

## Start-Up Financing 2.0

Seth C. Oranburg

Abstract: Entrepreneurs raise money for start-ups by acquiring debt, selling stock, mixing the two, and crowdfunding. This chapter explains the pros and cons of those start-up financing options. Start-ups must repay debt on time, which is hard for them to do before they start making profits. Stock investors collect repayment only when the start-up is acquired or goes public, but entrepreneurs cede some control of the start-up to stockholders. Hybrid options like convertible debt provide a temporary solution to some financing problems. Crowdfunding is a new way to fundraise through peer-to-peer networks, but it works well only for a few types of start-ups. Entrepreneurs should perform a careful analysis before choosing a fundraising option because fundraising has long-term consequences for start-ups.

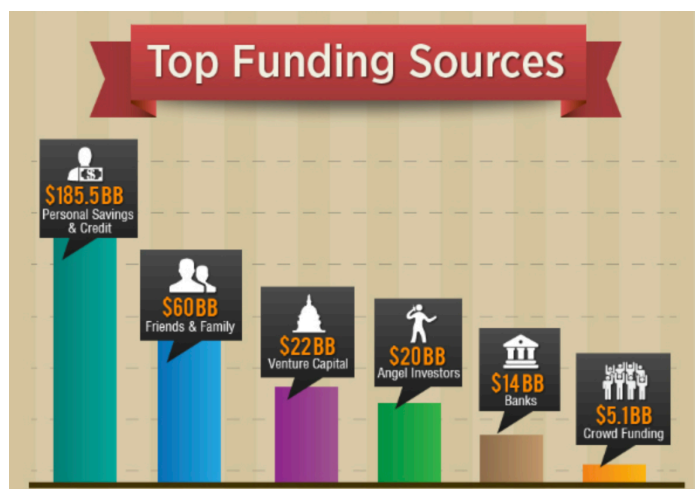
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## 1 Introduction

Start-ups are innovative, high-risk, high-growth business ventures that often require a significant amount of external financing (Vaznyte, 2019). Most start-ups “bootstrap,” meaning self-fund in their earliest stages, generally through various creative methods designed to reduce the need for outside financing, and to minimize the need for cash (Ye, 2017).

In the early stages of a start-up’s life, most entrepreneurs tend to finance their ventures using their personal savings (Aydin, 2015). Many start-ups raise fund through family members and friends, whereas less than 1% of startups are funded by venture capital and angel investors. However, these professional investors contribute much more money per financing round, so VC and angel funds still represent a significant portion of start-up financing on a per-dollars basis. Bank loans tend to be difficult for start-ups to secure, although the Small Business Associations makes debt financing more feasible. Finally, crowdfunding is small but fast-growing source of funds. Fig. 4.1 shows the top funding sources in a study by the Center for Venture Research.



*Figure 1. Top Funding Sources for Start-Ups.*

As Figure 1 makes clear, most start-up funding comes from founders and their family and friends, who contribute an average of about \$23,000 each. However, some business models require massive and repeated infusions of millions of dollars, which is only feasible to obtain through venture capital. High-growth startups need venture capital like spacecrafts need rocket fuel. Moreover, obtaining funding from outside investors such as venture capital impacts the business model and have legal effects. Accordingly, this chapter will focus on how start-ups are formally financed by outside investors to grow rapidly.

Professional investors fund start-ups primarily through the use of debt, equity, or convertible debt (a hybrid of debt and equity) (Deeb, 2014). Crowdfunding is emerging as a new way for start-ups to get outside investments. At the outset, it is important to note that all of these methods may involve the issuance of securities, which are subject to various laws. Engage a competent attorney in any securities issuance because compliance can be tricky, and penalties can be harsh.

Before a company can issue securities, it should be formed or incorporated. Start-up formation involves two formative decisions that affect financing and have repercussions for the life of the company: In what state should you form or incorporate the company? What type of entity do you want to form there? There are many excellent resources about how to make this critical decision – and limited liability companies are quickly growing in popularity. – but most American entrepreneurs who seek venture capital still choose to form a Delaware corporation. This chapter will, therefore, focus on start-up financing for a Delaware corporation, although it may be helpful to understand the reasons why many entrepreneurs make this choice.

Corporations are the most common entity choice for a start-up because the corporate form is well understood, separates ownership and control, limits liability for shareholders and directors, simplifies accounting, can be created quickly and easily, and has many standard characteristics that make it possible to use standard forms to issue securities (Hyman, 2014, §1:1). This is not, however, the only choice. In recent years many states have authorized the creation of new entity types. The most popular new entity type is the Limited Liability Company, which is lauded for its flexibility and tax benefits (Sargent and Schwidetzky, 2014, §1:1). Flexibility is not always a benefit to start-ups seeking financing because complexity and customization quickly increase legal costs, and investors have to review more information to understand investors' rights in flexible entities. The tax benefits may also be illusory, as most start-ups lose money for years before they turn a profit.

The state of incorporation matters a great deal because the corporate law of the state of incorporation governs the corporation's internal affairs (such as voting rules and other shareholder protections), and corporations may be sued in their state of incorporation. Most start-ups incorporate in Delaware because Delaware law is generally considered to be the most predictable (Fisch, 2000; Jagannathan, 2017).

