Chapter 5

Financing

Many producer marketing associations need substantial amounts of capital to operate the business. The necessity of locating financing can be the first big challenge for the group and can occupy a significant amount of time during the start-up process. This chapter considers some of the possible avenues to obtain capital and raises some of the special legal issues involved with these different approaches.

Importance of having enough capital

Almost any type of business needs some infusion of capital to get started. Even if your group merely wants to market products locally, there may be some marketing costs and wages for part-time help to coordinate deliveries. On the other end of the spectrum, you may decide to enter a value-added processing venture requiring sophisticated machinery, experienced management, research and development, an elaborate distribution system, and vast amounts of inputs. Either way, the organization needs to consider where it will come up with the necessary capital.

Before searching for capital, you might want to step back and ask how much your group really needs. Starting a business is a risky process, especially when dealing in emerging markets. The sober fact is that many new businesses fail, and when they fail the people who contributed money usually lose most or all of their investment. This fact leads many veteran entrepreneurs to advise newcomers to start off on a scale they know they can handle and that limits the amount of money people might lose. This is an especially important consideration for organizations expecting producers and other people from the local area to provide the start-up capital. In this case, if the business is not successful, the whole community will suffer.

Once you have decided how much you need, you will look at two basic sources for capital:

1. **Equity financing**. In equity financing, people invest capital in the business in return for ownership rights, usually including some right to profits and a level of control.

2. **Debt financing**. In debt financing, an outside entity lends money you will need to pay back with interest. Generally, you will not be required to give up

any of your legal rights to control the business in debt financing, but lenders may still influence your operation because they may not lend money unless you conduct the business a certain way.

Capital questions

As your group considers how to obtain needed capital, it will want to ask some basic questions:

- How do you define your capital needs? Is it for start-up, expansion, or to manage risk? Lenders will want to know the specific need for which the capital will be used.
- How great are your risks? The level of risk will determine the cost and availability of financing options.
- Can you obtain capital by doing a better job of managing your cash flow? Before going outside the organization, be sure to consider ways to obtain the capital from within the business.
- What is the status of your product's market? Depressed, stable, or growth conditions require different approaches to financial needs and sources.
- Is your business seasonal or cyclical? This consideration can be especially important in agriculture. Seasonal needs for financing are generally short term, while loans designed for cyclical businesses are often designed to support a business through depressed periods. Agriculture can fit both of these categories.
- How strong is your management team? Potential financers will focus closely on the people you have running your business.
- Finally, how does your need for financing fit into your business plan? As discussed in Chapter Two, the need for capital should be a step in a well-developed plan to becoming a viable business.

Source: Adapted from U.S. Small Business Administration, *Financing Basics.* www.business.gov/phases/launching/finance_startup/financing_basics.html.

The capital paradox

Those in most need of capital are usually the ones who have the hardest time obtaining it. Investors and lenders look for a combination of low risk of loss and high rate of return when deciding to whom to provide money. So the ideal business has a lot of assets and relatively strong profits, in other words a business that can probably rely on its own resources to finance expansion. The paradox is that start-up businesses often have the most need of money but usually have few assetts and only projections of profitability. The challenge is matching your business plan with the available capital.

What are the pros and cons of equity financing versus debt financing?

	Pros	Cons
Debt Financing	• The lender has limited participation in management of your business. • The lender's share of the profits is limited to the interest payments. • Loans from those close to the business (producers or local citizens) often have flexible repayment terms.	• The loan repayments may be due when your need for the cash is greatest. • The business or those involved with the business may need to assign a security interest in the business or personal property to obtain the loan. This can place your own personal property at risk.
Equity Financing	• Repayment requirements are generally more flexible. • Investors may be experienced in the field and can provide valuable advice. • If the business loses money or goes broke, you do not have to pay the investors.	• Equity investors may take a large share of the profit. • Equity investors may exert control of the business and take it in directions you do not want it to go.

Source: Findlaw.com, *Loans and Equity Investments Compared.* www.smallbusiness.findlaw.com/starting-business/starting-business-financing/starting-business-financing-loans-equity-compared.html.

What do you need to attract capital?

Both investors and lenders will usually look at two key factors when considering whether to invest or lend to a business: A strong business plan and an experienced and proven management team.

Control – who has the right to make which decisions

Probably the largest practical concern with obtaining capital (beyond whether you will be able to find it) relates to control of the business. When someone contributes capital to your business, whether with debt or equity financing, you usually need to give up at least some decision-making control of the business. Exactly what this means will depend on the agreement you reach with the investors or lenders. In the most clear-cut example, an investor might require a certain percentage of the shareholder or board of director voting rights. An investor might also be interested in becoming directly involved in the day-to-day operations of the business.

Grants as an alternative source of capital

A grant is usually the transfer of monetary aid that does not require repayment or give the grantor any ownership interest in the business. Because foundations and governments often use grants to encourage development of certain kinds of businesses, to obtain a grant you will need to meet their criteria. Sometimes significant strings are attached, such as requirements on what you produce, how you produce it, and where it is produced. As a rule, nonprofit groups are most commonly the recipients of grants, but for-profit businesses might be eligible for grants for such things as market research and feasibility studies.

