspective and provide oversight of sustainability risk and opportunity. Sustainable investors will shun companies that have demonstrated poor governance, including failure to practice transparency in disclosures to shareholders or respond to shareholder communications or proposals, or engaged in harmful or unethical business practices.

- Commit to an external code or standard or a set of business principles that provides a framework to measure the company’s progress on environmental and social issues.

- Integrate environmental and social risks, impacts and performance in their material financial disclosures in order to inform shareholders, benefit stakeholders and seek their ideas and views and contribute to company strategy.

- Lift ethical standards in all operations, including in dealings with customers, regulators and business partners. Sustainable investors require that the companies in which they invest adopt and rigorously follow codes of conduct that are based on recognized global best practices to guide their policies, programs and operations.

- Demonstrate transparency and accountability in addressing adverse events and controversies while minimizing risks and building trust.

Sustainable investors often focus their activities on companies engaged in addressing needs, problems and challenges in a specific societal domain and/or geographic area. Popular target societal domains include agriculture, education, safety, demography, community, poverty, environment, health and well-being, housing, and ethical goods and services. Geographic areas that have attracted substantial interest from sustainable investors include East Africa, West Africa, India, Pakistan and Latin America.

Given the nature of some of the requirements described above, it is not surprising that many sustainable investors are not interested in pure “startups” and are looking for companies that have advanced to the “early stage” of development and have identified a stable business model that has already achieved some minimum level of revenues.

Many sustainable investors have developed “exclusionary criteria” that list activities and other characteristics that will disqualify companies from investment consideration. For example, a sustainable investor is quite likely to rule out funding companies that:
Seed Capital Financing Instruments

Founders, as well as investors contemplating a significant amount of investment in seed capital financings, need to have a basic understanding of the most commonly used types of instruments for seed financing. In general, these include the following:

- **Convertible Notes**: Convertible notes are arguably the most frequently used instrument for seed financings and should be thought of as debt securities (i.e., including principal amounts due at a maturity date, accrued interest provisions and a claim on the company’s assets as an unsecured creditor (although in rare instances a convertible note will also be “secured”). It is intended that the notes will eventually, prior to the maturity date, convert into the same preferred equity security that the company issues in its Series A round to venture capitalists and institutional investors. The terms of that conversion will depend on provisions negotiated by the company and the noteholders, including the discount rate and the valuation cap. Provisions are also included to address what happens in the even the company is sold prior to a Series A round and what happens if the notes remain outstanding on the maturity date.

- **Convertible Preferred Stock**: Although less common in the range of seed capital financings, companies may issue some form of convertible preferred stock in the later stages of seed financing and/or when the size of the financing is relatively large and the investor group is experienced and sophisticated and each investing fairly large

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3 Adapted from *Startup Seed Financings: Overview* (New York: Thomson Reuters Practice Law Corporate and Securities, 2017).
amounts of money (i.e., over $100,000 per investor). The instrument is often referred to as “Series Seed Preferred Stock” and will include several of the same protections and rights afforded to investors in the Series A round such as information rights and rights to vote separately on certain actions proposed by the founders as common stockholders. At the same time, Series Seed Preferred Stock typically does not include some of the more complex terms seen in Series A rounds such as registration rights, rights of first refusal and co-sale, price-based anti-dilution provisions, drag-along rights and rights to designate a representative on the board of directors. The liquidation rights of Series Seed Preferred are typically limited to a return of the purchase price before distributions are made to common stockholders, with a right to convert to common stock and waive the liquidation preference.

- **SAFEs (Simple Agreement for Future Equity):** Safes were developed as a company-friendly alternative to convertible notes that have the same conversion features of notes (and the same variables to consider, such as discount rate and valuation cap) without a maturity date or interest accrual. Safes seem to be more prevalent among “hot” deals where investors are scrambling to be included and have less leverage to negotiate more protections like those normally seen in convertible notes. Safes were developed to provide a quick and low cost solution to seed financing, and this can be accomplished if investors understand what they are buying. Investors seeking some protections or rights while accepting a Safe can bargain for information rights, rights of first refusal etc. to be included in a side letter.

- **Common Stock:** While not frequently used for raising capital from seed investors, companies can issue common stock, which is the same security that will be held by the founders and employees of the company. The main reason for using common stock is simplicity and relatively low legal costs. However, while investors issued common stock can be given voting rights and rights to receive dividends and distribution on liquidation, they would generally not have the same rights, preferences and privileges given to later round investors unless those are negotiated separately, which would increase the cost of issuing the common stock. Moreover, issuing common stock significantly complicates valuation of those types of shares for equity incentive purposes. All in all, common stock has drawbacks for both sides of the transaction—founders and investors—and it is therefore unlikely that common shares will be used for seed capital financing.

### Choosing the Right Seed Capital Instrument

Choosing the right instrument for raising seed capital involves weighing several different factors:

- **Investor sophistication:** As discussed in the text, there are several different categories of potential seed investors and they often vary dramatically in their level of sophistication regarding investing in startup companies. These disparities will in knowledge regarding investment and startup often drive transactions toward a particular form of seed capital instrument. For example, less experienced investors will have difficulty understand and “negotiating” some of the terms that are typically included in more complex seed financing instruments and may be reluctant to hire their own legal counsel to educate them. In these cases, a simple form of convertible note or Safe may be most appropriate; however, the company should take care to disclose the risks associated with those


instruments to investors. On the other hand, seed capital funds are generally quite sophisticated and may insist on detailed documentation similar in length and complexity to a Series A preferred stock round.