The Delaware courts are also reputed to be the best in resolving corporate issues quickly and fairly. Some start-ups choose to incorporate in the state in which they do business because this saves costs, but outside investors from other states may be hesitant to invest in entities that could be subject to quirky state laws. Accordingly, this chapter assumes the entrepreneur will form a Delaware corporation, which is widely regarded as the safest choice for a start-up that seeks outside investment, even though there are many good reasons to make other choices. Consult a legal advisor to determine if another entity choice or state of incorporation is better for you.

## **2 Debt financing**

## 2.1 Introduction

Many entrepreneurs are already familiar with debt financing from their personal life. While debt agreements to borrow money can be very complicated, they have several common and straightforward characteristics. The most essential characteristics of debt financing to many entrepreneurs are, first, that lenders typically do not have rights to tell the entrepreneur how to run the business and, second, failure to make regularly scheduled debt payment can put the start-up into bankruptcy.

## 2.2 Pros and cons

Perhaps the biggest advantage of debt financing is the end of the relationship when the debt is repaid and lenders do not have the right to tell the entrepreneur how to run the business in the meantime (unless such rights are given by contract, which is unusual). This is a pro for the entrepreneur who wants to maintain total control of the start-up. So long as the debt is repaid on time and as scheduled, the entrepreneur does not have to answer to investors. Doing so can even raise the start-up's credit rating, making it easier to borrow money in the future.

However, early-stage start-ups often have dips in cash flows that make it challenging to make debt payments every month. Moreover, the entrepreneur may prefer to reinvest profits in growing the business, rather than making debt payments. Entrepreneurs may not realize that corporate debt requires regular repayment; severe repercussions can result when payments are missed.

When a start-up fails to make a debt payment when it is due, the loan immediately goes into default. However, default for nonpayment is only one of many ways in which a start-up can default on a loan. Commercial debt agreements also have a several covenants, which are conditions that must be met while the loan is outstanding. Financial covenants can include a requirement to maintain a minimum level of assets or not to take on more debt. Another con associated with these covenants is that the entrepreneur will have to provide the bank with balance sheets, income statements, and cash flow documents regularly so the bank can confirm that the financial covenants are not violated (Booth, 2014, Chapter 6).

Banks may also ask start-ups to agree to operating activity covenants. These can be unobjectionable, like a requirement to pay taxes and comply with laws and regulations, or they can be onerous, like a prohibition against using company money for a specific purposes—such as leasing equipment or real estate, changing management, selling assets, or paying dividends—without bank approval (Booth, 2014, § 6:13). It may feel like there is a banker in the boardroom while the debt is outstanding.

Fortunately, not all loans are so burdensome. In fact, another advantage of loans is that there are many products from which to choose. For example, the Small Business Association helps start-ups get commercial loans up to \$5 million at reasonably good terms (SBA loans, n.d.). Such

loans can have fixed interest rates and long terms, so the monthly payment is low and certain. There is also a new lending industry called peer-to-peer (P2P) lending or crowdfunding, which does not use a traditional bank at all (see Section 4.5).

These alternative (non-bank) lenders are important for start-ups because many banks are unlikely to fund a start-up that does not have sufficient collateral to guarantee a loan. Collateral is property of the borrower that can be seized if the borrower does not repay the loan. This is often called a security interest, and it can include cash, real property, and intellectual property. Posting security often helps the borrower obtain a lower interest rate because it makes the loan less risky for the lender, but many early-stage start-ups (and some late-stage ones) lack sufficient collateral for a traditional loan (Bradford, 2012; Lee, 2018).

### 2.3 Issues

There are a number of issues with start-up debt financing, but perhaps the most significant issue is that currently, it is hard for a small business in America to get a loan, especially without collateral. Small business owners generally have difficulty obtaining loans (Chakraborty and Mallick, 2012; Belás, 2015). This is particularly problematic for the busy entrepreneur. Filling out each loan application can take hours, and the bank may require days' worth of follow-up information before denying the loan application. Studies show that the trend away from small business bank lending is unlikely to reverse (Peirce et al., 2014).

Fortunately, there are new sources of debt financing that put fewer arduous requirements on start-ups. The new industry of P2P lending has emerged to provide personal and small business loans. Lending Club, Prosper, Realty Mogul, and other companies provide a P2P platform where borrowers and lenders can transact without going through a traditional bank. Each platform has its own methods, but generally, the P2P lending works on a reverse-auction model. The start-up creates a profile and submits financial information to the platform, which assigns a credit rating. Then the start-up posts a request on the platform's website for funds. Lenders view potential borrowers and contribute some fraction of the requested amount. Depending on the attractiveness of the borrower, it may take some time for enough lenders to syndicate and fund the entire loan amount. Typically, the cash is not available to the borrower until the loan is fully funded, so this creates an issue if money is needed urgently.

Another issue with P2P lending is that the request for a loan is visible to thousands of people, not just a few banks. Some entrepreneurs may not want to disclose their business model and financial situation so broadly. An analogy may be posting a request for a personal loan to a Facebook page, something which may not be desirable for the entrepreneur.