Grant seeking is not for the faint of heart. Grant writing can be a very time-consuming activity that involves cultivating relationships with the grant community and dealing with long and cumbersome grant applications. Some people like to think of grants as "free money," but the time and energy expended in obtaining a grant can sometimes be costly, especially if you do not receive the grant.

On the other hand, you might have a lender who does not request any formal control of the operation, but for most major decisions the lender may require its approval as a condition of maintaining a line of credit in the future. A lender might also put certain contingencies on a loan that essentially cause you to change your business plan. Many times these influences from investors and lenders can be positive; you can benefit from this business experience. You should be aware, however, that sometimes outside actors may not have the same priorities as you or may not agree with where you want to take the business. The best way to deal with possible disagreements is to consider them up front and make clear who has the right to make certain decisions. If the investor or lender is demanding significant changes, the group will have to determine whether the access to the capital is worth the demands.

These control issues cut across all types of financing. The rest of this chapter is more specialized in nature and looks at debt financing, equity financing, and then two federal agencies that offer both types of financing and have missions to help small businesses in rural America – USDA Rural Development and U.S. Small Business Administration.

Debt Financing

Debt financing can be difficult to obtain for start-ups because lenders like to have a good idea of cash flow and the value of the business' assets before lending money. Nevertheless, if members of the business are willing to use some of their own assets as security or if some type of program guarantees at least a portion of the loan, lenders will consider lending to start-ups. The first thing to think about with debt financing is who will be responsible for paying back the loans.

The five C's of credit

Lenders look at certain characteristics of your business when determining what terms to offer in the loan package. To make sure your organization receives the best terms possible, you will want to highlight those characteristics where you excel. This can be done with a solid business plan. The traditional list of characteristics is known as the Five C's of Credit:

Capacity to repay is the most critical of the five factors. The prospective lender will want to know exactly how your group intends to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment. Payment history on existing credit relationships – commercial and personal - is considered an indicator of future payment performance. Prospective lenders will also want to know about your alternative sources of repayment.

Capital is the money producers already have invested in the business and is an indication of how much the producers will lose should the business fail. Prospective lenders and investors will expect producers to contribute their own assets and undertake personal financial risk to establish the business before asking the lender to commit any funding. If the business has a significant personal investment from the participants, the lender will assume producers are more likely to do everything possible to make the business successful.

Collateral or guarantees are additional forms of security you can provide the lender. If the business cannot repay its loan, the bank wants to know if there is a second source of repayment. Assets such as equipment, buildings, accounts receivable, and in some cases, inventory, are considered possible sources of repayment. Business and personal assets of the producers can be sources of collateral for a loan. A guaranty, on the other hand, is just that - someone else signs a document guaranteeing to repay the loan if the organization is unable. Some lenders may require such personal guarantees in addition to collateral for security.

Conditions focus on the intended purpose of the loan. Will the money be used for working capital, additional equipment, or inventory? The lender will consider the local economic climate and conditions - both within your industry and in other industries - that could affect your business.

Character is the personal impression the people involved in the business make on the potential lender or investor. The lender subjectively decides whether or not a borrower is sufficiently trustworthy to repay the loan. People's history with the lender, educational background, and experience in the particular business and industry will be reviewed. The quality of your references as well as the experience of your employees will also be considered.

Adapted from Small Business Administration, *Applying for a Loan.* www.business.gov/phases/launching/finance_startup/applying_for_loan.html.

Will I be personally liable for the loans incurred by the organization?

It depends. If you have joined with other people in a business endeavor but you have not legally organized the business as a cooperative, LLC, or some other type of formal business organization with limited liability, then the law treats you as a general partner in the business. If the business incurs debt, general partners are responsible for paying back the debt whether or not they are the ones who signed the loan documents. For further discussion on who may be liable within different types of business organizations, please see Chapter Four.

Even if the business is not a general partnership, an individual may still be responsible for its debt. The most clear cut example is when an individual signs a guaranty for the loan. In this case, a banker might ask the farmer to guarantee payment of a loan taken out by an LLC. This guaranty circumvents the limited liability status that the farmer currently has with the company. For example, an LLC involved in making cheese with milk from twelve different farms plans to buy some new equipment for the business. If a farmer guarantees the loan for the LLC, he will be responsible to pay back the loan if the LLC does not. So if the business fails, both will be responsible for payment. The lesson here is you always need to be aware of what you are signing, especially when a lender is involved.

Will I be personally liable for debts guaranteed by someone else?

As described later in the chapter, a number of government organizations such as the U.S. Small Business Administration and USDA Rural Development provide guarantees to lenders who agree to lend to certain types of businesses. For instance, USDA Rural Development may agree to guarantee up to 80% of the amount of a loan your business receives from a local bank. This does not mean you do not have to worry about 80% of the loan. The guaranty is to the bank, not to the business. If the business fails, your business will be responsible for the first 20% of the loan while USDA will pay off the rest if your business cannot. Even then, USDA may still require you eventually pay back the money they provided to the lender.