- **Investor preference**: The preferences of the larger investors in a seed round also play an important role in determining the instrument the company ultimately uses. Founders of early-stage startups typically want to minimize negotiation and friction with their seed investors and don’t want the capital raising process to get too bogged down to the point where the company plunges into a financial crisis (which can put the founders at a serious disadvantage with respect to any negotiations that do take place). If the investors are most comfortable and familiar with convertible notes, the founders will generally agree to issue notes. If the investors have experience investing in preferred stock and prefer that instrument, as is often the case with seed capital funds, the company likely issue preferred stock. A Safe is an innovative alternative to convertible notes, but it is clearly “company friendly” (e.g., no maturity date and no accrual of interest) and may not be acceptable to investors unless they are given additional rights similar to those included in preferred stock transactions.

- **Cost vs. amount raised**: Obviously cash is an important and limited resources for most businesses, particularly companies in the startup phase, and certainly one of the last priorities or preferences for the founders is writing checks for legal fees in order to raise seed financing. In the extreme situation, legal fees can eat up a significant of the proceeds of the financing if the amount raised is relatively small yet the investors insist on complicated documentation and the founders lack the experience to push back and/or respond efficiently to investor requests on their own. If a complex financing instrument is used, the founders need to expect more negotiation and documents, particularly if the amount being raised is at the higher end of the seed capital range. The ratio of legal fees to amount raised is the key metric and it is fair for the founders to make that point to the investor group, be it sophisticated angel investors investing large amounts or friends and family putting in smaller amounts. Efforts have been made to simplify and standardize the document; however, things can still seem complicated. With larger deals, the costs can be mitigated if investors can agree on a lead investor and give it authority regarding terms and words. With smaller deals, the founders need to stand firm on avoiding customization for each investor.

- **Time**: While the amount of money raised in seed capital financings is less than in Series A round deals, this does not necessarily mean that the process of completing the small funding will go any quicker, an ironic situation that causes great frustration for founders. One program is that seed stage financings often have more investors than later-stage deals and this means that the founders will have to spend time “herding” the members of the investors group, with their different schedules, attention spans and level of experience, to a definite closing date. Founders need to find a way to build momentum toward a specific closing date, generally be concentrating on three or four of the largest investors and making sure they are committed to the specific financing instrument and documentation. With these “major” investors on board, the founders can prod the others along, particularly if the financing instrument is kept relatively simple to avoid too many questions and opportunities for negotiation. Seed capital financings often have multiple closings because some investors simply are not available or need a little more time for their due diligence; however, if this approach is taken the documents need to be frozen since modifications after the first closing require a significant amount of time and legal costs.

- **Market cycle**: As with any financial market, the “market” for seed capital varies from time-to-time depending on general economic conditions and specific factors such as the amount of capital available from potential seed investors and the number of suitable companies and their specific financing requirements. Also relevant is the state of the venture capital market, since it will impact expectations of founders and seed investors about the timing and feasibility of a future Series A round that will convert the instruments sold to seed investors (or otherwise adjust their rights when seed investors receive a “lite” version of preferred shares). When the market is “hot”, founders can generally convince investors to accept more company-friendly seed capital investment instruments and get deals closed quicker because there will be less negotiation on “bells and whistles” outside the basic form of the instrument. On the other hand, companies that are not necessarily in the latest “hot market” can expected that investors will exert their leverage in their demands with respect to the terms of the investment.
§2 Founders

A common financing technique is for the founders of the start-up company to make initial capital contributions and loans necessary to start the company. These funds can be drawn from the personal savings and credit of the founders. The remaining financing is provided internally from the revenue generated from the company. The benefit of this method is that the founders remain in control and benefit from the success of the company. On the other hand, unless the start-up company has sufficient capital, it will suffer from constant shortages of working capital. In addition, its growth will be limited. Moreover, while the founders can anticipate the possibility of future wealth from their significant equity interest in the new venture they generally must live and work through the early weeks and months without a regular paycheck and the financial pressure can be overwhelming. The initial capital contributions of the founders of an emerging company are generally quite modest and they will typically receive a relatively large ownership stake in the business at the outset in consideration of the ideas for new products and services that they are bringing to the venture and their technical expertise in the areas most closely related to the projected core competencies of the company.

§3 Relatives, friends and business associates

As noted above, founders typically do not have the personal financial resources to fully fund the early stage financial requirements of the new company and will need to rely on support from outside parties. However, unless the founders have a strong track record and/or an exceptionally strong business concept that attracts the immediate interest of venture capitalists and other investors willing to provide large amounts of capital before the product or service has been fully developed, they may find that funding is difficult to secure on reasonable terms. For example, banks will rarely loan money to a start-up company without unlimited personal guarantees from the principals, which means their personal assets will be placed at risk, and the amount of cash that can be obtained from government funding programs for “small businesses” may not be sufficient to get the company to the point where the product is ready to show to professional investors. Also, while some venture capitalists might be willing to provide seed capital most are unwilling to fund a new venture until there is a clearer picture of the products and/or technologies upon which the business will be built. Those who do make investments at this embryonic stage may extract a high price from the founders by demanding a larger percentage of equity ownership and other concessions relating to influence over management of the company in the future.

Lacking viable alternatives, the founders often turn to their family and friends, as well as long-standing customers and suppliers, for financial support. These types of potential investors usually are familiar with the operating history of the business and know its need for capital and are already well acquainted with the founders and can therefore be...
relatively easily interested in providing capital. While private funding from these sources can often be closed relatively quickly and with far less formality than what is expected when dealing with venture capitalists and other professional investors, the founders must proceed with caution and consider the impact on management of the business and their ability to raise the additional funds that will inevitably be necessary in the future to expand operations. One important legal issue for founders in the US to consider is making sure that the sale of securities to family and friends does not run afoul of federal and state securities laws. If stock is to be sold to be sold only to persons with high net worth who are only committing a small portion of their personal assets than they will likely qualify as “accredited investors,” which significantly reduces the formal disclosure obligations of the founders (e.g., preparation of a private placement memorandum). However, if capital is being raised from unaccredited investors who are familiar with the enterprise but lacking other business sophistication the founders may need to incur legal fees and other expenses satisfying disclosure requirements.

