

How to Set Up a Money Deal

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This chapter explores some of the forms of financing that are available and shows how to analyze and structure a financial package to obtain the money for your project. The examples used will draw on the music industry, but the concepts and ways of structuring deals apply whether you are a musician, writer, actor, or, for that matter, if you want to establish your own instrument manufacturing company.

Developing the Business Plan

A business plan tells potential investors who you are. It describes your professional goals, what you plan to do to achieve those goals, and how that achievement can generate income to pay back the investor and further finance your career. An outline of the general headings of a business plan is at the end of this article.

Identifying Your Goals

The first and most important thing to be done is to identify the reasons you need to raise money. To establish a clear focus, you must determine your career goals, your immediate project goals, and your strengths and weaknesses. Identifying your goals, such as securing a recording contract or getting a name artist to record your songs, will assist you in determining a feasible project to undertake to achieve that end. The project might be producing an independent record so you can market it and demonstrate that there is an audience for your product or it could be preparing a publishing demo to shop your songs.

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You need to analyze your strengths and weaknesses. What is your best selling point? Pinpointing your strongest talents will assist in determining the project that would be most appropriate to achieve your goals. If your best skill is songwriting, perhaps you should raise funds to do a publishing demo of some of your songs to send to publishers and to performers that record material written by others. If your best talent is performance skill, perhaps you should develop a video package that will show the style you use to slay your audience. Money can be raised for other projects as well, such as producing a master sound recording, backing a tour for promotional or showcase purposes, buying equipment to enhance your stage show, or hiring a publicist to orchestrate a media blitz before you storm into Los Angeles.

Reaching a final decision on your goals and the projects designed to achieve them is a precondition to figuring out how much money you must raise and what kind of information to include in the business plan you will present to prospective investors.

Preparing the Budget

Once you have decided on the project, your next step is to determine its costs. You must develop a budget that shows the amount of money you need and how it will be spent. To do this, you must research the cost of each of the various elements of your project. If you plan to produce your own recording, you must budget the cost of studio time, tape, musicians, arrangers, producer and engineer, mixing, mastering, manufacturing, cover art, design, packaging, distribution, advertising and marketing. Each project has its own cost items. It is your responsibility to develop a clear and accurate picture of what those costs will be. The section in this chapter entitled, Identifying and Evaluating Sources of

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Income, discusses analyzing future sources of income to be used in scheduling payback arrangements with investors.

Preparing the Proposal

Once you have established your goals, the project, and the amount of money you will need, you must reduce all that information to a proposal or business plan to submit to individuals that may have an interest in funding your project. The proposal should itemize the elements we have just explored, explain what the end product will be, how your business operates, how marketing the product or implementing the service will assist you in developing your career, and how money will be earned to repay the investors. The proposal should also contain information on your background and the current status of your career, and a clear statement of your goals. There is no better way to force yourself to develop a clear focus than having to articulate it to others, especially if you are asking them for money.

Raising Capital

Your project, most likely, will be financed by one of three methods: self-financing, borrowing or profit sharing. This section will discuss these methods and the advantages and drawbacks inherent in each.

Self-Financing

The best way to retain full control of your project is to use your own money. It is the only technique that allows you to be free of financial obligations to lenders and gives you

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maximum artistic and financial control. Although it means that you must bear all the risk of the project, it also means that you will enjoy all the benefits.

Self-financing also minimizes the paperwork, record keeping, and other business complications involved in other ways of raising money.

Borrowing

If you are not in a position to self-finance, borrowing is the second basic technique for raising funds. Borrowing means accepting a loan for a fixed sum and agreeing to repay that sum plus a specified percentage of interest by a certain time. Arrangements where the return to the lender depends on the success of the project will be discussed under the section on investments and profit sharing.

Loans are, usually, absolute obligations that must be repaid whether or not the project is successful. If the rate of interest is high, you will have to earn a substantial amount of money from the project before you make any profit. For example, on a loan of \$10,000 at 12% annual simple interest payable in two years, your interest obligation would be \$2,400. To pay back the principal and interest on a self-produced recording that sells for \$7.25 (average wholesale price), you would have to sell about 1710 recordings, plus an additional number to cover your cost of sales. Only then would you be able to sell for a profit. As costs climb, of course, the number of recordings you must sell to break even also rises.

Loan Sources

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There are several possible sources of loans. The first are commercial sources. They include banks, finance companies, savings and loan associations, and credit cards with cash advance provisions.