Finally, loan documents, especially ones with security or collateral agreements, are complicated, technical, and hard to read. The loan agreement may set forth a large number of restrictive covenants, and it can be hard to track when they are breached. The risks of default not only for

nonpayment of principal and interest but also for technical noncompliance, may require the entrepreneur to dedicate substantial efforts to servicing the loan. It is critical to read carefully and fully understand any loan agreement before signing. If the terms of the loan are so troublesome that they will prevent the business from running properly, it may be best to look for another source of financing.

### **3 Equity financing**

#### **3.1 Introduction**

Equity is a share of a business. In fact, equity in corporations is actually called shares or shares of stock. An entrepreneur who raises money through equity financing effectively sells pieces of the company in return for outside investment. The outside investors thereby become inside shareholders, who have certain legal rights and privileges that lenders do not enjoy.

Professional equity investors include angels and venture capitalists (Oranburg, 2015a). Angels form groups that collectively invest an average of \$350,000 of their own money in a very early-stage start-up, while venture capitalists form funds that invest an average of about \$7.3 million in a more mature company (Oranburg, 2015a). These independent venture capital (IVC) investors (which may also include private corporations that have venture funds) contribute the vast majority of start-up capital in America and the world, but some countries have established government venture capital (GVC) funds and mixed public-private partnership funds. Public investors provide capital to entrepreneurs that IVC investors may not because GVCs are under political pressure to pursue domestic employment and other nonfinancial goals (Cumming et al., 2014).

#### **3.2 Pros and cons**

The overwhelming advantage of equity financing for start-ups is that there is no loan that must be paid back. With equity financing, there is no risk of bankruptcy as a result of failing to repay investors. This gives start-ups the flexibility to deploy invested capital in growing the business. Investors do not expect to be repaid until the business becomes profitable, and even then, equity investors may be willing to reinvest the profits to continue growing the business, especially for social reasons (Terziev, 2017).

The reason equity investors are so flexible about being repaid is that equity owners are entitled to a share of the total value of the start-up. The investor joins the entrepreneur in sharing business risks by providing risk-bearing capital (Weijs, 2018), and both have similar incentives to grow the business as large as possible before cashing out (Huang, 2017). This creates a partnership dynamic between the entrepreneur and the equity investor, which may be welcome in some situations, but also one that can create frustrations for the entrepreneur.

As a co-owner in the business, the equity investor is entitled to vote on fundamental transactions, such as a merger or a sale of substantially all the company's assets. Once equity investors

purchase stock in a start-up, the entrepreneur may lose control over when to liquidate the business and exit the market. In fact, many equity investors will push for an exit within eight to ten years of their initial investment. While the entrepreneur frequently gets paid to operate the business, the equity investors typically get a return on their investment only when it liquidates. Some equity investment contracts even contain a provision where the investors can force the company to go public (Smith, 2005).

Another con about equity financing is that the investors typically receive preferred stock, whereas the founders and employees typically receive common stock. Preferred stock is so named because it has certain preferences, including the right to be paid first in a merger or liquidation, the right to receive dividends, and the right to block certain transactions such as another debt or equity financing. Founders need to realize that equity financing not only gives up a share of their business to investors, but it also subordinates founders' equity position to investors. The common stockholders usually have financial rights only in the residual, which is the amount that remains after the preferred stockholders are fully paid for their initial investment, dividends they have accumulated, and any liquidation preference they are owed. Preferred stockholders may even have the right to participate, which means that after they receive their preference, the preferred stock converts to common and receives a percentage of the residual as well (Walther, 2014, p. 167).

Preferred stockholders lack the affirmative covenants often found in bank loans, but they need a way to make sure that management is acting in the investors' best interests, so they often bargain for management rights or even a seat on the company's board. Giving an investor one seat out of three may not seem like a big deal at first but remember that start-ups often raise multiple rounds of outside investment. Each fundraising round may result in giving up another board seat, so that by the third round the equity investors may outnumber the founders on the board by three to two. At this point, the investors can fire the CEO and replace management. Only the strongest start-up founders are able to raise multiple rounds of equity financing without eventually giving up a majority of board seats to investors. Most founders who raise equity financing should expect to be at the mercy of outside investors at some point in their start-up's life cycle (Wasserman, 2012).

But founders are often overly worried about maintaining control. Equity investors are in the business of selecting and overseeing start-ups in which to invest, not in the business of running them. A good CEO will find his position secure, and quite frankly it may be in everyone's best interest to replace an underperforming CEO with someone who can really build the business. The original founding team should be vested in most or all of their common stock (meaning they have the right to keep that stock even if they are fired) by the time equity investors control the board, so they can actually profit financially from such a change of control (Empey, n.d.). Sometimes the founding CEO is a visionary who can build something new, but not an

administrator who can run a large and successful organization. This can be hard for a CEO to admit, but successful repeat entrepreneurs learn their own strengths and weaknesses.

The close and interdependent relationships between entrepreneurs and investors that arise from equity financing agreements are not for every start-up founder. Those founders who demand complete control may be frustrated when each financing round slowly drains power from their grasp. But founders who are open-minded about the business model and their role in the company may actually find that equity investors have valuable experience, connections, and skills that can be employed to dramatically improve the business. The key thing to remember when sorting out the pros and cons of equity financing is this: equity investors are more than money. Equity investors are partners. Some analogize the founder/investor relationship to a marriage. Choose someone you trust and want to work with for many years.