Another thing to consider is the new relationship between the founders and their family and friends. These types of investors generally are not interested in monitoring day-to-day operations, nor will they demand the protections typically provided to venture capitalists because of the trust and familiarity developed through their prior personal relationships with the founders; however, they do have certain statutory rights to information and the founders must be mindful that they have fiduciary obligations that must be observed. With respect to the investors, they must understand the need to maintain the confidentiality of information that they receive about the business and must be sure that their investment does not violate any contractual obligations they might have to their employer. The founders must also prepare for the time when venture capital funding is obtained and disclose the potential consequences to their family and friends—for example, subordination of their rights upon liquidation and the possibility that oversight of their investment will be transferred from the founders to a new group of professional managers that they do not know. Finally, while relatives and friends may be excited to be part of the venture at the outset and eagerly contribute financial support they may be less enthusiastic if and when problems develop with the progress of the company and many personal relationships have crumbled under the stress that arises when the founders are unable to provide the promised investment returns.

§4 Crowdfunding

Extensive changes were made in the regulatory framework for financing of emerging growth companies when the President signed the “Jumpstart Our Business Startups Act” (“JOBS Act”) into law on April 5, 2012, as Public Law 112-106. One of the most publicized, and controversial, elements of the JOBS Act was the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012”, or “CROWDFUND Act”, which added a new § 4(a)(6) to the Securities Act (15 U.S.C.A. 77d(a)(6)) that exempts from registration under the Securities Act transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control
with the issuer), provided that⁴:

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, is not more than $1 million;
- The aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, does not exceed: (i) the greater of $2,000 or 5% of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10% of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;
- The transaction is conducted through a broker or “funding portal” that complies with the requirements on intermediaries set forth in § 4A of the Securities Act⁵; and
- The issuer complies with the requirements imposed on issuers under § 4A(b) of the Securities Act, which are described below.

The requirements on issuers referred to above are set forth in § 4A(b) of the Securities Act, which provides that for purposes of § 4(a)(6) of the Securities Act, an issuer who offers or sells securities shall:

(1) File with the SEC and provide to investors and the relevant broker or funding portal, and make available to potential investors⁶:

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⁴ The dollar amount thresholds referred to below were applicable as of the May 16, 2016, the first date that eligible companies were allowed to raise capital using Regulation Crowdfunding, and will be increased annually to take into account inflation. Issuers should check the then-current limits and restrictions before launching a new Regulation Crowdfunding offering in the future.

⁵ In general, § 4A(a) of the Securities Act provides that a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others pursuant to § 4(a)(6) of the Securities Act shall, among other things, register with the SEC as a broker or a funding portal (as defined in Exchange Act § 3(a)(80); register with any applicable self-regulatory organization (as defined in Exchange Act § 3(a)(26)) (i.e., FINRA); provide such disclosures, including disclosures related to risks and other investor education materials, as the SEC shall, by rule, determine appropriate; ensure that each investor: (A) reviews investor-education information, in accordance with standards established by the SEC; (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and (C) answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the SEC determines appropriate, by rule; and take such measures to reduce the risk of fraud with respect to such transactions, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the outstanding equity of every issuer whose securities are offered by such person. Additional requirements are also applicable including requirements set forth in any rules prescribed by the SEC.

⁶ The dollar amount thresholds referred to below were applicable as of the May 16, 2016, the first date that eligible companies were allowed to raise capital using Regulation Crowdfunding, and will be increased annually to take into account inflation. Issuers should check the then-current limits and restrictions before launching a new Regulation Crowdfunding offering in the future.
• The name, legal status, physical address, and website address of the issuer;
• The names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20% of the shares of the issuer;
• A description of the business of the issuer and the anticipated business plan of the issuer;
• A description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under § 4(6) within the preceding 12-month period, have, in the aggregate, target offering amounts of: (i) $100,000 or less: (I) the income tax returns filed by the issuer for the most recently completed year (if any); and (II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects; (ii) more than $100,000, but not more than $500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC, by rule, for such purpose; and (iii) more than $500,000 (or such other amount as the SEC may establish, by rule), audited financial statements;
• A description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
• The target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount;
• The price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
• A description of the ownership and capital structure of the issuer, including: (i) terms of the securities of the issuer being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer; (ii) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; (iii) the name and ownership level of each existing shareholder who owns more than 20% of any class of the securities of the issuer; (iv) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and (v) the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties; and
• Such other information as the SEC may, by rule, prescribe, for the protection of investors and in the public interest;

(2) Not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;
(3) Not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the SEC shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication;

(4) Not less than annually, file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule; and

(5) Comply with such other requirements as the SEC may, by rule, prescribe, for the protection of investors and in the public interest.

The SEC rules for the “crowdfunding” initiative are set out in 17 C.F.R. Part 227, titled “Regulation Crowdfunding, General Rules and Regulations” and include the crowdfunding exemption and requirements (17 C.F.R. 227.100), requirements for issuers (17 C.F.R. 227.201 et seq.), requirements for intermediaries (17 C.F.R. 227.300 et seq.), funding portal regulations (17 C.F.R. 227.400 et seq.) and miscellaneous provisions relating to topics such as restrictions on resales and disqualification provisions (17 C.F.R. 227.501 et seq.). While “crowdfunding” has received a large amount of media attention, it remains to be seen whether or not it becomes a practical alternative for issuers given that they are limited to $1 million (as adjusted for inflation) in 12 months; investors are limited to small amounts; transactions must be conducted through a regulated intermediary—either a registered broker or a registered funding portal; and they are subject to significant disclosure, financial information and reporting requirements and restrictions on outside advertising. Information regarding Regulation Crowdfunding, including the new forms, is available on the SEC website.\(^7\)

§5 Venture capitalists

Venture capital companies include those investing private funds exclusively and those that utilize both government and private funds. Venture capitalists are a primary source of equity-type financing for small- and medium-sized businesses in the US and other developed countries, particularly companies focusing on the development and commercialization of technology-based products. Venture capitalists are receptive to proposals from companies in many different situations and will arrange varied financing plans. Some companies prefer straight equity interests in high technology or marketing firms, while others prefer to minimize risk through convertible debt in seasoned companies. Often venture firms are helpful in providing business contacts, management advice, and members for the management team.