Interest on commercial loans, secured by such collateral as a home, auto, recording or performing equipment or even the cosignature of a person in whom the bank has confidence will usually be lower than interest on unsecured loans. The reason is obvious: the risk is lower. Loans backed with collateral or the cosignature of a creditworthy individual are also easier to secure.

In deciding whether or not to give you a personal loan, a bank will look at your credit rating and at whether you own property that can be used as collateral for the loan.

Unfortunately, musicians' credit ratings are not always good, because of the fluctuating conditions of their employment. But if you have a credit card or two and have lived in the same place for a couple of years without having trouble paying the rent, you may be able to convince a bank to loan you a modest amount of money (e.g., \$5,000). Some banks will loan more than this amount if the borrower's credit rating is good. Banks may want to see your income tax returns for the last couple of years.

Some banks refuse to make a personal loan of more than \$5,000 unless it is secured by collateral, such as a house in which you have equity. If you are looking for a loan to buy new keyboard equipment, you will find that banks generally will not consider securing the equipment itself as collateral. Some banks will let you use an automobile as collateral, however, provided you have title to it.

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In the event you do not qualify for a personal loan yourself, you can ask a relative or a friend to act as a cosigner, which means they promise to make the payments if you are unable to. The bank will be more concerned with their credit rating than with yours, but will still want to make sure that you actually have the ability to make the payments.

In addition to personal loans, banks regularly make commercial loans to businesses. You may feel that since music is your business, you belong in this category, but you will find that commercial loans have their own rules and regulations. If you have a solidly established band with ongoing income, a commercial loan might be your best option. But if what you have in mind is borrowing money to start a project, you will probably have to go with a personal loan. When you become more established, some banks, especially those with operating offices in Los Angeles or New York, may lend money secured by the copyrights in your songs, master recordings, and other intellectual property.

A commercial loan package usually contains your business plan, the profit and loss statements of your business, tax returns for the last two or three years, and a personal financial statement. Banks will check your credit history. They need to know you have a sound financial plan and that you are financially responsible. They will generally insist that you put up as much as 50% of the money for improving the business out of your own pocket, with the loan supplying the balance.

Since commercial lenders make money lending money, you should shop for the best deal. This should also apply to loans from individuals that lend money to you for your project as a business venture, even if they are personal friends.

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A second source for loans is family and friends. Usually, they will lend money at a rate lower than that of a commercial lender. The important thing to consider when borrowing from friends is that strong pressure for timely repayment may result, which often is more burdensome (because of the personal nature of the debt) than the legal obligation to repay.

When you borrow from friends, the usury laws of most states come into play. These statutes limit the amount of interest a private lender can charge a borrower. Banks and other commercial lenders are generally exempt from the usury limits and can charge higher rates.

Whether you borrow from friends or from commercial lenders, you will want to structure a written repayment plan that states the amount of money that was borrowed, the rate of interest, and the method of repayment.

This can be a simple written promissory note: “On or before June 15, 2003, John Debtor promises to pay Sally Lender the sum of \$2,500 plus 9% interest per annum from January 1, 2000, (signed) John Debtor.”

The note from a commercial lender is more complex, but it will contain similar elements. Sometimes commercial loans are structured so that you pay a smaller monthly amount the first two years and a larger one the next two to three years. Once again, you should shop for the most favorable terms, interest and monthly pay back amounts.

Investments/Profit Sharing

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If self-financing is not an option and you have not been able to obtain a loan, the third option is to find candidates to fund your project, such as investors, and offer them a profit share. The arrangement can take several forms, depending on whether the investor is “active” or “passive.” The different alternatives are discussed below.

Active Investors

Active investors are individuals that put up money to finance a project for another person and become involved in the project (or fail to take adequate action to insulate themselves from responsibility). They assume all of the risks of the business, including financial liability for all losses, even if the losses go beyond the amount invested. Generally, such persons are responsible for the obligations of the business even if they have not given their approval or have not been involved in incurring business debts.

The forms of businesses in which the financing participants are active include general partnerships, joint ventures, corporations and limited liability companies. The profits or losses of such businesses are shared among the participants according to the nature of their agreement. These business structures are discussed more fully in the chapter, **Business Entities**.

A general partnership is co-ownership of an ongoing enterprise in which the partners share both control and profits. A joint venture is a general partnership that either has a very short term or a limited purpose. For example, the production of a single recording by a group of people could be structured as a joint venture.