### 3.3 Key issues

The biggest issue with equity financing is that it may not be available during certain stages of start-up development. There are currently two main types of equity financing investors, angels and venture capitalists. Angels typically fund less than \$1,000,000 and venture capitalists typically fund more than \$5,000,000, so start-ups trying to raise about \$3,000,000 often have trouble attracting investors (Oranburg, 2016). Moreover, these investors prefer business models that can scale quickly, which is why they often invest in software start-ups. Start-ups that make physical goods or that require a large input of human capital may find it difficult to attract equity investors. Fortunately, there are more resources than ever to find angels and venture capitalists who are in specific sectors. Web sites like Angel List connect start-ups to equity investors, incubators and accelerators have “demo day” to highlight emerging companies, and many large corporations have established venture financing groups to help grow start-ups in their sector (Incubator, n.d.). Start-ups should plan their business model around the realities of equity financing by planning to seek financing at points in the start-up's life cycle where investment will be at the highest levels.

Another issue is that raising money through equity financing requires a public disclosure of the securities issuance. There are web sites like Crunch Base, whose business is to look for filings about such securities issuances and to post that information online ([www.crunchbase.com](http://www.crunchbase.com)). Therefore, one key issue with equity financing is that it effectively takes the start-up out of stealth mode and subjects it to public scrutiny. The solution to this issue is to treat the equity financing like a PR campaign and use the press to the company's advantage through effective communication and good timing.

Once a start-up raises money through equity financing, the company effectively has a value as of a certain point in time. The value is determined simply by dividing the amount of money invested in the start-up by the percentage of equity received from that investment (e.g., if investors pay \$1,000,000 for 10%, the start-up has a value of \$10,000,000). This has many

implications. For example, start-ups often incentivize employees to work long hours for less pay by offering stock options. The value of a stock option is the difference between the price that the employee must pay to get the stock (this strike price is set by contract and does not change) and the value of the stock (the market price, which changes frequently). Clearly, the employees prefer to get stock options when the strike price is low, but there are laws about setting the strike price based on the value of the company. Once the company has a value determined by outside investment, the strike price typically increases dramatically, making stock options less valuable. Therefore, it may be a good idea to grant stock options before seeking an equity investor (Casserly, 2013).

Another issue is the expense of doing an equity financing. Expect legal fees to cost at least \$25,000 for a standard equity financing. That cost can increase dramatically if the start-up has done a poor job of maintaining records and complying with corporate formalities before the financing. The equity investors will require the start-up to pay lawyers to clean up the books and records before closing the investment. This process can also require the entrepreneurs to spend a lot of time on due diligence, the process by which the start-up discloses information to the investor who then reviews the business. During this process, some issues like lawsuits, patent infringement, and disgruntled employees may come out and be memorialized indefinitely in the stock purchase agreement. Start-ups that have the financial means to do so would be well advised to ensure their corporation is compliant with the law before seeking financing (Gartner et al., 2012).

Finally, the stock purchase agreement and other equity financing documents are technical and complicated, but in a different and more dangerous way than bank financing documents. Whereas debt-financing documents can contain numerous restrictive covenants and severe penalties for late payment, a founder can easily recognize the important economic terms such as interest rate and loan term. In equity financing, however, the economic terms are much more complex. For example, simply changing the liquidating preference multiple from one to two means that, in the event of an acquisition or liquidation, the preferred stockholders get twice their investment before the common stockholders get anything. A sophisticated entrepreneur can learn about these terms by studying a term sheet and reviewing the annotated version of these forms (available online at [nvca.org](http://nvca.org)), but a good lawyer is truly worth hiring in this context, where a seemingly tiny detail can result in millions of dollars.

## **4 Convertible debt financing**

### **4.1 Introduction**

Convertible debt is a hybrid between debt and equity. Convertible debt is technically a loan, typically with a very low or nominal interest rate. The interest rate can be low because the point of the loan is not to earn money on interest but to convert the debt to equity upon a triggering event, such as another financing or the expiration of a period of time. Convertible debt was

traditionally used for bridge loans, which are loans between two rounds of financing to carry the start-up through a brief but tough time. Nowadays, start-ups frequently receive their first financing (also called seed financing) through convertible debt because this seed note method is relatively quick, cheap, does not require the company to be firmly valued, and may not require the start-up to make the public disclosures associated with stock issuances (Werner, n.d.).

#### 4.2 Pros and cons

The main advantage of convertible debt is that this method is quick and inexpensive. Whereas an equity-financing round can easily cost \$25,000 or more, a seed note round can be accomplished for \$5000 or less. The reason for the low cost is that seed notes are very simple instruments that effectively put off discussions regarding valuation, board seats, protective provisions, liquidation preferences, and many other complex terms until a triggering date or event in the future (Werner, n.d.).

Until the seed note converts to equity, the noteholder is not a stockholder. Noteholders are not entitled to shareholder rights such as voting on mergers, and they almost never receive protective provisions. Seed notes also generally lack the strict affirmative covenants found in conventional debt agreements. As a result, entrepreneurs are generally free from virtually any investor influence during the pre-conversion period (Kramer and Levine, 2012).