Venture capitalists are, first and foremost, financial investors who are only interested in opportunities that are likely to satisfy the return-on-investment requirements of their own

\(^7\) For detailed discussion of crowdfunding opportunities and activities, see “Finance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
clients (i.e., the individuals and institutions that have entrusted their capital to the management of the principals of the venture capital fund). As a general rule of thumb, venture capitalists are looking for portfolio companies that deliver a return of at least 10 times the invested amount within a specific window of time—three to five years. Venture capitalists also want to be sure that the company will be large enough at the end of the three to five year period to support a legitimate liquidity event (i.e., an acquisition or an initial public offering); therefore, they will be looking for reasonable and realistic projections from the founders regarding the future size of the market and the company’s share of that market.

While venture capitalists understand, and are willing to accept, the risks associated with developing and commercializing a new technology they are not interested in worrying about whether or not there will be actual demand for the products or technologies that the company is able to create. Market size and share will be factored into the way that venture capitalists value the company for purposes of negotiations with the founders and other senior managers. For example, they may take the projected earnings of the company five years down the road, apply a multiple to that forecast, and then discount the result to the present using their minimum required return in order to establish the current valuation for the company. Alternatively they may discount the projected cash flows over the holding period to arrive at a valuation. In addition to high returns venture capitalists demand terms and conditions to manage their downside risk including liquidation preferences, redemption and co-sale rights, anti-dilution protection, control of the board of directors and class voting rights. While venture capitalists provide business contacts and advice to the members of the management team of their portfolio companies, their representatives may be difficult to work with and usually focus solely on the interests of the venture firm as opposed to the founders and other managers.  

Is the Silicon Valley Way Sustainable?

Writing about “the ugly unethical underside of Silicon Valley” in Fortune, Griffith suggested that “Silicon Valley has always seen itself as the virtuous outlier, a place where altruistic nerds tolerate capitalism in order to make the world a better place”. There is no doubt that Silicon Valley companies, and the culture that has developed to surround them, have made significant impact on people’s lives all over the world and that Silicon Valley can and should be held up as the model of Schumpeter’s “creative destruction”. However, Griffith suggested that perhaps Silicon Valley is not as pristine as it would like everyone to believe that that a “fake it until you make it” mindset is being exposed by a continuous stream of disclosures of fraud and mismanagement like the following:

- **Fall Short of Hype:** A relatively mild, yet often quite devastating, problem is slow growth that flies in the face of the initial hype associated with the launch of a new product or service. In some cases, the company will struggle to defend a lawsuit over labeling or intellectual property rights and even if the claims against it have little merit the distraction of the lawsuit will damage sales and marketing efforts.
- **Dubious Metrics:** Companies choose from an almost unlimited universe of metrics to describe the performance of their products and their acceptance and popularity in the marketplace. In many cases, these metrics are difficult to understand and provide a confusing and misleading picture of how well

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8 For detailed discussion of the terms and conditions of venture capital financing and the procedures for selecting and working with venture capitalists, see “Finance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
the company is doing with respect to revenues, number of customers, product quality etc.

- **Augmenting Product Demos:** Companies like to create impressive “demos” of their products in order to woo potential investors and customers and create a media buzz. Realizing that many of these demonstrations can and will be strictly controlled by the company, there may be a temptation to augment the presentation with technologies and tools that are not really part of the product (e.g., the virtual reality startup that used animation to augment its stunning demo videos).

- **Manipulating Sales Results:** If a company’s products are not gaining traction with customers, it may be tempted to manipulate sales metrics or otherwise cover up problems that it is having with building a following in the marketplace. Few companies go as far as having their employees go out and buy back their products from retailers and then reporting those transactions as actual sales; however, companies have been known to report products shipped to retailers on consignment as completed sales and fail to adequately disclose “return rights” that might result in a flood of products coming back to the company along with refund claims in subsequent periods.

- **Fraudulent Test Results:** Companies have soared to staggering valuations based on new technologies that ultimately turn out to be based on fraudulent test data and which do not support products that will actually work. These companies may commission private tests that appear to validate the technologies and the results of which are widely publicized in the media and the founders may engage in aggressive speaking and promotional campaigns to create a sense of legitimacy for the products. Problems begin to occur when customers start to complain and the push to expand forces the company to expose its products and initial test results to tougher scrutiny.

- **Sidestepping Regulatory Hurdles:** One famous episode of nefarious activities to avoid regulatory burdens that could have slowed projected growth was the development of software, directly overseen by one of the founders of the company, which would allow employees to quickly pass tests to obtain licenses required by the state without studying. Coupled with the fact that many employees began work without even trying to obtain their licenses, with the knowledge of senior management, and you quickly had a situation where the company was not only breaking the law but also disseminating advice and services to customers that was ill-informed and likely to cause harm to their businesses and their employees (e.g., a risk to employees of not having the health care insurance benefits they expected).

