

# Debt vs. Equity Financing: Legal Considerations for Businesses

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*Educational information for business owners and operators. Not legal advice.*





In practice, companies finance growth with a blend of debt and equity. Debt adds payment obligations but preserves ownership. Equity trades ownership dilution for flexibility and investor participation. The goal is a capital mix that fits cash windows, risk tolerance, and milestones.

## What it is and why it matters now

- **Debt financing:** You borrow money and promise to pay it back with interest on a fixed schedule. If your business struggles, lenders can still demand payment or seize collateral. Loan agreements include covenants—rules like maintaining minimum cash reserves or debt-to-income ratios—that restrict how you operate.
- **Equity financing:** You sell a portion of your company to investors in exchange for capital. Those investors now own part of your business and often gain voting rights on major decisions like hiring executives, raising more money, or selling the company. They share in profits but also in losses.
- **2026 context:** Interest rates remain elevated, banks are more cautious about lending, and equity investors are pickier about which companies they fund. To secure either type of financing, you'll need clear visibility into your cash position and enough breathing room in your loan covenants to weather unexpected challenges.

## Options at a glance

When a business borrows money, the starting point is not which loan product to use, it's why the money is needed. The purpose of the financing determines where to look for it and how to structure it. Smoothing out cash flow between invoices and collections calls for a different solution than funding an acquisition or capital to support a growth push. A revolving line of credit works well in the first scenario; a term loan or acquisition financing fits the second; and a more customized facility – potentially from a private credit lender or the SBA – may be the right answer for the third. Whatever the structure, debt comes with two things: a repayment schedule and covenants, which are contractual rules the lender imposes on how you run your business while you owe them money. Common covenant requirements include maintaining a minimum debt service coverage ratio (DSCR) (meaning your business must generate enough cash flow to cover your loan payments by a set margin), staying within a maximum leverage limit relative to your earnings, and restrictions on taking on additional debt or making distributions to owners while the loan is outstanding.

# Selling Ownership: Equity Financing

Equity financing means selling a piece of your company. One of the first distinctions I explain to clients is the difference between common equity and preferred equity. Preferred shareholders get their investment back before anyone sees a dollar – ahead of common shareholders, though still behind lenders. Preferred equity can also come with additional protections, like anti-dilution adjustments, and board or consent rights. Equity can also be raised in early-stage structures like convertible notes or SAFEs (Simple Agreements for Future Equity), which provide capital now and convert to an ownership stake later, usually at a discount, once the company completes a formal priced funding round. These structures are popular in early stages because they let both sides avoid the negotiation over valuation until there is more data to work with.

## A Hybrid Option: Venture Debt

Venture debt is borrowed money, but it behaves differently from a traditional bank loan. It is typically available to companies that have already raise a round of equity financing and have institutional investors behind them. In exchange for the loan, the lender will receive warrants – rights to purchase equity in the company at a set price – as additional compensation for the risk they are taking. Founders use venture debt to extend their runway between equity rounds, buying time to hit milestones that will support a stronger valuation at the next raise, without having to give up additional ownership.

## Debt vs. Equity Financing Comparison

Feature	Debt Financing	Equity Financing
Ownership	Retained	Diluted
Repayment	Fixed schedule + interest	None; paid via profit/dividends
Lender/Investor Rights	No control/voting	Voting/board rights, consent
Tax	Interest deductible (§163(j))	Dividends not deductible
Cash Flow	Fixed outflows	No obligation, but investor pressure
Cost of Capital	Generally lower, but riskier	Higher (investors want upside)
Downside Risk	Default/bankruptcy consequences	Loss of ownership/control

## How choices are framed

- Time window: near-term obligations vs. long-term optionality
- Cash profile: volatility, seasonality
- Creditor map: seniority, cross-default, and acceleration triggers
- Control tolerance: founder decision authority versus investor consent rights

People often compare financing through debt vs. equity when planning growth or covering working capital. The table above shows the core difference between debt vs. equity financing and guides a conversation about capital structure.

## How Debt and Equity Financing Work

Debt financing means you borrow funds and agree to pay them back with interest over a set period. Lenders can be banks, credit unions, online lenders, private credit funds, or bond investors. Common instruments include term loans, lines of credit, equipment loans, SBA 7a and 504 loans, and corporate bonds. Payments are usually monthly and include principal and interest. Some loans are interest only for a time then amortize.

### How debt financing works

Lenders assess credit based on cash flow coverage, collateral value, time in business, and management history. They may require covenants like a minimum debt service coverage ratio, limits on additional borrowing, or controls on owner distributions. Loans can be secured by assets like receivables, inventory, equipment, or real estate, or unsecured for stronger borrowers. Default can trigger late fees, acceleration, or foreclosure on pledged assets.