Seed notes also do not require the entrepreneur and the investor to agree on a valuation of the company. The notes do not translate into a percentage of equity until the next equity financing. This eliminates what is often the most contentious aspect of start-up financing: valuing a new and unique company in its very early stages. The flip side of this kick-the-can-down-the-road method is there is a great amount of uncertainty as to what investors will ultimately receive. To understand why requires a brief discussion of how seed notes work. There are essentially only four material terms in a seed note agreement. First, how much will be invested as debt? Second, at what interest rate should the debt accrue? Third, when does the debt investment convert into equity? Fourth, does the debt investor get a discount (relative to later investors) when the note converts at the next financing? There are some other material terms such as what happens in the event of a pre-conversion acquisition and whether the investor shall receive financial statements during the pre-conversion period, but the focus is generally on the economics of conversion in the next financing (Werner, n.d.).

The seed notes will likely stipulate that the noteholder gets equal or better rights than any new investor in the next equity financing, and the noteholder will pay the same or less than any new investor in that next round (Werner, n.d.). However, when the note is formed, neither party has any way to know what the rights nor price of the next financing will be. There are a few techniques employed to address this uncertainty, such as a valuation cap, which reflects the highest price per share that the noteholder will pay upon conversion, but the uncertainty

regarding final terms about control, preference, and voting rights is the unavoidable consequence of not negotiating these terms upfront.

#### 4.3 Key issues

Negotiations over seed notes typically focus on two main economic terms, the cap and the discount. First, consider a situation where there is no cap and no discount. The start-up issues 1,000,000 shares of common stock to founders. Then a seed note investor purchases a \$100,000 note with 0% interest. Later, an equity investor values the 1,000,000 shares at \$1,000,000 (this is called the pre-money valuation), or \$1.00 per share, and agrees to purchase 200,000 shares of preferred stock for \$200,000. Upon the closing of that stock purchase, the seed note investor receives 100,000 shares of preferred stock, too. After the equity financing, the founders hold 77% of the equity (Werner, n.d.).

Now take these same facts, except that the note has a 20% discount. That means the noteholder pays \$0.80 per share and receives 125,000 shares of preferred stock. After the equity financing, the founders hold only 75% of the equity.

Instead of a discount, assume the note has a \$500,000 valuation cap. That means that the noteholder will never pay more than \$0.50 per share (which is derived from a \$500,000 valuation for 1,000,000 shares). Now the noteholder receives 200,000 shares of preferred stock, and after the equity financing, the founders hold only 71% of the equity.

Finally, consider a note that has a \$500,000 cap and a 20% discount. Typically, a noteholder gets the better of the two options, but not both. Under the previous facts, the cap is more valuable than the discount. However, if the new equity investor valued the company at less than \$625,000, the discount would instead be applied because it is more valuable to the noteholder.

As this hypothetical situation should make clear, the number of shares that a seed note investor ultimately receives cannot be determined when the note is issued. Rather, the noteholder receives a number of shares that is dependent on the valuation by the next equity investor. This can create a conflict of interest between the noteholder and the founder. The holder of a note that does not have a cap may want the company to close its next equity financing when the stock value is as low as possible as to get the highest number of shares, whereas the company is best served by holding out for a higher valuation. On the other hand, if the note is capped, both the note holder and the founders may want to receive a high valuation in the next round, but if the valuation is too high, then the note holder will effectively get a massive discount vis-à-vis the next equity investor. This can seem unfair and thus discourage an equity investor from investing in the start-up.

Another issue with seed-note financing is that the noteholders eventually become equity holders, so many of the same issues discussed earlier apply here. Founders should consider how such investors will act as stockholders before accepting their investment. In the early stages of a

closely held corporation, stockholders can influence management and prevent certain corporate actions. An investor who contributes \$100,000 in a seed note round may need to consent to a sale of the company for \$10,000,000 several years later. Before accepting funds, remember that equity investment is a long-term relationship, and that seed noteholders will become equity holders.

## **5 Crowdfunding**

### **5.1 Introduction**

Crowdfunding is “the use of small amounts of capital from a large number of individuals to finance a new business venture.” (Smith, 2019). This is typically accomplished utilizing the internet and various social media platforms, allowing the general public to take part in the investing process (Prive, 2012). This “approach is attractive to entrepreneurs, because it not only allows raising capital for small businesses, which have very limited financing options, but also serves as a tool for testing marketability.” (Valanciene & Jegeleviciute, 2013). Others have described this “market test” function as the non-pecuniary value of crowdfunding. (Oranburg 2015b).

New laws allowing crowdfunding have been promoted by the Obama administration because “crowdfunding offers real promise for underserved business entrepreneurs and may allow the organizations that serve them the ability to reach even deeper into the entrepreneurial community” (Rand, 2012). There are high hopes for this new fundraising model. Business scholars have even suggested that crowdfunding can change the very nature of capitalism by dramatically lowering the difficulty of raising funds (Macaulay, 2015) by bringing about “more efficiency, lower transaction costs and increased flexibility in world financial markets.” (Fanea-Ivanovici, 2019).