What happens if a business exaggerates its net worth or does not disclose all current liabilities to a lender?

Borrowers have a legal responsibility to be truthful when communicating with the bank. For example, when dealing with a federally insured bank (those insured by the Federal Deposit Insurance Company or FDIC), it is a federal crime to obtain money or credit as a result of false pretenses. (18 U.S.C. sec. 1344). A similar provision makes it a federal crime to knowingly make any false statement in an attempt to influence an action of USDA Rural Development, the Farm Service Agency, or any Farm Credit institution. (18 U.S.C. sec. 1014). The punishments are harsh, with fines of up to one million dollars and imprisonment of up to 30 years. To convict someone of a crime the prosecution will need to prove intent.

Read the guaranty

In a case involving the Small Business Administration, the Mallett's guaranteed a loan taken out by Linderhoff Resorts. Linderhoff was unable to make the payments and its property was eventually foreclosed. The proceeds of the foreclosure sale were used to pay off some of the loan, yet there was not enough to pay the entire loan amount. SBA looked to the Mallett's to meet their commitments under the guaranty and pay off the rest of the loan. But the Mallett's argued they should not have to pay on the guaranty because SBA mismanaged the loan. In essence, they argued if SBA had not mismanaged the loan, the Linderhoff's would have been able to pay the entire amount and the Mallett's would not have been forced to pay under the guaranty. In particular, the Mallett's claimed "that the agency unreasonably delayed in pursuing its remedies against Linderhoff, failed to notify them of the serious nature of the default in time for them to take appropriate corrective action, failed to pursue other available remedies, altered materially the terms of repayment of the debt, failed to participate in the foreclosure proceedings, and made other decisions of a similar nature which constitute mismanagement."

The court, however, pointed to language of the guaranty that essentially waived Mallet's right to make this "mismanagement" argument. The language of the agreement, which is common in guaranty agreements, provided SBA with full discretion on how to handle the loan and said that in any case if the borrower does not pay, the guarantor (in this case, the Mallett's) must pay the unpaid amount.

The lesson here is that once you guarantee a loan, it may be completely out of your control on how the loan is handled. And how the loan is handled will determine how much you may need to pay under the guaranty.

United States v. Mallett, 782 F.2d 302 (1st Cir. 1982).

As opposed to criminal fraud, which involves the government prosecuting a crime, parties to a loan can also sue each other for non-criminal fraud or misrepresentation. If someone innocently misrepresents a material matter on a loan document, the lender may later decide to treat the contract as void. Black's Law Dictionary defines something as "material" if it has "such a nature that knowledge of the item would affect a person's decision making." For instance, suppose your group told the bank your equipment, which will be used for collateral for a loan, is worth $500,000 because you relied on an estimate from a reputable source. The bank agrees to provide you a loan, largely based on the fact it has a security interest in the equipment. Later you and the bank learn the estimator was wrong and the equipment is only worth $200,000. The bank would probably be able to void the loan agreement because the loan application included mistaken information material to the bank's decision to loan you the money.

Intentionally misrepresenting something to induce the bank to act is called fraud. In a fraud case, the bank not only has the ability to void or set aside the contract, it may also sue for any damages caused by the fraudulent act if it can prove you intended to misrepresent the information.

Say what you will do and do what you said

A cattleman in Oklahoma was having a difficult time paying back a loan to one bank, so he went to a different bank to obtain another loan. He knew he would not be able to get the money if he told the second bank why he needed the money (to pay back the first bank), so he lied to the second bank and told them he was borrowing the money to purchase cattle. He gave the second bank a security interest in the imaginary cattle. He continued to use this scheme until it was uncovered. A federal court convicted the cattleman of bank fraud.

United States v. Taliaferro, 979 F.2d 1399 (10th Cir. 1992).

The bottom line is you should always do your best to tell the truth in communicating with lenders. Failure to do so will open you to possible criminal prosecution and private lawsuits. Dealing with these kinds of problems can take a lot of time and resources you need to run the business.

Sources of debt financing

Different sources of debt financing may be more flexible, have more money available to lend, or even have a mission to lend in rural areas or to agricultural businesses. Because of all of these variables, you should shop around when considering debt financing. Different institutions may be willing to provide you packages that better fit your business plan. Variables to consider include interest rates, payment schedules, how much security the lender requires, whether the lender requires a guarantee, down payment requirements, and fees involved with the loan. Here are some different types of sources of debt financing:

1. **Producers involved with the organization**. This is the most logical place to start because it may provide you with the most flexibility. Because the producers involved with the project have a stake in the success of the venture, they may be willing to lend money to the new business. As with all loans, it is very important to get the loan in writing to avoid any misunderstanding in the future as well as to be able to prove to the IRS and others it is a loan and not an investment. One consideration is if the farmer already has capital invested in the project, lending more money may be putting too many eggs in one basket. Another consideration is if the organization provides favorable loan terms to one particular producer, others involved in the business may feel they have been cheated. Because of this, it is best to treat these deals at "arms length", in other words, deal with each producer the same way the business would deal with an outsider.