The illustrations above contain their own lessons and hope most entrepreneurs will see that the companies involved placed themselves and their stakeholders at great risk in engaging in those activities. However, Griffith argued that founders need to be more attentive to a handful of overriding factors that have been associated with higher instances of workplace fraud and which can also be seen in the way that Silicon Valley seems to conduct business: “pressure” from venture capitalists to generate hyper-growth and immediate growth and the real possibility of funds drying up if the company is not able to cope with intense competition; “opportunity” to fudge numbers and results, if not engage in outright fraud, because private companies are not subject to stringent reporting requirements and members of the tech media, many of whom are blinded by the celebrity status of the founders and have little business and technological experience, are more than happy to take an upbeat story and distribute it without much due diligence; and “rationalization” in the form of embracing Silicon Valley’s “change the world, move fast and break things, and disrupt” culture to legitimize “ignoring the rules” in the ways described above. Another factor that emerges from Griffith’s essay is “arrogance” seen among a few of the venture capitalists that loudly dismiss reports of problems and critiques of the Silicon Valley ecosystem and from founders who insulate themselves behind governance structures that allow them to retain control and leave investors with no voice or recourse when trouble brews and the founders are exposed as bad and/or dishonest managers. Complicating the situation even more is it is not only the founders that are vulnerable to the factors mentioned above but also the venture capitalists themselves. Under pressure to successfully invest a tsunami of capital, venture capitalists vigorously compete for the “best deals” and are often too willing to look the other way and cave to founder demands for control in exchange for entry into a financing round. Once a venture capitalist becomes an investor, he or she pushes the companies, in the words of one founder quoted by Griffith, “to pour more gas on the fire” to attract additional investors willing to bid up the value of the company to make the initial investors look good to their limited partners. The situation gets so frenzied that it has been reported that later round investors in Uber put their money up without getting financial information beyond a set of risk factors—technically “legal” in the case of offerings solely to
“accredited investors” but as a practical matter a breach of best practices and fiduciary responsibility to limited partners.

Griffith’s essay, and the comments of several sympathetic Silicon Valley investors and observers included in the piece, can be seen as a plea for integrating certain core principles of sustainable entrepreneurship into a situation that has damaged key stakeholders such as employees who have lost their jobs and been tainted by affiliations to shady businesses and investors who have lost money and confidence and trust in the entire ecosystem. Sustainable entrepreneurship addresses the factors discussed above head on by establishing clear and objective economic and social goals and transparent metrics to track progress. Sustainable entrepreneurship also stands for “intelligent disruption”: rules will not be changed without dialog and founders need to understand that while companies like Uber have aggressively challenged the status quo and legal hurdles it did so within the system as it presented itself and through extensive negotiations with regulators and other stakeholders in the communities where it was looking to operate. Finally, sustainable entrepreneurship is grounded in acting fairly and truthfully, guideposts that are unchallenged conditions to the long-term viability that makes a company sustainable. Fairness, truthfulness and transparency must be part of the company’s DNA from the very beginning, not things that are brought in later once expediency has been served.


§6 Wealthy individuals and angel investors

Wealthy individuals have always been benefactors of fledgling businesses, particularly when a company is involved in an area in which the individual has substantial prior experience. Recently, however, increasing focus has been placed on so-called “angel” investors, who are high net worth individuals, often businesspeople or professionals with high incomes or individuals from wealthy families who seek high-risk/high-return investment opportunities. The angel investor community has also been buoyed by the entrance of individuals who have previously been involved as founders and/or senior executives of successful businesses and who exited those businesses with significant sums of money from a public offering or acquisition by an outside party. Some of the key characteristics of angel investor preferences and contributions include the following:

- Angel investors are willing to accept more risk and to provide small amounts of money to allow the entrepreneur to develop the company's business plan and complete work on new product prototypes that can be shown to venture capital firms and potential business partners. Venture capitalists generally prefer to make fewer investments and each investment must equal or exceed a certain minimum amount to justify the time and effort that the venture capitalist will spend on the company. In contrast, angel investors (alone or as part of a group of several investors) are often able to provide seed capital in amounts ranging anywhere from a few thousand dollars to several million dollars.
- The due diligence and negotiation process for taking capital from angel investors is generally much shorter and simpler than similar activities with venture capitalists.
- Angel investors are generally more patient than venture capitalists and less likely to require a rapid exit from the investment. Also, the required rate of return for many
angel investors is lower than the requirements of venture capitalists, which must satisfy their own investors in order to raise new funds.

- Angel investors tend to place greater emphasis on the attributes of the entrepreneur and personal chemistry, and are more likely to get involved with a company due to interest or experience in a particular industry and their desire to bring their network of contacts to assist the company.
- Angel investors tend to be more proactive than professional investors in providing “hands on” assistance to their portfolio companies, thereby helping to strengthen the skill base of the firm’s management team. Studies have shown that primary assistance from angel investors is in the area of general strategic advice and in specialized areas such as marketing, finance and accounting.

However, while angel investors can be an attractive alternative, particularly since closing the deal with an angel is usually quicker and easier than it is with a venture capitalist or institutional investor, an obvious problem is that angel investment alone is generally not sufficient to permit portfolio companies to bring their products to the marketplace. Angel investors are not good sources of capital to build out manufacturing facilities or marketing and distribution channels; these projects are best left to larger investors once the product or service has been polished and verified. In addition, angel investors can be difficult to locate; however, various networks and organizations of angel investors have been formed to ease the process of matching investors with opportunities. At a deal-specific level, entrepreneurs must also be mindful that angel investors may not be able to provide the extensive network of contacts and resources that venture capital firms make available to companies that join their investment portfolio. Also, while the personal chemistry between the investor and the founders may be good, the actual experiences and specialties of the angel investor, such as marketing, may not be a good fit for the needs of the company, thus reducing the actual “value add” provided by the angel investor. Angel investors also impact the equity positions of the founders and may cause disruptions in management and control of the company. Finally, while angel funding is less formal than a venture capital transaction, the company and its principals must still comply with applicable laws and regulations with respect to disclosures and the manner of offering regardless of the actual size of the investment.