But crowdfunding is not entirely new. Crowdfunding is a blanket term that covers a range of different models for raising capital, which can be categorized into five types: (1) donations, (2) rewards, (3) pre-purchases, (4) lending, and (5) equity crowdfunding. Entrepreneurs can combine these models for specific fundraising purposes.

#### *5.1.1 Donations*

The donation model of crowdfunding does not involve the sale of securities (Sheik, 2013). Those who donate to crowdfunding projects do not receive any financial interest or material return on their investment. (Zhao, 2019). This appeals to donors who want to foster the development of intangible common goods and social welfare projects. Donors for these projects do not receive a direct, private benefit, although they may appreciate an indirect, public benefit to donors and nondonors alike. This altruistic donation model of crowdfunding has proven popular for charities due to its transparency and personal touch (National Overview, n.d.), but it is not a common way that for-profit start-ups raise money (Belleflamme et al., 2011). It is more common for

entrepreneurs to seek financing with an approach that eschews the donation model or combines it with one or more of the other models described next (Belleflamme et al., 2011).

### 5.1.2 Rewards

The rewards model of crowdfunding allows a supporter to invest in an organization or cause in return for a reward such as being “credited in a movie, having creative input into a product under development, or being given an opportunity to meet the creators of a project.” (Bi, 2017). The reward model is often combined with the donation model. For example, due to financing problems during the construction of the Statue of Liberty in 1884, Joseph Pulitzer urged the American public in his newspaper *New York World* to donate money for the statue’s pedestal. In response, approximately 125,000 people donated over \$100,000 to the project. As a reward, Pulitzer published the names of each individual who contributed to the project in his newspaper. (National Parks Service, 2019). More recently, large donors to *The Canyons* movie received cameos, script reviews, and even the money clip that Robert DeNiro gave director Burt Schrader on the set of the movie *Taxi Driver* as a reward for their contributions to the film. (Rodrick, 2013).

Kickstarter is a crowdfunding website that encourages the use of the rewards model (Rewards, n.d.). Rewards include copies of the thing produced, limited editions of the product, collaborations with the donor in the production, experiences with the producers, and mementos of the project (Rewards, n.d.). Being rewarded with the final product is similar to engaging in the pre-purchase model of crowdfunding described later, but the distinction is that rewards are technically considered gifts that are not offered for sale (Terms of Use, n.d.). Start-ups that produce consumer goods find that the rewards model is an effective way to raise capital, although more money can be raised more easily with the pre-purchase model described next. Start-ups that cannot easily produce an entertaining reward have trouble using the rewards model of crowdfunding.

### 5.1.3 Pre-purchase

The pre-purchase model is the most common type of crowdfunding (Bradford, 2012). Under the pre-purchase model, the consumer pays in advance for the product. If the start-up launches the product, the consumer typically receives that product for a lower price than regular customers who purchase the product after it is already on the market (Hossain, 2015), and the consumer receives nothing if the start-up fails (Manderson, 2012). For example, if you pledged \$185 or more on Kickstarter in 2014 for the Coolest Cooler™, that start-up promised to send you the cooler with some add-ons and “swag” by February 2015. (Kickstarter, 2019). This was a special price for early investors. Today, the Coolest Cooler™ has a starting retail price of \$249.99. (Coolest, 2019). However, the \$13 million they initially raised was not enough to get the product out to investors. “[M]ore than 60,000 backers were supposed to receive their coolers in February

2015. Many did, but many more did not as delays and glitches hit production,” requiring the company to raise additional funds. (Feldman, 2016).

#### *5.1.4 Lending*

Banking is a heavily regulated industry, and much of crowd-lending is regulated by federal agencies. As a result, there tend to be fewer platforms for crowd-lending. The crowd-lending platform Lending Club was the such platform to register with the Securities and Exchange Commission (FAQ for New Investors, n.d.). Lending Club’s financial innovation is to connect lenders and borrowers in what is called peer-to-peer (P2P) lending (Verstein, 2011). On Lending Club, customers interested in a loan complete a web-based application that is evaluated by Lending Club for creditworthiness and assigned an interest rate (FAQ for New Investors, n.d.). Investors select loans in which to invest based on risk factors and interest rates (FAQ for New Investors, n.d.). The minimum required to invest is only \$25, so broad diversification is possible for Lending Club investors with limited capital (Earn Solid Returns, n.d.). The term of loans on Lending Club are generally 3 or 5 years, at a fixed interest rate and straight-line amortization (Lending Club, 2014).

The lending model works best for start-ups that deal with tangible goods and have some sort of collateral. The risk of nonrepayment for unsecured business loans is very high, so investors require a commensurately high return on investment to compensate for this risk. To receive such a high rate of return through the lending model of crowdfunding, interest rates on the loans may be so high as to be illegally usurious. By posting collateral, producing valuable goods, or holding real property, start-ups can reduce their risk of nonpayment and obtain “crowdlending” on more favorable terms.

#### *5.1.5 Equity crowdfunding*

The Jumpstart Our Business Start-ups Act of 2012 (the JOBS Act) amends Section 4(a)(6) of the Securities Act of 1933, as amended (15 U.S.C. § 77d(a)(6) (2015)) (the Securities Act), to allow a private corporation to offer and sell up to \$1 million worth of equity securities (stock) in a 12-month period to the general public without registering the securities with the SEC. This new exemption to registration under the Securities Act is generally called crowdfunding, although this federal law is more accurately called equity crowdfunding. (Securities and Exchange Commission (SEC), 2012). There are also of dozens of intrastate equity crowdfunding laws that are available where companies and investors are located in the same state, but these varied and nascent laws are beyond the scope of this chapter.