   Producers need to consider whether to secure the claim to repayment by entering into a security agreement with the business. If the parties decide to enter into a security agreement, it will need to be perfected by filing a financing statement with the appropriate government office, usually the Secretary of State. By filing a financing statement, the producer gains a priority interest in the secured property relative to anyone who files a financial statement later.

Some common terms have special meaning in the context of debt financing

Promissory note. A promissory note is a contract. When you sign a promissory note, you promise to repay the lender a certain amount of money, at a certain time, and according to certain terms and conditions.

A promissory note may be *unsecured* or *secured*. If a promissory note is *unsecured*, the lender looks only to your cash flow and profits for repayment of the loan. If a loan is *secured*, the lender still looks to your cash flow and profit for repayment of the loan, but if you do not pay, the lender looks to the security or "collateral" as a secondary source of repayment.

Security agreement. A security agreement gives the lender a "security interest" in specific *personal property* owned by the signor. This means you pledge property as collateral for the loan. If you do not repay the loan as required, the lender can seize the collateral, sell it, and apply the proceeds to your loan. The lender may take all assets of your business (everything your company owns) as collateral up to the value of the debt. Sometimes the lender requires only certain assets as collateral, such as inventory and accounts receivable or specific vehicles or equipment.

Personal property. All property other than real estate.

Mortgage. A mortgage gives the lender a security interest in *real property* owned by you. This means if you pledge the real property as collateral for the loan and you do not repay the loan, the lender can foreclose on the real property, sell it, and apply the proceeds to your loan.

Real property. Real estate.

Loan or credit agreement. If your company's loan is fairly large, the lender may require a loan or credit agreement. A loan agreement contains terms and conditions for your loan in addition to those contained in the promissory note, security agreement, or mortgage. Common provisions in a loan agreement regard the lender's commitment to lend, repayment and note terms, conditions that must happen before the lender is obligated to advance funds, representations and warranties, agreements by the borrower to take or not take certain actions, and events of default.

Source: Findlaw.com. www.smallbusiness.findlaw.com/starting-business/starting-business-financing/starting-business-financing-loans-glossary.html

2. **People and firms from the area**. People or businesses in the area might also have an interest in supporting the producer association as a form of economic development. This means there may be people or firms in the area willing to provide loans to your new business. These types of firms may be able to provide more flexible terms than a mainstream lender. This means you might be able to include payment terms that will better fit into the business plan.

3. **Private banks**. Federal or state-regulated banks are the lenders with which most people are familiar. They offer both short and long-term loans and have a presence in just about every community. Banks are for-profit institutions that have a primary interest in making sure they are paid back the money they lend. Certain banks are more familiar with the challenges related to agriculture then others. These private institutions are generally not restricted on what type of business or the location of the business they lend to.

4. **The Farm Credit System**. The Farm Credit System (Farm Credit) can be a viable source of credit for producer-owned ventures. Farm Credit is a nationwide network of borrower-owned financial institutions and specialized service organizations. Farm Credit consists of four Farm Credit Banks and one Agricultural Credit Bank that provide funding and affiliated services to nearly 100 locally-owned Farm Credit associations and numerous cooperatives nationwide. The fundamental purpose of this network of government-sponsored enterprises created by Congress in 1916 is to provide American agriculture with a source of sound, dependable credit at competitive rates of interest. Farm Credit provides credit and related services to farmers, ranchers, producers and harvesters of aquatic products, rural homeowners, certain farm-related businesses, agricultural and aquatic cooperatives, rural utilities, and certain foreign or domestic entities in connection with international agricultural credit transactions.

   Farm Credit can lend money to businesses which process or market agricultural products, provided more than 50% of the business is owned by farmers and those owners provide some of the "throughput". Farm Credit can also lend money to businesses that provide services to farmers (such as crop spraying, seed cleaning, and cotton ginning.). The extent to which financing can be provided is based on the amount of the business's total income from farm-related services. (12 USC sec. 2017, 2019; 12 CFR 613.3010).

   Farm Credit also has a bank called CoBank with jurisdiction nationwide designed especially to serve the credit needs of cooperatives that does business with all types of cooperatives with a full line of credit services. Agricultural cooperatives, as well as aquatic cooperatives, may borrow from the bank if:

   - They do at least 50% of their business with or for their members;
   - Generally at least 80% of their voting stock is in the hands of farmers, ranchers, or commercial fishermen; and
   - They operate on a cooperative basis with respect to member control and distribution of earnings.
     (12 USC sec. 2129).

Joint ventures and partnerships of ag cooperative customers with noncooperatives in the U.S. and international markets are also eligible for financing by CoBank.

5. **State and local economic development programs**. Most states have loan programs that may share some of the features of the Small Business Administration programs discussed below. Some counties or cities may even offer some special loan programs. These loans may feature reduced interest rates, low down payment requirements, or delayed payment schedules. Many of the programs may guarantee portions of the loan. You should contact officials from your city, county, and state to see what they may have available.