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The general partners and the joint venturers are each personally liable for all the debts of the enterprise. The liability is not limited to the amount that they invested or to the debts that were incurred with their approval. All of the personal assets of each of the general partners or joint venturers are liable for repayment of the debts incurred by the enterprise.

If a corporation or a limited liability company is formed, then even if the project is a total failure, only the assets of the corporation or the limited liability company are vulnerable to the business creditors. A corporation is a separate entity formed under state laws. This also is the case for a limited liability company. The ownership of a corporation is divided among its shareholders, and the ownership of a limited liability company is divided among its members. A corporate structure provides limited liability to the shareholders. This also is the case for a limited liability company. If you are thinking about setting up a corporation or a limited liability company, you will need some sound legal advice.

Passive Investors

A more complex category of investments is that in which backers provide money for the project but take no role in the management and affairs of the project. Such backers are passive investors whose return is based on the success of the project.

The primary advantage of profit sharing arrangements, from the point of view of the person getting the money, is that the downside risks are shared. If a project fails to recoup the money invested, you are not obligated to repay the investors. Offsetting this advantage are several problems that make profit sharing the most complicated form of financing a project.

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The foremost problem is security law requirements. Any time one enters into an agreement in which people give money for a project with the understanding that part of the profits are to be shared with them and the investors do not actively participate in the management of the funds or the operation of the business, a “security” has been sold. A security can be a promissory note, stock, points or any other form of participation in a profit sharing arrangement, either written or oral, where the investor’s role in the business is passive. The investments of a general partner or joint venturer may be treated as a security, but they are a different class of security because those investors are actively involved in the business. The level of protection required for active investors is less stringent than for passive investors. Active investors are liable for the debts of the business beyond just the amount of their investment, while passive investors are only responsible for the debts of a business up to the amount of their investment.

Limited partnerships, promissory notes structured with profit sharing, corporate stock, limited liability company membership and contracts providing for points participation, where the persons that put up the money are not active in your business, are all securities, and state and federal securities statutes must be satisfied when these types of funding are used. Failure to comply may have serious civil and, in extreme circumstances, in situations involving fraud, even criminal consequences.

What does this legal talk mean to you? Why should you have to worry about it if all you want to do is raise some money to record some music or finance a performance tour? The securities laws were enacted to protect investors from being harmed by the fraud of others or by their own lack of sophistication or even their inability to afford to lose the money they invest in the project. The legal burden falls on the one seeking to raise the

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money to make certain the investors are getting a fair deal and fully understand the risks involved. “Let the seller beware,” is the rule that operates.

If you want people to invest money without allowing them a hand in controlling the project, then you should be willing to accept some responsibility to them. Willing or not, state and federal statutes place responsibility on you.

Investment Loans Conditional on the Success of the Venture

In these types of loans, the debt is evidenced by a promissory note and repayment is conditional on the success of the funded project. The note should set out the terms of repayment, including interest rates and payment schedules.

A common form of this kind of loan is a “point” arrangement in which a percentage (points) of sales from the funded project are shared with an investor who puts in only time or with some other investor who puts in only money. Another form is a percent interest in the income (or losses) generated by the business. This arrangement can be provided in a written contract rather than in the form of a conditional promissory note.

Limited Partnerships

Like a general partnership, a limited partnership has co-ownership and shared profits, but only some of the participants are entitled to control or manage the enterprise. Those persons are termed the general partners. The other investors are called limited partners and their only involvement is the passive one of putting funds into the project.

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A partner receives that percentage of the business profits or losses set out in the agreement between the partners, for example, 20% of the net profits up to \$10,000 and 10% of the net profits after the first \$10,000. The term of the limited partnership is often limited to a specified period. If the project has not earned the hoped for return by the end of the term, the investor has to absorb the loss.

There are rules in the federal law and in several states that apply to limited partnerships and other security investments that are structured as private offerings (i.e., to only a small number of people), which are easier to qualify under than the laws regarding public offerings (i.e., to the general public).

Corporate Shares and Limited Liability Company Memberships

Another way to raise investment capital is through the sale of shares in a corporation or memberships in a limited liability company. Corporate shares and limited liability company memberships are securities that usually are sold for a stated number of dollars per share or membership. That money is used to operate the business or pay for a specific project. Shareholders or members own whatever percentage of the corporation or limited liability company their shares represent in relation to the total number of shares sold.