The SEC issued its final rules on equity crowdfunding on October 30, 2015, and went into effect to allow Internet funding portal registration on January 29, 2016 and to allow stock issuance starting on May 16, 2016 (SEC, 2015). The size of this financing market, the role of the funding portals, and many other details will take time to emerge. However, some of the key crowdfunding rules are provided in the JOBS Act itself. Individuals who have between \$100,000

and \$1 million in annual income or net worth may invest 10% of it each year in start-ups through crowdfunding (15 U.S.C. § 77d(a)(6)(B)(ii) (2015)). Individuals who have or annually earn less than \$100,000 may invest the greater of \$2000 or 5% of their annual income each year in start-ups (15 U.S.C. § 77d(a)(6)(B)(ii) (2015)).

### *5.1.6 Venture Philanthropy*

At its core, venture philanthropy is modeled around the same concepts as venture capital. Venture capitalists aim to quickly grow start-ups by providing large amounts of funding in the hopes of earning a high rate of return off of their investment (Davila, 2003). Venture philanthropists have the same aim as venture capitalists but, instead of trying to grow their wallets, venture philanthropists “invest” in the hopes of increasing net social welfare for society (Defourny, 2016). They aim “to serve more people, more effectively.” (Grossman, 2013). Philanthropic investors concentrate their support on creating new and innovative answers to current social issues they are interested in like medical research, environmental clean-up efforts, or education reform (Zeichner, 2017). That is, investors are not, at least initially, concerned with turning a profit; their investment is intended mostly (or entirely) for philanthropic purposes. The Bill and Melinda Gates Foundation, for instance, provide funds worldwide for a variety of social issues (Gates, n.d.).

Venture philanthropy has characteristics similar to the various funding methods discussed above. Generally, this form of funding tends to act similarly to the donation model in that the investor gives a large sum of capital to the start-up but does not receive any financial interest or material return on their investment. Their “return on investment” is simply the benefit provided to society if the venture succeeds. However, this does not mean a monetary return is out of the question. Some reports have highlighted the importance of venture philanthropy and its effect on impact investing (Bannick, 2012). Impact investing is a combination of venture philanthropy and venture capital in that it serves the dual purpose of earning financial returns while addressing a specific social issue (Barber, 2017). Impact investing can then mimic the lending model for start-up financing and allow the philanthropist to transform into the capitalist once the philanthropic endeavor has scaled accordingly.

Start-ups whose value proposition includes a clear social benefit – such as providing clean water in rural areas, reducing environmental hazards in cities, connecting first responders with emergency situations, offering crisis counseling through chatbots and AI, optimizing food waste collection, and perhaps even offering mobility solutions like a network of scooters – may have access to capital from venture philanthropists and impact investors. For such mission-driven start-ups, venture philanthropists and impact investors offer financing on very company-favorable terms. Start-ups should note that while some venture philanthropists give generally, many have a particular focus on a sector or industry, or an even narrower focus on solving a specific problem. This is even more true with impact investors, who generally specialize in a particular industry or impact area. Accordingly, mission-driven start-ups should research which

venture philanthropists and impact investors may be interested in their region, industry, or solution.

### *5.1.7 Initial Coin Offerings*

Initial coin offerings (ICOs) are the newest form of start-up financing available today. These offerings raise funds by selling crypto-tokens or “coins” in exchange for legal tender or other cryptocurrencies through a blockchain (Amsden, 2018), similar to selling stock in an initial public offering (“IPO”). IPOs, however, are heavily regulated by the SEC, whereas ICOs remain mostly unregulated. In a typical ICO, the “coins” that are initially sold will later serve as the medium of exchange on a peer-to-peer platform (Li, 2018).

Blockchain start-ups have embraced ICOs as a vehicle to raise early capital. (SEC, 2018). The “coins” offered in these sales are intended to fill a widely varied set of roles on different platforms. Some “coins” are similar to currencies, others act more like securities in a publicly traded company, and others have properties that are entirely new (Conley, 2017). Such a new medium of exchange is not without risk: ICO advisory firm Stasis Group recently published a study claiming more than eighty percent of ICOs conducted in 2017 were scams (Alexandre, 2019). Cryptocurrency start-up Confido, for example, raised \$375,000 through one such ICO before vanishing with investors’ money (Kharpal, 2017). Instances similar to Confido are numerous, so it is recommended that entrepreneurs avoid ICOs for their financing needs. Presently, due to the absence of regulation, ICOs are too risky to properly employ for sustainable start-up financing.

### 5.2 Pros and cons

Whether or not crowdfunding is right for your start-up may depend on your mission or on the nature of the product your business will produce. Crowdfunding, especially donation and rewards crowdfunding, can be very useful for start-ups with a primary purpose of producing a social benefit because crowds may be inspired to fund projects that create a public good. The rewards model of crowdfunding, in particular, has been used by nonprofit organizations like the Smithsonian Institute to fund public-work projects like the Reboot the Suit campaign (Reboot the Suit, n.d.). This may extend to eco-friendly projects and socially responsible investing (Chamberlain, 2013).