Royalty financing

This unique way of financing gives a lender a stake in the sales of a company rather than ownership. It could be seen as a hybrid of lending and investing because the lender provides the capitalwith the intention of being paid back and not with the intention of owning a piece of the business it could sell, but it also looks like investing because it is understood if the business fails, the lender will simply lose its stake in the business. For example, an outside investor provides the business $100,000 for the right to earn 3% of all sales in the next five years, up to a maximum of $200,000. The upside to this deal is your group does not have to give up its stake in the equity of the company while receiving an influx of capital. These arrangements are also less likely to require the business to transfer much control to the investor. The downside is most investors will not consider this type of financing unless the business is established and in need of capital for intensive sales and marketing activities that will have a direct effect on what the investors will receive.

Source: Entrepreneur.com, *Royalty Financing*. www.entrepreneur.com/article/0,4621,300801,00.html.

Equity Financing

Those who provide equity financing usually attain some of the attributes of owners of the business. The rights and responsibilities of the equity financers will depend on the particular agreement you have with them and how your business is organized. Because the business organization is so crucial to equity financing, the major legal issues tend to be the same in both the equity financing and business organization areas. These issues include who has the right to control the business, who takes responsibility for liabilities, and how securities laws affect the business. These issues are considered in Chapter Four. This section focuses on the different types of equity financing available.

1. **Producers.** The most common source of equity comes from the producers involved with the business. This could occur in a traditional investment situation where the producer is treated like any other investor and contributes a certain amount of capital for a right to some of the profits and the ability to sell the equity interest.

Another way the group could raise capital from its producers is by retaining some of the money it would otherwise have paid to the producer. This could come from the proceeds of the sale of the producer's goods or from the dividends or surplus income of the group. The tax consequences of these retains may vary depending on whether the group is a corporation, LLC, partnership, or cooperative. The main advantage to retains are the producers do not have to raise capital from outside sources to contribute to the organization. The downside is this may not be a viable option for start-up capital because before retains flow into the organization, there must be income. Another downside is that depending on how the retains are structured, the producer may not have a choice of when to liquidate the capital.

How can cooperatives raise equity capital from members?

Subchapter T of the Internal Revenue Code allows cooperatives to retain patronage dividends and allocate them to the patrons' equity accounts with the cooperative through "written notices of allocation." Patronage dividends are surplus earnings returned to the members. If the equity is qualified, as defined in the code, the cooperative can deduct the amount of allocations from its taxable income the same year. Patrons include the amount allocated in their taxable income in the year they receive the qualified written notices of allocation. Subchapter T requires at least 20 percent of the patrons' patronage dividends be paid out in cash in order for the allocation to be qualified. The result is the cooperative can retain up to 80 percent as equity investments without owing tax on those investments.

Cooperatives can choose to delay the pass-through by retaining patronage dividends as nonqualified investments. The cooperative can retain any amount of the patronage dividends and add the amount to its taxable income for the year. When the patronage dividends are later redeemed in cash by the patrons, the cooperative can deduct the amount from its taxable income for the year of redemption.

Source: National Cooperative Business Association, *Legal Considerations When Forming a Cooperative*. www.ncba.coop/abcoop_ab_legal.cfm.

2. **Venture capital and angel investors.** The internet craze of the 1990's raised the profile of one particular kind of investor, the venture capitalist. Venture capitalists (VC) provide relatively large amounts of capital to small but proven businesses that are on the verge of rapidly expanding. As with all equity investments, the capital provider is not looking to be repaid; rather, the VC wants a piece of the business in order to receive high returns and look for the right opportunity to sell the shares for a profit. VC's are willing to take risks many others avoid. In return for shifting some of the financial risk to the VC, the business must be willing to be flexible and possibly change its business plan to suit the wishes of the VC. As with obtaining grants, searching for venture capital can be a very timely process and may require the assistance of specialists.

   Although traditional VC's are not usually interested in small, unproven start-ups, a first-cousin of the VC, the angel investor, might be. Angel investors are often successful entrepreneurs who understand the possible risks and rewards of start-up businesses. Some angel investors have a particular agenda they pursue with their investments, such as sustainably raised food, and might be willing to forgo some of the high returns for the satisfaction of helping build a business or industry in which they believe. Many times they will want to become a close consultant to the business. Angel investors come in many shapes and sizes so their legal involvement with the business will depend on the particular investor.

With both VC's and angel investors, the main thing to consider is the degree of control the outside investor will have in the company. As you consider their involvement you should determine whether the outside investor will have the power to take the business in a direction unacceptable to the producers, such as changing the product line or the place of production.

Finding VC's and angel investors is not as easy as walking into your community bank or talking to your local investment advisor. The best advice is to talk to attorneys, accountants, and others in your industry to seek referrals to venture capital firms that might be a good fit for your company.

What is a venture capitalist looking for?