Shareholders or members participate in the profits of the corporation or limited liability company when they are distributed as dividends and vote on shareholder or member issues according to their percentage of ownership.

Whatever method of financing you use, it is wise to check with your lawyer and set up a good financial record keeping system with your bookkeeper.

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Complying With Legal Statutes

After deciding on the legal structure to use in raising the money for your project, you must make certain that your efforts comply with state and federal law. California statutes require that (unless an exemption applies), the party raising and accepting investment capital must file documents with the Commissioner of Corporations explaining, in part, the proposed investment project, how the money will be used, all of the risks in the venture, the financial ability of the investors, and the background of the persons seeking the funding. The commissioner must conclude that the proposed offer and sale is “fair, just and equitable.” On an affirmative finding, the commissioner will issue a permit authorizing the sale. A negative conclusion will bar the sale. Most states have statutes imposing similar requirements.

Fundamental in any offering of a security (whether public or nonpublic), is the disclosure, to potential investors, of all the risks involved in the project, including the risk that the project may fail, that no profit may be made, and that the investors may never have their investment returned. In seeking investment money, you must disclose, in writing, the risks, the background of the principals (the people starting and running the business), the nature of the proposed business, the manner in which the money will be used, and the way that the investor will share in any profits (or losses). Also, the offer and sale of securities that involves an interstate transaction may require registration of those securities with the Securities and Exchange Commission (SEC) in Washington, D.C. Knowledgeable legal counsel should be obtained before seeking to offer any securities.

State Law Exemptions

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Under the securities statutes and regulations of most states, there are certain exemptions from the requirement to obtain a permit. These exemptions occur only in very specific situations. Three common exemptions are the nonpublic partnership interest, the limited number of shareholder exemptions for corporations, and the nonpublic debt security (note for a loan). In California, a limited partnership interest or other security will be presumed to be a nonpublic offering not requiring a permit from the commissioner provided that (1) there is no advertising of the investment; (2) there are no more than 35 investors contributing to the project; (3) the investor represents that he or she is purchasing the interest for his or her own account and not with the intent to distribute the interest to others; and (4) either the persons investing the money have a preexisting business or personal relationship with you, or their professional financial advisor can reasonably be presumed to have the ability to protect their interests because of the advisor's business experience. Also, a notice detailing information about the investment must be filed with the Commissioner's Office, which office establishes the kind of information that must be presented.

If the financing arrangement is to be in the form of a debt that is secured by a note with payment to the investor to come from the proceeds, if any, of the venture, then the requirements just described must be met to qualify the arrangement as an exempt nonpublic debt offering under California law. However, the investments may not be taken from more than 10 persons. This description is overly simplified and is not intended to be a full explanation of all the nuances and requirements of the security statutes and regulations. Its purpose is merely to give you a sense of how the laws operate.

Identifying and Evaluating Sources of Income

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If you lack your own money for your project, and do not have the credit necessary to borrow money, then you must face the reality of raising investment capital and complying with the appropriate securities statutes discussed above. Probably the most frustrating aspect of this will be your quest to identify the angel who will give you the money you need. Frequently, investors are attracted by the idea of putting money into entertainment projects because of the mistaken impression that it is a glamorous business and they desire to be associated with the glamour, or they have read that the entertainment industry can generate a substantial amount of money and wish to gamble that they will earn a great return if your project is successful.

For the most part, the money usually comes from family, friends, or interested persons that have seen your talents and wish to be involved in developing your potential. If the money does come from family and friends, however, it is critical that you act in a businesslike manner to help preserve your personal relationships.

Unfortunately, there is no magic source of money. It will be up to you to identify who has enough faith in your talents and future to make their money available. Other possible sources of money are investment counselors and accountants that are searching for reasonable business opportunities for their clients. In reviewing proposals for investments, financial advisors analyze the possibilities of eventual return on the investment and the tax benefits, if any, that may be made available to the investors.

Educating Investors About Risk

Once you have identified individuals that are willing to put money into your project, it is very important that you examine their expectations and compare them with your own

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perspective. It is crucial for you to educate your investors about the risks, the rewards, and all the problems and variables that can arise over which you may have little or no control. Investors need to know how much money is required for your project in order to evaluate whether they can afford it. If they have any reservations, you should uncover them. If the reservations cannot be resolved, you should not accept money from them. Spend time talking with them and make certain that you really understand each other and that they are people to whom you want to be committed.

