The Strategic Business Lawyer

S. Barrett & Associates, P.C.

Next Issue:

Simple Estate Planning that Creates Peace of Mind

THE SB&A LEGAL STRATEGIST

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Welcome

Happy Holidays! As the Fourth Quarter comes to an end, SB&A wishes all of our clients, colleagues and friends the very best for the Holiday Season. As we reflect on all of our relationships that make our Firm a success, we send out a heart felt "Thank You" to everyone.

This quarter's feature deals with debt and equity financing. As with all of our "Feature Topics" we merely provide an overview of a topic that we feel may be of interest to our readers. This particular topic deals with the differences, advantages and disadvantages of debt and equity financing. There are various types of debt and equity financing, such as commercial and personal loans, receivable factoring, private placements, angel investment, declining equity as well as a number of combinations that are outside the scope of this article. Hopefully, our topic will alert and inform our readers. If you would like more information on a particular topic covered in our newsletter, please contact our office to set up a consultation.

Please take a few minutes to browse the newsletter. We invite all comments and suggestions; let us know how we can improve or offer up a topic that you would like to see in an upcoming issue.

Enjoy!

Scott Barrett

COMING SOON: Back issues of THE SB&A LEGAL STRATEGIST will be posted and can be viewed on our web site at http://www.sbarrettlaw.com. The newsletters may be found under the *Publications and Links* tab. FYI: Last quarter's Featured Topic dealt with sexual harassment in the workplace.

Texas Esoteric Facts

* Texas' largest county is Brewster with 6,208 square miles. Connecticut (5,544 Sq Mi), Delaware (2,489 Sq Mi) and Rhode Island (1,545 Sq Mi) can fit inside this county.
* State vegetable – Sweet onion.
* Texas is the only state to enter the United States by treaty instead of territorial annexation.

Feature Topic: Raising Capital Through Debt and Equity Financing

In both the commencement and operation of a business, there are two basic types of financing: debt and equity. The financing of a business is an on-going process, and at each stage of business growth appropriate funding must be sought. Many businesses will depend on a mix of financing options. In selecting the options, the business planner should look to both debt and equity financing, seeking to maintain an appropriate ratio of debt to equity.

In all cases, the cost of the financing method must be assessed. There are, of course, financial costs to be considered, such as impact on cash flow, legal commitments to make repayment, and financing fees. There are also costs of another nature, such as loss of ownership rights, or loss of the freedom to pursue certain business options. Additionally the lender or investor may impose burdensome reporting and consultation requirements. The following briefly describes the advantages and disadvantages of both debt and equity financing.

The choice between debt and equity has many ramifications. These forms of financing have basic differences in tax consequences, impact on the control and ownership, and maturity periods. Debt financing is, in essence, the procurement and management of funds from external sources in exchange for the obligation to repay the funds with interest. Debt financing is provided on a short-term, intermediate, or long-term basis. The primary sources of debt financing are commercial banks. However, when commercial loans are unavailable on reasonable terms and conditions, government assistance may be available, either as direct loans or government guaranteed loans. Equity financing is the procurement and management of funds from internal or external sources in exchange for ownership rights. Internal sources are the original ownership investment by the founders and retained earnings. Procurement of equity funds from external sources requires selling part of the business.

One issue of great concern to business owners is whether the owner will have ultimate control of business decisions. Equity financing obviously involves a loss of control to some degree, since an ownership interest is purchased by the investor. In the case of venture capital financing, for example, the investor will commonly require a voice in management of the business. However, in return, the investor can often provide skill and expertise that may be lacking in current management of the business. Venture capitalists are rarely interested in obtaining operating control of the business but may desire a minority voice on the board of directors or a consultant's role in order to exercise a degree of discipline over management.

Debt financing may leave the owner with a higher degree of independence. However, even debt financing will impose limitations on the owner's control. For instance, the lender may require the owner to agree that the business will not borrow from other sources, increasing the total business indebtedness. The lender may insist that the business limit issuance of dividends to shareholders. Affirmative covenants, addressing such matters as maintaining minimum net working capital, carrying adequate insurance, or supplying the lender with detailed financial reports on a set schedule may be required in a loan agreement financing agreement containing various positive and negative covenants. However, regardless of the form of financing, requiring the owner to justify and explain business decisions to investors or lenders can have a strong, positive impact on operation.

The duration of the involvement with the funding source is another consideration. Although equity investors may look to an ultimate buy-out or retirement of their interest, equity interests are by nature permanent interests that can often continue for the life of the business. Loan arrangements, on the other hand, set a time frame in the loan agreement.

Repayment obligations are another matter to be evaluated in the selection of the funding source. Debt financing requires repayment on a set schedule, and the obligation to repay may severely impair liquidity in some situations. Equity financing does not depend on set repayment schedules but looks for return on investment generated by the growth and success of the business. However, the ultimate return to investors may be more costly to the original owners than repayment of a loan.