An article on Findlaw.com lists the following characteristics sought by venture capitalists:

"The strength of a company's management team can be more important to a venture capitalist than the company's product. A venture capitalist wants to see a capable, committed set of managers who are adaptable and comfortable with growth and change. A venture capitalist is always looking for a high rate of return. The earlier your company is in its business cycle, the higher that rate will have to be to compensate the venture capitalist for his or her risk. This means that the company must be positioned for rapid growth, in terms of both management and product.

"A venture capitalist also wants to see a realistic set of financial projections and requirements. He or she will take a conservative view of your company's chances for profit and success. It is helpful to emphasize financial requirements for this stage in your company's growth. Showing a realistic reflection of the company's financial state shows discipline and the ability to plan for the future.

"The owners' commitments to the business through personal financial stakes are also key. A venture capitalist will be leery of investing money in any enterprise in which the principals are unwilling to invest their own.

"Finally, the venture capitalist will want a clear exit strategy -- how to get his or her investment and return back out of the company. Some preferable exits are through an IPO [initial public offering of stock] or the sale of the company. However, other methods include management buyout, corporate redemption, forced receivership, sale of shares to principals, or sales of shares to other equity partners."

Source: FindLaw.com. *FAQ: Venture Capital*, www.smallbusiness.findlaw.com/starting-business/starting-business-financing/starting-business-financing/starting-business-financing-venture-capital-faq.html.

3. **Acquisition or merger**. Another way to get a fledgling business off the ground is to join your group with another existing, business. This strategy may give you access to some of the infrastructure needed to get your product on the market such as distribution and marketing channels. The catch with this strategy is determining who will control the business once the merger is complete. If your group purchases the ongoing business, it would retain control of the firm. On the other side of the coin, if the ongoing business contributes most of the capital, it is likely they will gain control of the business. Nevertheless, if you have a new product, production method, or brand you can bring to the new business, you may have some negotiating leverage.

4. **Federal, state and local programs**. Just as in debt financing, government bodies may have programs to increase the amount of equity capital available in certain areas or firms. Typically your group will actually deal with a private intermediary who has tapped into government resources to enlarge the amount of capital it has to invest. In the federal government, the primary examples include USDA Rural Development Rural Business Investment Companies as well as the Small Business Administration Small Business Investment Companies, both of which are discussed later in this chapter. State and local governments may also have funds set aside and may deal directly with your group.

Federal programs

A number of programs exist at different levels of government to help joint producer associations obtain capital with loans or equity. The next section focuses on two federal agencies charged with helping certain kinds of businesses. USDA Rural Development focuses on businesses in rural areas, while the Small Business Administration works with small businesses in both rural or urban areas.

1. **USDA Rural Development.** An agency in USDA called Rural Development, www.rurdev.usda.gov/, offers a number of programs to assist a producer associations locate capital. This financial assistance may come in the form of guaranteed loans, low interest loans, or grants. In general, the programs have a goal of spurring economic activity, job growth, and sustainable development in rural areas, which usually means in any city or town with a population of less than 25,000 or 50,000 people, depending on the program.

   USDA often administers these programs indirectly, there may be some type of intermediary between USDA and the rural business. This intermediary might be a bank, a cooperative, a local non-profit, or a regional government. Some programs may not be available in your area because no local intermediary is participating. Another limiting factor to many of these programs is USDA usually does not have enough funds to meet the demand in the countryside.
   The best advice when thinking about accessing USDA Rural Development programs is to talk to your state Rural Development office. The appendix to this book includes contact information for the state Rural Development office in each state.

The following are summaries of Rural Development's programs:

- **Business and Industry Guaranteed Loan Program**. By far the most accessible and flexible of the Rural Development programs, B and I loans are where USDA guarantees up to 80% of a loan made with most any financial institution, such as a bank, Farm Credit Service institution, or credit union. Individuals, as well as nearly any legally organized entity, are eligible for this program, including for-profit businesses, non-profits, and political subdivisions. Loan proceeds can be used for working capital, machinery and equipment, buildings and real estate, and certain types of debt refinancing. Types of businesses eligible include manufacturing, wholesaling, retailing, and renewable energy projects. The applicant must be located in a rural area (an area that does not include a city of more than 50,000 people), although some exceptions are made for value-added ventures and cooperatives. The maximum any one borrower can borrow is $10 million; the administrator may waive that limit under certain circumstances. To determine who receives the guarantees, USDA prefers businesses that provide numerous and decent jobs, and are in areas with high levels of poverty and declining populations.

- **Intermediary Relending Program**. In this program USDA utilizes intermediaries – a nonprofit, cooperative, or state or local government – to create revolving loan funds. A typical intermediary is a local economic development corporation or an electric coop. The ultimate recipients of the loan funds must establish new businesses, expand current businesses, create employment opportunities, or assist community development projects. While the ultimate recipients must live in a rural area (for purposes of this program, outside of a metropolitan area of greater than 25,000 people), there is no "rural area" restriction for

Rural Cooperative Development Grants and Rural Business Opportunities Grants support entities that provide technical assistance

Two different types of grants provide certain entities the funds to provide technical assistance to help establish rural businesses. Nonprofit institutions, colleges and universities are eligible for Rural Cooperative Development Grants to help groups form successful cooperatives. If your group is considering establishing a fairly complex business with other producers, it should consider checking to see if anyone in your area has received this type of grant. A good place to start might be the local extension office or land grant institution.