Two practical examples. A manufacturing firm buys a \$500,000 machine with a five year equipment loan secured by the asset. A services company draws \$200,000 on a revolving line to smooth receivables and repays as customers pay invoices. In both, the business keeps full ownership, but monthly debt service is a must-pay item.

### How equity financing works

Equity financing raises capital by selling ownership stakes to investors. This can be common stock, preferred stock, membership interests, or SAFEs and convertible notes that later convert to equity at a priced round. Investors might be friends and family, angels, venture capital, growth equity, or strategic partners. Returns come from dividends or eventual sale proceeds at an exit.

Terms center on valuation, percentage sold, and investor protections. Preferred shares often carry preferences such as liquidation priority, dividends, anti-dilution adjustments, and board seats or observer rights. These rights influence major decisions, such as raising more capital, selling the company, or changing leadership. Issuing equity dilutes existing owners but removes fixed repayment pressure, which can be helpful during early growth or during heavy R&D cycles.

Convertible structures bridge the gap. A convertible note or SAFE provides cash now and converts to equity later, usually with a discount or valuation cap. This avoids lengthy price negotiations in very early stages, though it still leads to dilution when conversion happens.



# Debt vs. Equity Financing Pros and Cons

## Advantages of debt financing

- Retain control. Borrowing does not give lenders voting rights or ownership.
- Tax benefits. Interest expense is generally tax-deductible, subject to limits under section 163(j) for larger businesses.
- Predictable cost. You can plan around a payment schedule and a stated interest rate.
- Build credit. On-time repayment can improve access to larger facilities later.

## Advantages of equity financing

- No required repayments. Equity capital does not force monthly payments, which helps during long product cycles or volatile cash flow periods.
- Risk sharing. Investors share downside and bring networks, hiring help, and governance that can speed growth.
- Flexible structure. Preferred equity, participating preferred, or simple common can be tailored to goals and stage.

## Disadvantages to consider

- Debt downsides. Fixed payments strain cash during downturns. Covenants can limit flexibility. Default can damage credit and result in the loss of collateral.
- Equity downsides. Dilution lowers the founders' ownership. Investor rights can slow decisions. VCs often expect an exit within 5 to 10 years with growth targets tied to that timeline.

This summary covers the advantages and disadvantages of debt vs. equity financing at a practical level. For many teams, the right answer is a mix that reflects current goals and risk tolerance.

# Cost Control and Risk Compared

## Cost of capital and tax impacts

The cost of capital blends the cost of debt and the cost of equity. Debt is usually cheaper because lenders have priority claims on assets and cash flows. After-tax cost matters. Interest is usually deductible, so a 9% loan has a lower effective cost depending on your tax rate and any federal limits on how much business interest you can deduct.

Equity has no tax deduction and often costs more because investors take residual risk. Your weighted average cost of capital, or WACC, is the yardstick for evaluating investments. Projects that return more than WACC add value. Projects that return less erode value. This is where capital structure debt vs. equity financing choices roll into strategy and day to day decisions.

## Ownership dilution and control rights

Debt protects ownership but may constrain operations through covenants. Equity adds partners with voting power. Protective provisions can require investor approval for new financing, option pools, acquisitions, or changing leadership. Liquidation preferences and participation rights affect exit proceeds between founders and investors.

Plan dilution over multiple rounds. A clear cap table model shows how each new raise affects founder stakes and employee options. Many teams set guardrails such as minimum ownership targets at each stage and a budget for option refreshes so control and incentives stay balanced.

## Why equity is riskier than debt

Equity sits last in line in the capital stack. Lenders get paid first, then preferred shareholders, and finally common shareholders. Equity holders bear residual risk. If a company underperforms or fails, equity can be wiped out while lenders recover part of their capital through collateral or restructuring. This priority is why equity investors target higher returns than bondholders.

# Common Pitfalls and Legal Risk Patterns

## Loan acceleration and default cascades

Many loan agreements include cross-default provisions that trigger acceleration if any other debt defaults. Missing one payment can cascade into multiple lenders demanding immediate repayment. Acceleration clauses allow lenders to declare the full balance due upon specific events such as covenant breaches, material adverse changes, or ownership transfers. Companies

commonly review all debt documents together to map interconnected triggers and maintain covenant headroom across facilities.

## Collateral recovery and priority disputes

Secured lenders hold liens on specific assets and can foreclose or repossess collateral following default. When multiple lenders hold overlapping liens, priority determines recovery order. First-lien holders recover before second-lien or unsecured creditors. Intercreditor agreements document these arrangements, but disputes arise when collateral values fall below outstanding balances or when asset classifications are ambiguous. Clear UCC filings and documented perfection reduce recovery conflicts.

