Minden Gross LLP

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Topic:

Raising Capital

One of the biggest challenges facing a start-up company is raising money or having enough money to fund its working capital. At its earliest stages, a start-up company will typically receive an infusion of capital from the founders. Not only is this an obvious first source of capital but financing from founders sends an important signal, to future investors, about the founders' commitment and belief in the business.

An entrepreneur has the choice to advance funds as equity or as a loan. Founders of a company should not treat themselves as secured lenders. The concern that founders' debt adds unnecessary leverage to the balance sheet is often unfounded. From other lenders' perspective, the debt in favour of the founders is often viewed or treated as equity when outside financial analysis is conducted. The founders still may have some of the same protection afforded to or enjoyed by a third party lender.

The following documents are to protect your investments.

The General Security Agreement

A General Security Agreement ("GSA") is a document whereby the company pledges most of its assets as security for repayment of the lender's loan. Under the *Personal Property Security Act*, a GSA gives a lender the right to security over a broad range of assets including vehicles, machinery, equipment, receivables, inventory and anything else of value, as well as after-acquired property. To perfect its security, the lender registers a financing statement with the Personal Property Registry. Registration establishes the priority of the lender's security over the assets among the secured and unsecured creditors of the company (although individual lenders may agree among themselves to alter the priority of their respective interests).

Having a properly registered GSA from the company, in favour of founders, at the outset of the company's existence will place the founders' interest in priority relative to any other secured or unsecured lender. Utilizing a secured loan structure may yield some additional asset protection against unforeseen events, including litigation or other claims against the company. Accordingly, an investment in an owned business deserves the same care that would be applied to any other investment.

The Loan Agreement

The GSA is usually provided to support a separate documented agreement or acknowledgement evidencing the debt, which reflects the conditions under which the loan is being advanced. The rate of interest charged, terms of repayment and the conditions under which the secured lender has the right to seize and dispose of the collateral in order to repay the loan are all part of this agreement.

Each founder will execute its own agreement with the company wherein the respective loan terms are specified. The form of this agreement can vary. The loan agreement's purpose can also be served by way of a debt acknowledgement agreement, which takes into account that amounts may be lent by a founder to the company from time to time and that the amounts outstanding may increase or decrease over time.

Pari Passu Agreement

Pari Passu is Latin for "with equal progress." In this context, the phrase is used to indicate a similar ranking of lenders.

A *pari passu* agreement is made between the joint lenders and the borrower-company, where the lenders agree that in case of a default, their security interests in the borrower's assets will rank equally.

Where founders consider themselves "partners" of one another, it often makes sense for all of the founders to enter into an agreement with the company so that all of the founders are treated equally in respect of the amounts they advanced to the company.

Conclusion

Founders may not be sufficiently aware of – or may be reluctant to acknowledge – the need to protect their initial investment. However, establishing priority for the founders' investment through a series of properly executed agreements will provide the necessary security and a mechanism for resolution of unanticipated disputes.

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Owner-Manager Update

As many readers can attest, it has long been a common practice for owner-managers to pay themselves sufficient salaries from their corporation in order to maximize his or her RRSP contributions in each year. However, as RRSP contribution limits increase and corporate tax rates decline, this longstanding practice warrants a re-visiting. Using 2011 maximum RRSP contributions and accounting for Canada Pension Plan (CPP), albeit on a limited basis, I recently compared the amount of dividends that must be distributed from corporate-earned income in order to leave an owner-manager in the same after-tax cash position he or she would be in if a salary sufficient to maximize RRSP contributions had been utilized. I then compared the future value of the "excess" retained in the corporation to the future value of the RRSP.

My calculations revealed an interesting result: in almost all cases, an owner-manager is better off using the dividend alternative than the salary alternative.

Technically speaking, some of the reasons for this result are as follows:

1. The cash in the corporation after distributing dividends is almost 20% higher than the amount of cash in the RRSP. This amount is largely attributable to neither the corporation nor its owner contributing to CPP.

2. When comparing the future value of the amounts in the corporation to the amounts in the RRSP, the preferred alternative will be largely dependant on the type of income earned by the corporation in the years of accumulation (interest, capital gains or dividend).

3. Where the corporation is earning interest income only (a highly unlikely situation), the salary alternative is preferable to the dividend alternative, but it's close.

4. Where the corporation earns capital gains and/or dividend income, the dividend alternative is preferable to the salary alternative, and the difference may be substantial (especially where the corporation earns only capital gains).

5. Where the corporation is earning a mix of interest, capital gains, and dividends, the dividend alternative will almost always be preferred to the salary alternative (it is only when a very significant portion of the income is in the form of interest – again, a highly unlikely situation – that the salary alternative is preferred, albeit only marginally).

Despite these results, non-tax considerations should also be examined (i.e., saving for retirement, creditor protection) as such considerations do not always dovetail with tax savings. Accordingly, depending on such circumstances, the dividend alternative may not be best for the owner-manager, despite the tax advantages it presents.

For further information, please contact the author or any member of the Minden Gross tax group.

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Professional Notes

David T. Ullmann was interviewed for the July edition of *Canadian Business*. He was quoted in the article "*Nortel Networks patents to shape wireless tech for a decade to come.*"

Steven I. Pearlstein was interviewed for the June edition of *Law Times*. He was quoted in the article "*Strong opposition to paralegals in real estate.*"

Hartley R. Nathan Q.C. was quoted in an article entitled "Advice for men mentoring women lawyers" published in the June 20th, 2011 edition of *Law Times.* On July 20th, 2011 Hartley delivered a paper at Sherrard Kuzz LLP on "Due Diligence Before Becoming a Director and while serving as a Director". Summer student Ira Trifu assisted in preparing the paper. Hartley is also the editor of Nathan's Company Meetings and Rules of Procedure. The 9th edition will be published in the Fall of 2011. Hartley will also be a keynote speaker at the National Symposium of the Not-for-Profit and charitable subsection of the Canadian Bar Association in May of 2012. On the non-legal side, his monograph on Who Was Jack the Ripper? was published in July 2011.

Firm News

Kenneth L. Kallish has been appointed a Vice Chair of Meritas, and will Chair a Governance Task Force. The role of the Task Force is to examine the governance structure of Meritas, and present its findings and make recommendations to the Board of Directors in October, 2011.

Howard S. Black received the Adjunct Faculty Distinguished Service Award from Osgoode Hall Law School. This award is granted to adjunct faculty in recognition of their valued contribution as adjunct faculty members at Osgoode Hall Law School for more than 20 years. Howard teaches two courses in Estates and one seminar in Estate Litigation.

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