If, after taking all of the factors mentioned above, a decision is made to move forward with an angel financing round, consideration should be given to which of several financing structures might be appropriate for the company and the investor group. Some of the alternatives that might be used include the following:

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9 For example, Active Capital, formerly known as the Angel Capital Electronic Network (ACE-Net), is a nation-wide Internet-based option for matching individuals and institutions that qualify as “accredited investors” under Regulation D promulgated under the federal Securities Act of 1933, as amended, with companies that have satisfied the requirements for issuing securities imposed under applicable federal and state securities laws.

10 The following discussion is adapted from a summary presented by R. Karamali, Starting Up the Start-Up: Approaching the Angel Financing Round (Social Media Update, April 6, 2011) http://www.socialmedialawupdate.com/2011/04/articles/startups/starting-up-the-startup-approaching-the-angel-financing-round/ [Accessed May 31, 2011] For further discussion, see “Seed Capital” in “Finance: A
• Common stock, the same form of equity instrument issued to the founders and set aside for employees, may be sold to the angel investors at an agreed valuation; however, this approach as drawbacks for almost everyone. The investors have none of the protections that will inevitably be given to the next group of outside investors who demand and received preferred stock and the company will have set a valuation for the common stock that undermines its ability to issue stock options with attractive exercise prices to employees, advisors and others needed to assist the company in getting off the ground.

• The most common form of investment instrument for angel investors is probably a convertible note that provides for automatic conversion of the principal and accrued interest into the company’s initial preferred stock financing round provided that certain requirements with regard to that financing are satisfied (e.g., size of the round and closing on or before a specified date). In order to reward the angel investors for the risk that they took on to finance the company at an early stage, the conversion rate will reflect an agreed discount from the price paid by the preferred stock investors. They will also gain the benefits of all of the rights given to the preferred investors, including the full liquidation preference even though a discounted price has been paid. Early investors may also receive warrants and other benefits.

• A twist on the traditional convertible note is the so-called “capped” convertible note that provides for conversion into the first round of preferred stock financing at either an agreed discount or at an agreed capped valuation, with the outcome based on what provides the most benefit for the angel investors. Assume, for example, the angel investors have agreed that upon the closing of the preferred financing a 25% discount and $3 million “cap” would apply. If the pre-money valuation at the closing is $2 million, the notes would convert at a per share price determined as if the pre-money valuation was $1.5 million (i.e., the 25% discount would apply). If, however, the pre-money valuation was $5 million, the cap would apply and the conversion would occur at a per share price determined as if the pre-money valuation was $3 million rather than 75% of $5 million (i.e., $3.75 million).

• Some angel investors and law firms have suggested “light” preferred stock as an appropriate way to provide early stage funding instead of convertible notes, arguing that fairly simple terms can be created as an “industry standard” to facilitate efficient preparation of documents without too much expense. Light preferred stock instruments go by a variety of names, including Series AA Equity Financing, Plain Preferred and Series Seed Financing. In reality, however, no standard has emerged from among the various examples that have been proposed and angel investors have also complicated the process by becoming more aggressive about receiving management rights and legal opinions.

§7 Seed capital funds
As the challenge of closing the initial round of funding from venture capital investors increased the demand from founders for financing at the early development pre-revenue stage led to the emergence of seed capital funds that purport to specialize in seed round financings ranging from $25,000 to $2 million. The size of these seed capital funds varies from $5 to $50 million and while some of them have raised money from the same institutional investors that participate in larger venture capital funds it is more common to see seed funds being support by capital obtained from wealthy individual investors, sometimes referred to as “super-angels” who have made investing in startups their full time passion and are well known in the startup community, and smaller family endowments. The principals of the seed funds typically argue that they will be able to give more attention to smaller companies than the larger venture capital firms and thus be able to guide the founders of those companies through the milestones that needed to achieve in order to secure the interest of venture capitalists and close the elusive Series A round. The reality is that many of the promoters of the seed capital funds lack the experience and external relationships found among larger venture capital firms to provide meaningful assistance to their portfolio companies. In particular, many of the seed capital funds lack the strong relationships with venture capital firms that would be helpful in securing additional financing for their investees. As a result, data shows that companies that obtain seed financing only from seed capital funds have more difficulty in closing a Series A round than those companies that have forged financial and business relationships with larger venture capital firms that also invest a portion of their available capital in seed stage deals.

While founders should exercise care in vetting potential seed capital fund investors, there are several funds who have carved out a strong reputation for their focus on seed-stage companies in specific geographic areas and/or industry sectors and their ability to provide funding, accelerator programs and entrepreneur events. Go observed that while there are now a large number of funds willing to consider investing at the seed stage, not all of them are positioned to “lead” deals. Go suggested that the capacity of a seed fund to act as a lead is constrained by the number of partners and the time and effort required to do spot promising ideas, interview the founders, conduct due diligence and contact the references provided by the founders, draft and issue a term sheet and coordinate finalization of the terms with other investors. According to Go, the best lead investors limit themselves to less than six investments per year per partner and are typically willing and able to get everything done in a few weeks and provide the founders with regular reports on their progress. Go cautioned that if an investor is not willing to commit to an efficient and transparent deal process, or does so and then disappears, it is a sign for the founders to look elsewhere. Go also advised that founders should not waste too much


12 The discussion in this paragraph is adapted from R. Go, “How to Raise Seed Capital: Crucial Steps to Know” (June 20, 2014), http://nextviewventures.com/blog/how-to-raise-seed-capital/ [accessed May 30, 2016].
time on convincing investors who are skeptical about the proposed business model and that the fundraising efforts should be focused on identifying the “true believers”.\(^\text{13}\)

§8 Corporate partners

Another important source of capital for new technology-based companies is “corporate partnering,” sometimes referred to as a “strategic alliance.” Corporate partnering is the creation of a relationship with a large established company that is interested in participating in the development and commercialization of the technology that the founders have identified. In addition to providing funding the corporate partner will also provide contractual support for specific research and development activities and/or functional needs such as manufacturing and distribution. The corporate partner benefits not only from what it hopes will be a good return on its investment but also from being to access new technologies that allow it to remain competitive in its existing marketplace and perhaps expand into new areas without having to do all the work internally. The founders obviously secure the needed capital to finance the development work; however, they also are able to leverage the resources of the corporate partner in manufacturing and distribution to introduce products more quickly without the need to raise additional capital to build those functional capabilities internally. In addition, a deal with a well-known and respected corporate partner makes the founders’ business plan more credible and can lead to opportunities with suppliers and customers.