## Convertible note litigation and valuation disputes

Convertible notes and SAFEs convert to equity at future financing events, typically with discount rates or valuation caps. Disputes commonly emerge around conversion mechanics, triggering events, and whether subsequent rounds qualify as qualified financings under note terms. When companies raise at lower valuations than anticipated or restructure without a priced round, noteholders may challenge conversion treatment or seek alternate remedies. Well-drafted conversion definitions and regular investor communication reduce litigation risk.

## Control disputes when equity is layered post-financing

Each equity round typically adds new preferred classes with distinct rights. Protective provisions can create consent deadlocks when investor interests diverge. Board composition shifts as new investors claim seats, sometimes marginalizing earlier stakeholders. Liquidation preferences stack across rounds, creating scenarios where founders and common holders receive minimal proceeds even in modest exits. Drag-along and tag-along rights affect exit flexibility. Companies navigating multiple equity layers commonly model voting thresholds, preference waterfalls, and exit scenarios before raising subsequent rounds to avoid unexpected control or economic outcomes.

### WHEN TO USE DEBT VS. EQUITY FINANCING

Stage of business and growth goals

IDEA TO EARLY TRACTION	POST PRODUCT MARKET FIT	MATURE GROWTH
<p>Equity or convertible instruments fit because revenue is uncertain and cash needs are lumpy.</p> <p>Debt without collateral or cash flow is rare at this stage.</p>	<p>Mix of equity and some debt for working capital, equipment, or marketing scale can work if churn, margins, and unit economics are strong.</p>	<p>Debt can fund acquisitions or capex when cash flows are stable.</p> <p>Equity may support larger strategic bets or recapitalizations.</p>

# When to Use Debt vs. Equity Financing

## Stage of business and growth goals

- Idea to early traction. Equity or convertible instruments fit because revenue is uncertain and cash needs are lumpy. Debt without collateral or cash flow is rare at this stage.
- Post product market fit. Mix of equity and some debt for working capital, equipment, or marketing scale can work if churn, margins, and unit economics are strong.
- Mature growth. Debt can fund acquisitions or capex when cash flows are stable. Equity may support larger strategic bets or recapitalizations.

## Cash flow stability and collateral

If revenue is predictable and assets have resale value, debt works well. Examples include equipment heavy industries, healthcare groups with steady payor contracts, or real estate backed cash flows. If cash is volatile or assets are light, equity or convertible notes reduce default risk and preserve runway.

## Industry norms and investor expectations

Tech startups often lean on equity or SAFEs until metrics support venture debt. Healthcare practices may combine equipment loans with minority equity for growth. Real estate is built on asset backed lending with measured equity to absorb shocks. Investor expectations differ by sector, so benchmark terms to peers before committing.

## Planning framework

1. Define the next 18 to 24 month plan. Quantify cash needs, milestones, and risks.
2. Map funding options. List debt or equity financing by amount, timing, cost, and terms.
3. Stress test cash flows. Check coverage under downside cases.
4. Choose a mix. Match instrument terms to milestone timing and asset life.
5. Negotiate protections. For debt, focus on covenants. For equity, focus on control and preferences.

# Capital Structure Strategy for US Businesses

## Balancing debt and equity over time

Target a flexible capital structure. Early on, equity funds discovery. As revenue stabilizes, add prudent debt to lower WACC. Keep headroom in covenants and maturities to absorb swings. Revisit the mix each year or after major events like acquisitions or market shifts. This is a practical lens on debt vs. equity capital structure in action.

#### FINANCE LONG LIVED ASSETS

Use long term debt or a blend of long term debt and equity.

#### SHORT TERM LINES

Use short term lines for seasonal working capital.

#### RATE STRATEGY MATTERS

Locking in fixed rates can stabilize costs. Floating rates add risk and potential savings.

#### AVOID THE MISMATCH

Avoid using short term debt to fund long term losses.



## Long term debt vs. equity financing

Match funding to asset life. Finance long lived assets like property or core equipment with long term debt or a blend of long term debt and equity. Use short term lines for seasonal working capital. Locking in fixed rates can stabilize costs, while floating rates add risk and potential savings. Avoid using short term debt to fund long term losses.

## Venture debt vs. equity financing

Venture debt can extend runway between equity rounds. It usually follows a priced round, has interest and principal payments, warrants for a small equity kicker, and covenants tied to cash or performance. It works best when a company has strong metrics but wants to reduce dilution before the next raise.

# Debt and Equity Financing In Healthcare and Other Sectors

## Healthcare capital needs and reimbursement risks

Healthcare groups invest in clinical equipment, IT, and facilities while managing reimbursement lag and payer mix risk. Debt fits when patient volumes and contracts are steady and assets hold value. Equity or quasi-equity can buffer expansion into new service lines where payor approvals or rates may shift. Recent margin pressures have pushed many providers to tighten capital plans and prioritize liquidity.