Rural Business Opportunities Grants provide public bodies and nonprofit institutions with the ability to offer a broader array of business development assistance, such as assisting with feasibility studies, training, and economic development planning.

the intermediary. The loans may not be used for agricultural production. The largest loan a recipient can receive from an intermediary is $250,000.

- **Value-Added Producer Grants**. Rural firms that plan on creating a business that adds value to agricultural products can apply for this grant to use for planning purposes or working capital. Producer organizations, including cooperatives or other types of entities, must have at least a majority control by producers. Any producer group that applies for a grant must propose to enter an emerging market. Independent producers who apply for a grant may propose to enter an existing market. The applicant must provide at least fifty percent matching funds. A planning grant can be used for such things as hiring independent consultants to perform feasibility studies and business plans. A working capital grant can provide start-up funds for legal assistance, purchasing inventory, and making payroll. These grants are limited to $500,000. Evaluators prefer grants with a likelihood of success,which improve the local economy, and have well qualified people involved.

RBIP: Encouraging venture capital in rural America

The 2002 Farm Bill directed USDA to develop a Rural Business Investment Program to promote investment in rural areas. USDA and the Small Business Administration are implementing the program together. The program is designed to use federal money to leverage private investment in rural areas. The program also certifies certain venture capital firms, known as Rural Business Investment Companies (RBIC's), and provides funds for technical assistance to rural businesses. RBIC's can invest in any commercial or non-commercial activity (for profit or nonprofit).

At least 50% of a RBIC's investments (measured by number of entities and dollars invested) must be in "smaller enterprises," those with a maximum net worth of $6 million and net income of $2 million in the prior two years. At least 50% of these investments (measured by number of entities and dollars invested) must be in smaller enterprises that also qualify as small business concerns.

RBIC's share many of the same qualities possessed by Small Business Investment Companies (SBIC's), which are discussed later in the chapter.

2. **Small Business Administration**. The Small Business Administration is a federal agency charged with helping develop small businesses. A small business can be any type of legal entity - an individual proprietorship, joint venture, partnership, LLC, corporation, or cooperative. Whether a particular business is small depends on the industry in which it operates and generally depends on whether the business could dominate the industry.

   Although its focus is not exclusively in rural areas like USDA's Rural Development Agency, SBA offers loan programs many rural entrepreneurs find useful. Most

SBA programs focus on guaranteeing loans commercial lenders otherwise would not have made if not for the guaranty. The following is a summary of the loan programs described on SBA's website. www.sba.gov/financing/index.html.

- **Basic 7(a) Loan Guaranty.** The 7(a) program serves as the SBA's primary business loan program to help qualified small businesses obtain financing not available through normal lending channels. The program works as a guaranty for a loan at a commercial institution. It is also the agency's most flexible business loan program since financing under this program can be guaranteed for a variety of general business purposes. Loan proceeds can be used for most sound business purposes including working capital, machinery and equipment, furniture and fixtures, land and building (including purchase, renovation and new construction), leasehold improvements, and debt refinancing (under special conditions). Loan maturity is up to 10 years for working capital and generally up to 25 years for fixed assets. Typical customers include start-up and existing small businesses.

- **Certified Development Company (CDC) or 504 Loan Program.** The 504 Loan Program provides long-term, fixed-rate financing to small businesses to acquire real estate, machinery, or equipment for expansion or modernization. A business accesses the program through a Certified Development Company, which is a private, nonprofit corporation set up to contribute to the economic development of a community or region. Typically a 504 project includes a loan secured from a private-sector lender with a senior lien, a loan secured from a CDC (funded by a 100 percent SBA-guaranteed debenture) with a junior lien covering up to 40 percent of the total cost, and a contribution of at least 10 percent equity from the borrower. The maximum SBA debenture generally is $1 million (and up to $1.3 million in some cases). Typical customers include businesses requiring "brick and mortar" financing

- **Microloan or 7(m) Loan Program.** The 7(m) Loan Program provides short-term loans of up to $35,000 to small businesses for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery or equipment. Proceeds cannot be used to pay existing debts or to purchase real estate. SBA makes or guarantees a loan to an intermediary, who in turn, makes the microloan to the applicant. The intermediary is a nonprofit organization with experience in lending. These organizations also provide management and technical assistance. The loans are not guaranteed by SBA. The microloan program is available in selected locations in most states. Typical customers include businesses needing small-scale financing and technical assistance for start-up or expansion.

Small Business Investment Companies: SBA licenses venture capital firms and banks to serve as Small Business Investment Companies (SBIC's). SBIC's are private companies allowed to leverage the financial resources of the federal government if they meet regulatory requirements, the most significant being that they finance small businesses in a particular area. The following Q and A is adapted from the SBA website, www.sba.gov/INV/overview.html.