Consumer products are the basis of the most successful crowdfunding campaigns on leading platforms like Kickstarter and Indiegogo. Only one of the top 15 crowdfunding campaigns in 2014 was not for a consumer product, although it was for Reading Rainbow, a social benefit project (15 most funded, 2015).

Business-to-business (B2B) crowdfunding has not taken off with a donation, reward, or pre-purchase model. B2B companies and service companies are probably limited to the lending and equity crowdfunding models unless their business focuses primarily on providing a compelling

social benefit. Therefore, start-ups offering B2B solutions will probably not seriously consider crowdfunding as the primary means to finance the business; however, as equity (investment) crowdfunding develops, it could become a useful financing tool for B2B start-ups.

A benefit of non-equity crowdfunding is that entrepreneurs maintain control of the business. Backers obtain no control rights under the donation, reward, or pre-purchase model, although start-ups that raise money in these ways may feel obligated to keep backers informed about progress. That is not to say, however, that there are no rules regarding non-equity crowdfunding. To the contrary, the Federal Trade Commission has sued start-ups that sought money on Kickstarter and failed to deliver products (Federal Trade Commission (FTC), 2015). Therefore, non-equity crowdfunding creates legal risks for entrepreneurs and companies. Under lending crowdfunding models, the lender may obtain some contractual rights to the start-up's books and records, and the start-up may be forbidden from selling more equity or taking on more debt while the crowdfunded loan is outstanding. The restrictive covenants on crowdfunded loans vary widely depending on the platform, loan amount, and other factors.

Raising money through equity crowdfunding requires making a number of disclosures. Start-ups must file a Form C with the SEC, keep various records, and produce financial statements before raising more than \$500,000 (Lingam, n.d.; Crowdfunding, 2013). If a start-up raises a substantial amount of money through equity crowdfunding, it may have to get stockholder approval from the crowdfunding investors, which may be a diverse and hard-to-contact group. That can slow down or even prevent management from engaging in corporate finance and acquisition activities.

### 5.3 Key issues

The donation, reward, and pre-purchase crowdfunding models do not involve the sale of any securities under federal law (Bradford, 2012). The touchstone of the Supreme Court's test for what defines a security is whether the investment is premised on a reasonable expectation of profits (United Housing Foundation, 1975). But start-up investors are generally not interested predominately in nonfinancial rewards. Investors generally want to earn a return on their investment, so donations, pre-purchases, and nonfinancial rewards can only attract a limited number of investors (Bradford, 2012). To offer investors an opportunity to earn business profits, entrepreneurs will have to comply with securities regulations including Title III of the JOBS Act of 2012.

As discussed earlier, the biggest issue with donation, rewards, and pre-purchase crowdfunding is that there are very few examples of B2B or service companies using those models successfully. That means lending and equity crowdfunding may be the only crowdfunding options for many start-up. Crowdlending has many pros and cons, as discussed earlier, but it may be easier for a start-up to get a loan through crowdfunding than through a conventional bank.

The biggest issue with equity crowdfunding is that it is new, so investors are skeptical and unsure how it will work. This limits investor interest in this fundraising modality. Congress is working on JOBS Act 2.0, so there is additional regulatory uncertainty around equity crowdfunding because Congress may change the statute that enables it (Clifford, 2015). If companies use crowdfunding to commit fraud, that may cause a backlash against equity crowdfunding that potentially shuts down the entire model (Hazen, 2012). At this stage in the development of equity crowdfunding, there are many political, legal, business, and societal uncertainties that make this new model both exciting and risky.

## **6 Conclusions and future trends**

The financial future looks bright for many high-growth start-ups. Thanks in part to social media and Web 2.0 technology, new approaches to start-up financing are rapidly emerging. Equity (investment) crowdfunding is now permissible in the United States, and over two dozen equity crowdfunding web sites have registered as funding portals. Crowdlending web sites like Lending Club and Prosper continue to increase access to debt financing without banks. Angel investors are sourcing deals online through angel crowdfunding portals such as Angel.co and OurCrowd.com, which led to angel investments in 66,110 different companies in 2018. Meanwhile, venture capitalists pumped \$131 billion into start-ups in 2018 – eclipsing the \$100 billion watermark previously set at the height of the dot-com boom in 2000. Hundreds of billion-dollar start-ups – once called “Unicorns” for their rarity – are now common household names.

Yet there are several mars on this otherwise rosy picture. Minority, female, and rural businesspeople still do not receive venture capital at the same rates as white, male entrepreneurs in big cities such as San Francisco and New York. Crypto-currencies turned out to be fraught with scams and other perils. And some companies – notably slow-growth small businesses in more traditional industries – have seen relative or absolute diminutions in their financing prospects. However, scholars and policymakers are now focusing on finding solutions to these problems, and venture philanthropists and impact investors are actively seeking opportunities to make investments in diversity and inclusion.

With all the options that abound in start-up financing today, it's more important than ever to formulate a business plan includes a financing strategy. Working with a good start-up lawyer can help entrepreneurs understand the legal and business implications of financing choices.

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