Fair Return/Profit Sharing

In discussing payback, essentially as profit sharing, with the investor, you need to identify and explore three specific areas. What will be the share of the investor's participation? For how long will the investor participate? And from what sources of income will the investor be repaid? The argument that the investor can make, and it is a good one, is that he or she is taking a substantial risk in putting money into your project that could be invested in other ways for a more certain return. As a consequence, the investor will insist on a very healthy return. This is not unreasonable, provided it leaves you with enough to continue your life and career.

Measuring a fair return or profit sharing with the investor is a function of how badly you need the money and how eager the investor is to put money into your project. This will frequently determine how much each side is willing to offer. Investors generally have alternative places to put their money for a good return, and if you have no other source of income for a project, you may not be in a position to do a lot of arguing. If you have to

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give up an amount that you feel will hurt your business or your ability to fund your career, then you should not accept the money; go look for another investor.

A more constructive way of measuring a reasonable return is to look at the amount of risk assumed by the investor in relation to the amount of money invested; the smaller the number of dollars and the smaller the risk of failure, the smaller the return. For example, if your project cost \$2,000 it would be hard to justify returning 10% of your income for life to an investor. A more fair return would be the return of the money plus an additional percentage, e.g., 50%. If however, the investor put \$200,000 into your project, it is easy to justify committing a reasonable percentage of your income (e.g., 10% to 15%) to the investor (after out-of-pocket deductions for payments to certain third parties, such as managers and business creditors) for a substantial period of time (e.g., five years to seven years) or until a return of a multiple of the amount of the investment (e.g., two to four times), whichever happens first, at which time the participation stops. If the investment is for a specific project, e.g., a full CD of your recorded musical performances, first dollars in could be used to reimburse the investor, with additional money being split evenly until the investor has gotten two to three times the investment, and thereafter a reduced percentage, e.g., 20% to 25%, to the investor for so long as that recorded project is generating income, without any restrictions in time.

You can determine the proper percentage to offer to an investor by looking at how much you can afford to give up. Remember, there are only so many slices in the money pie, and if you give up too many slices there will be little for you to eat. Consequently, you should identify all of your existing commitments, such as those to managers, attorneys, other investors, partners, and the like. After you pay those people, you will still need money to

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run your business and support your personal needs. You must carefully analyze your income potential and anticipated expenses.

It is important to specify the sources of income from which the investor will be repaid. Will the money be coming from the revenue generated by the project itself or will it be coming from other sources such as record sales, live performances, music publishing, or merchandising? These points must be clearly and carefully thought out before you commit to a participation with an investor.

Conclusion

There are no simple answers. Deals can be structured in many ways. Your decisions depend on a business analysis of your funding sources, the urgency of your needs, the risks the investors are taking, their alternative investment possibilities, and your other money commitments. Do your homework and be very careful about the commitments you make. When in doubt, seek advice. If the deal does not make sense or does not feel good to you, trust your instincts and walk away. Do not be pressured into a commitment that may later hinder your career. In any event, be honest with yourself; figure out your goals, your value system and what you are willing and not willing to give up. Only by taking all these factors into account can you arrive at a financial package that will work for you. Once you set up such a package, however, you may be able to accomplish career objectives otherwise beyond your reach.

BEGIN BOXED INFORMATION

Business Plan Outline

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Here are the topics usually covered in business plans. Even if you are not using a business plan to find financing for your project, it will help identify your goals, outline the strengths and weaknesses of your project, and help determine when your project will make a profit. In short, a business plan is the map that shows how to get from an idea stage to project completion and profit.

When you want to obtain investment money, the business plan is a vital sales tool that can impress prospective investors with your planning ability and general competence as a manager.

1. Summary of your project, including the money you need to successfully launch it and reach your market.
2. Company description (history, background and management).
3. Description of your background.
4. Description of industry you are operating in.
5. Project description and planning schedule.
6. Description of the market for your project.
 - A. Market size
 - B. Market trends
 - C. Competition
7. Marketing plan.

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- A. Estimated sales and market share
 - B. Strategy
 - C. Pricing
 - D. Sales and distribution
 - E. Publicity and advertising
8. Operations (If project is a product [i.e., a compact disc or new software], describe how it will be produced, manufactured, marketed and distributed).
9. Project timeline.
10. Critical risks and problems.
11. Financial information.
- A. Financing required
 - B. Current financial statements
 - C. Financial projection (three-year profit and loss, cash flow and balance sheet projections).

END BOXED INFORMATION