It is fair to say that corporate partners are more interested in the strategic return on their investment in a company than they are about how much they eventually will receive when their equity position is liquidated; however, corporate partners will certainly run a conventional financial analysis before committing capital for the purchase of securities as opposed to funding a particular project of strategic interest. All potential corporate partners have different strategic goals and interests and companies actively engaged in partnering with smaller firms should have their own processes for establishing goals for their alliances and measuring performance. For example, if the corporate partner is funding technology development work by a smaller company than the partner will measure success by reference to the revenues that it receives from licensing the technology back and using it in various applications and markets that have been mutually agreed upon by the parties.

§9 Institutional lenders

Banks, commercial finance companies, insurance companies, pension funds and other institutional lenders are a major source of private financing; however, availability of financing from these sources is often limited in many countries where institutional lenders are reluctant to advance credit to new and untested businesses. Transactions with these lenders ordinarily are structured as direct loans, but significant terms such as

\(^{13}\) For detailed discussion of seed capital financing opportunities and instruments, see “Seed Capital” in “Finance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

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interest rates, maturity, and prepayment may be favorably negotiated with many institutions when the loan is coupled with warrants or other equity features. A line of credit may also be available. Institutions vary with regard to the minimum and maximum sizes of loans they will make. Debt financing provided by these institutions can be helpful in growing the business and meeting working capital needs. However, most lenders insist on fully secured loans using equipment, inventory, or accounts receivable. Most technology-based start-ups have little or no assets. The value in these companies is in their technology (which may or may not be developed) and talent of their employees. Most banks and similar financial institutions have little ability and even less interest in understanding the technology, its market potential and other factors which give the start-up company value.

§10  Government financing

Government financing, in the form of direct grants or loan packages, can be a good way to get a new business up and running. In the US a number of federal and state governmental agencies have a small business financing program. For example, the federal Small Business Administration makes direct loans and guarantees loans to eligible businesses. Other agencies may have programs that are targeted to particular types of businesses and ownership groups. Government financing may be available on terms that are more attractive than those which may be offered by private sources. Moreover, since each program is tailored to a particular segment of the business community, it may be possible for businesses that would not otherwise qualify for conventional financing to obtain government financing. Government financing is typically restricted to “small businesses” that satisfy various qualification requirements and companies that need substantial amounts of capital to complete development and commercialization of their initial products and services will also need to look to other sources described above.

§11  Lease financing

While companies need working capital to finance the entire spectrum of operational activities consideration should also be given to specialized financing strategies that can be used to obtain use of particular assets. For example, rather than raising capital to purchase needed equipment companies can take advantage of equipment lease financing arrangements. Leasing packages come in a variety of types through many sources. Leasing companies typically will accept a somewhat higher degree of credit risk because they are seeking the value of the equipment for collateral if the company cannot make the agreed upon payments. For this reason, leasing companies generally prefer to finance new equipment of a general-purpose nature that can be resold if necessary. Leases often run for a period of three to five years and because of the risk that leasing companies are willing to take, they are somewhat more expensive than commercial bank loans.

§12  Trade creditors
A very important source of financing may be from the vendors and suppliers with whom the company does business. Many suppliers will originally ask for cash on delivery or in some instances they want payment before starting on an order, depending on the nature of the purchase. Most suppliers will quickly establish trade credit with a company once confidence has been built through continued business and timely payments. Establishing good relationships with trade creditors is essential because it allows the company to use the goods and services in its operations and sell their products to the company’s customers, in some instances before the company even pays for them. The trade credit built today will be relied upon by other vendors as the company attempts to establish itself with other vendors in the future. Trade credit terms will vary depending on the type of purchase, the supplier’s industry and the company’s industry.

§13 Venture capital or corporate partnering?

Emerging companies—new firms formed to develop and commercialize innovative technologies—typically receive attention from both venture capitalists and corporate partners. Each source of funding can provide the necessary support and financial resources for rapid growth and development; however, there are significant differences between venture capital financing and obtaining capital from corporate partners that should be carefully considered by the founders. For example, venture capitalists are well known for their desire to exercise control over the management of their portfolio companies and drive them toward a liquidity event, such as an acquisition or an initial public offering, within a predictable period of time. The founders need to decide how important control of the business is to them and must also consider the impact that venture capital investment might have on their job security. Certainly being able to sell their shares at a large profit at some point in the future is important; however, many founders have discovered that professional investors are not averse to bringing in new executives and senior managers to replace the founders and remove them from day-to-day involvement with the business of the company. Corporate partners, on the other hand, may not care about control and be more interested in strategic advantages such as being named an exclusive supplier or distributor. Before this route is taken the founders need to determine how exclusivity will impact future growth of the business and the company’s ability to raise additional funding from other sources at a later date.