## Tech startups and venture funding

Tech companies with rapid growth potential often lead with equity or convertible instruments like SAFEs, then layer in venture debt after Series A or B. The benefit of equity is speed and flexibility. The trade off is dilution and governance. Venture debt adds cost discipline and extends runway but must be sized to realistic burn and milestones.

## Real estate and asset backed lending

Real estate is an example of financing via debt vs. equity working in tandem. Loans are sized to value and cash flow, often using metrics like loan to value and debt service coverage. Sponsor equity absorbs volatility and aligns incentives. Raising more equity lowers risk but dilutes returns. Conservative leverage and strong reserves keep projects resilient through cycles.

## Patterns Observed in Durable Capital Structures

- Cash flow stress testing under base and downside scenarios guides instrument choice and sizing.
- Covenant maps across all debt facilities identify cascade risk before cross-default triggers fire.
- Cap table modeling through multiple equity rounds surfaces dilution and control thresholds early.
- WACC calculations after tax, updated annually, ground capital allocation decisions.

① **Methodology.** This guide reflects commonly accepted corporate finance principles and US regulatory guidance. Claims were cross-checked against cited authoritative sources. Market conditions shift, so confirm current terms during diligence.

**Planning considerations.** Match capital type to asset life and cash profile. Blend instruments to balance cost, control, and flexibility. Test structures under stress before committing. Revisit capital mix as the business scales and milestones shift.

### A Practitioner's Perspective: Equity Is a Business Partnership

The most important question I ask a client considering equity financing is not “how much do you need?” – it’s “are you ready to take on a business partner?”

Taking on an equity investor is not a transaction, it’s a relationship. Your investor will have rights to information, to a board seat, to approve or block certain decisions. That relationship can be difficult to unwind if your visions for the company diverge. I have seen equity arrangements succeed spectacularly, and I have seen them create real friction and cause business failure. Before you sign a term sheet, you should be as confident in your investor as you would be in a co-founder.

I came to transactional work through project finance, advising on large-scale energy development – wind farms and similar infrastructure projects – where the capital stack was everything. In that world, getting the financing structure wrong didn’t just affect returns, it could derail the entire project. That experience gave me a foundational appreciation for how debt and equity interact under real-world pressure: covenant defaults mid-construction, lender disputes over collateral, investor consent rights that created gridlock at critical moments. These are not just theoretical risks, but the kinds of problems that doom projects and businesses that should have succeeded.

I approach financing decisions the same way I approach M&A transactions: as a puzzle. The pieces are your cash flow profile, your growth timeline, your tolerance for shared control, your exit horizon, and your relationship with the people who will hold your debt instruments or equity. My job is to help clients see how those pieces fit together before they commit, not after.

I have helped clients raise capital across a range of structures, from early-stage convertible notes and SAFE financings to debt facilities for working capital and growth. I have also been on the operator side of this equation as a co-founder and owner in businesses I built, which means I understand the decisions my clients are facing not as legal abstractions, but as real choices with real consequences. That experience shapes how I counsel clients. I am not just reading the documents, I am thinking about what happens inside the business when the terms kick in.

## FAQs

### What is the difference between equity financing and debt financing?

Debt financing is borrowing that must be repaid with interest on a schedule. Equity financing sells ownership stakes to investors who share in future profits and influence decisions. Debt keeps control but adds fixed payments. Equity reduces payment pressure but dilutes ownership and often adds investor rights.

### Is it better to be financed by debt or equity?

It depends on stage, cash flow, and goals. Stable cash flow and collateral favor debt. High growth with uncertainty often favors equity or convertibles. Many businesses blend both to balance cost, control, and runway. Compare options against your WACC and covenant headroom before deciding.

### Is debt better than equity?

Debt can be cheaper after tax, does not dilute ownership, and has predictable cost. It also builds credit for future needs. The downside is default risk during downturns. Equity costs more and dilutes control, yet it removes fixed payments and shares risk during early growth.

### What is a disadvantage of equity financing?

Dilution and loss of control are the main drawbacks. Preferred investors may have vetoes, board seats, and liquidation preferences that affect strategy and exit outcomes. Founders should model cap table impact across multiple rounds before raising equity.

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## About the Author

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### Strategic Partnership for Legal Protection

This article highlights debt instruments and covenants, equity terms and control rights, convertible note conversion mechanics. Dunlap Bennett & Ludwig helps teams turn these frameworks into documented structures that align cost, control, and runway while reducing dispute risk.

If you are negotiating term sheets, drafting loan agreements, modeling cap table impact across equity rounds, or resolving priority disputes among multiple lenders or investor classes, our attorneys can help design guardrails that protect both immediate execution and long-term flexibility.

*Dunlap Bennett & Ludwig is a veteran-owned law firm with offices across multiple states. Our privacy and business attorneys combine legal expertise with practical operational experience to help companies navigate workplace monitoring compliance while maintaining focus on their core business objectives.*

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