Who benefits from the SBIC program?

Small businesses which qualify for assistance from the SBIC program are able to receive equity capital, long-term loans, and expert management assistance. Venture capitalists participating in the SBIC program can supplement their own private investment capital with funds borrowed at favorable rates through the federal government.

Who usually becomes an SBIC?

People with solid venture capital expertise and capital. Most SBICs are owned by relatively small groups of local investors, although many are owned by commercial banks. Some SBICs are corporations with publicly traded stock.

What are SBIC's supposed to do?

SBIC act as a financier for small business concerns. SBIC's have great flexibility in terms of financing options, which result in financing specifically tailored to the needs of each small business concern.

Can SBIC's make loans?

SBIC's can make long-term loans to small businesses to provide them with funds needed for their sound financing, growth, modernization, and expansion. An SBIC may provide loans independently or in cooperation with other public or private lenders. Such a loan may have a maturity of no more than 20 years, although under certain conditions the SBIC may renew or extend a loan's maturity for up to 10 years.

What type of equity position can an SBIC take in a small company?

By law, the SBIC must provide equity capital to small businesses and may do so by purchasing the small business's equity securities. The SBIC may not, however, become a general partner in any unincorporated small business or otherwise become liable for the general obligations of an unincorporated business.

Leasing

As a substitute for raising equity or debt capital, your group could consider leasing land or equipment. Under a lease, you pay rent to the owner of land or equipment for the privilege to use it. Once the agreement is over the owner of the equipment takes it back. The main advantage to leasing is the initial lease payments require much less capital than needed to buy the equipment. Another advantage of leasing is you will have newer equipment less likely to break down. The downside of leasing is you are making payments to use the equipment but you are not building equity.

Producers involved in a joint producer venture may decide to lease some of their equipment to the business. As with other legal agreements between joint producers and their organizations, the best piece of advice is to get the agreement in writing so both parties have a clear understanding of the arrangement. This might be necessary for tax purposes so both the producer and the business have evidence of the precise type of arrangement.

Sometimes sales and leases are treated differently for tax purposes. The main tax advantage of a lease is you can usually deduct the cost of a lease as a business expense, as opposed to deducting only part of the expense of buying the equipment through depreciation. As with most tax situations, this area is highly technical and requires the advice of an accountant or an attorney familiar with the area.

One of the main legal issues with leases is whether the arrangements are true leases or sales. The typical instance where this issue arises is in a rent-to-own contract where the contract provides that if you make lease payments for a set number of years, you can own the equipment in return for an added fee. To determine whether the arrangement is a true lease or a sale, courts will usually look at whether the leasing company intended to retain ownership in the property. The main factors are whether the renter has the right to purchase the equipment at the end of the lease and how much it costs to exercise the right.

This distinction can make a big difference to the owner of the equipment if the person leasing the equipment has financial trouble. The business' other creditors may argue the business owns the equipment so it can then be sold to pay off other debts of the business. To protect the leasing company's interest in the property, most states allow leasing companies to file a financing statement with the state to warn others of its financial right in the property. If the lease is a true lease, this filing is not necessary. But if there is any question, the leasing company should file the financing statement.

Conclusion

Obtaining capital can be the first real test of your project's viability because you are asking others to risk their money. Control should be one of the major considerations when thinking about capital needs – how much and what type of control will you need to give up to get the capital. Although control is always an issue when dealing with capital, your group also needs to be concerned with special legal issues related to debt and equity financing. A variety of financing options exists, your task is to determine which ones fit the goals of the business.

Additional Internet Resources for Financing

Finance 101 – The following links serve as launching points for further exploration of financing sources and techniques.

- Financing for Small Business (Findlaw.com)
- Financing Start-up (www.business.gov)
- Getting Financing for Your Business (CCH Business Owner's Toolkit)
- How to Raise Money for Your Business (Entrepreneur Magazine)
- Raising Money (Ag Marketing Resource Center)
- Raising Start-up Capital (Inc. Magazine)

Leasing 101

- Leasing 101 (Farm Credit Leasing)
- Leasing Your Equipment (CCH Business Owner's Toolkit)

The Farm Credit System

- Overview of the Farm Credit System
- Which Bank serves my area?
  - CoBank (also serves cooperatives nationwide)
  - AgFirst Farm Credit Bank
  - AgriBank Farm Credit Bank
  - Farm Credit Bank of Texas
  - U.S. AgBank, FCB

Federal Government Financing Programs and Funding Sources*

USDA Rural Development Business and Cooperative Programs

- Business and Industry Guaranteed Loan Program
- Intermediary Relending Program
- Rural Cooperative Development Grants
- Rural Business Opportunity Grants
- Value-Added Producer Grants
- Rural Business Investment Program

U.S. Small Business Administration Financing Resources

- 7(a) Loan Guaranty Program
- Certified Development Company (CDC) or 504 Loan Program
- Microloan or 7(m) Loan Program
- Small Business Investment Companies (SBIC's)

*Be sure to check out your state and local government for any online information regarding similar programs offered in your area.

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