§14 --Impact on control over company management and direction

The founders must carefully consider how the choice between venture capital and corporate partnering will impact their control over the management and direction of the company. Venture capital investors will often demand, and receive, a large ownership interest in the company—even a majority of the ownership interests depending on the pre-money valuation and the amount of their investment—and will not hesitate to exercise the legal rights that go with being significant shareholders. Typically they will have the right to designate a majority of the directors, while allowing the founders to continue to fill one or two seats on a five to seven member board, and will exercise effective veto power over the recruitment and selection of the senior executives of the company. In contrast, corporate partners usually do not want to own more than 20% of
the companies they choose for their strategic investments in order to avoid any issue about consolidated financing reporting. While corporate partners certainly do not want to lose money on their investment they are usually motivated by opportunities to gain access to new technology, products, research and development capabilities and markets and as long as those goals are achieved they will stay out of debates regarding the overall direction of the company. However, even if a corporate partner is a relatively small investor it may make demands that may ultimately constrain future actions of the management team. For example, an agreement with a corporate partner may include restrictions on licensing technology, or selling products, to competitors of the partner and may grant the partner a “right of first offer” with respect to company efforts to exploit new markets using technology that have been licensed to the partner. Corporate partners may also demand the right to increase their investment and even acquire a majority interest in the company.

§15 --Non-cash contributions to continuing growth of the business

When evaluating any prospective investor the founders should consider what the investor can bring to the company apart from the cash needed to fund the continuing growth of the business. A good corporate partner is a “strategic” partner who can provide the company with resources and contacts to allow the company to accelerate product development and subsequent penetration of targeted markets. For example, a corporate partner may be able to license needed technology to the company and share scientific and technical know-how during joint development programs that are launched after the investment is closed. A corporate partner may also be able to use its existing distribution and marketing channels to assist the company in introducing its products. Venture capitalists, on the other hand, do not have their own technology or functional resources (e.g., manufacturing, sales or marketing); however, the best venture capitalists have the ability and willingness to assist the management of their portfolio companies in forging strategic alliances by making introductions to firms that are active in markets or industries that might be a good fit for the company’s technology or products. If done well, the end result may be a network of corporate partnering arrangements that are free of the conflicts and restrictions that might have accompanied large funding from a single partner.

§16 --Time required to close investment and obtain capital

Another important issue for the founders is how long it will take to actually close the investment and obtain the money necessary to continue operating and growing the business. The founders should be prepared for the fact that both venture capitalists and corporate partners will not be rushed in making their decisions and that there will need to be some period during which the parties get to know one another and the prospective investor completes what it deems to be an adequate level of due diligence about the company, its management and the technology and markets in which the company hopes to be involved. It is not uncommon for venture capitalists to take anywhere from six to 12 months to make a decision to invest in a new company although they may move a little more quickly in unusual situations when there is real competition among investors to get into an attractive deal. Corporate partners generally move more slowly although
the actual amount of time will depend on several factors including the size, bureaucracy and culture of the partner and the level of inter-dependence that is projected to occur between the parties assuming the arrangement actually comes together. Founders should not be afraid to court venture capitalists and corporate partners simultaneously and should make sure that any preliminary term sheets or letters of intent include termination dates that would allow the company to go in a different direction if an investor is not willing or able to close a transaction in a timely fashion.

§17 --Impact on future capital raising activities

Another issue to consider is how the choice of the financing source this time around will impact the ability of the company to raise additional money in the future. As a general rule, venture capitalists are more likely to be willing to provide follow-on funding for their portfolio companies as long as the development of the business is on target and there is a reasonable expectation that the investment will be returned in a timely fashion through some sort of exit event (i.e., an acquisition or an initial public offering). Corporate partners, however, will typically prefer to limit their support to the particular technology or product line that interested them in the first place and should not be expected to provide their strategic partners with general working capital or funds that are earmarked for projects that fall outside of the specific interest of the partner. In fact, if the company begins to run into trouble the corporate partner would only be interested in purchasing the specific technology or product line that it is interested in and will not offer any value for the remaining assets of the company. Founders should also realize that strategic investments made by corporate partners are typically consummated at higher deemed valuations than what venture capitalists would assign to the company and should be prepared for a bit of a disappointment with regard to valuation and dilution if the next round of financing is negotiated strictly with financial investors.

§18 --Impact on founders’ activities with the company

The founders must evaluate how their choice of an investor partner will impact their day-to-day activities with the company and their ultimate career path as the company continues to mature and, hopefully, grow. Once again, venture capitalists are notorious for replacing founders with professional managers and it is common for founders to find that their role with the company is substantially reduced if not eliminated. If the founder is not performing he or she should be asked to leave the business or take another position; however, if the founder is continuing to provide value to the company the venture capitalists, and any outsiders they bring on board as executives, should find a way to keep the founder engaged with the business. Regardless of what happens though the founders will still have a significant equity stake in the business that will hopefully lead to a nice payoff at some point in the future. Corporate partners generally have less interest in meddling in the executive suite issues of the strategic allies; however, they certainly will have an opinion regarding the skills and responsiveness of the founders and other key personnel who are involved in the areas of specific interest to the partner.

§19 Finders’ arrangements
The founders will sometimes use “finders” to assist them in capital raising activities. In general, finders are small organizations or individuals who raise small amounts of money for start-up and early stage development. Finders usually do not identify themselves as such; most finders hold themselves out as venture capitalists, consultants, business advisers, or investment bankers. Some finders will write the business plan, recruit a management team, and put together a board of directors, in addition to finding money. If a start-up company elects to use the services of a finder, references should be checked and prior deals studied. Finder's fees costs are negotiable. In the US, for example, small deals are more expensive, often costing 5% to 10% of the first million dollars raised. In some deals, the finder who does everything such as putting together a management group, writing a business plan and establishing a board of directors, may charge 30% of the funds raised.\footnote{For discussion of the terms and conditions generally included in finders’ agreements, see “Business Planning” in “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).}

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About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, Business Transactions Solution, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 80 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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