

CORPORATE FINANCE

The three basic methods that a company can use to raise money are by borrowing it, by selling shares in the company or the old fashioned way - by earning it. The last way, making a profit, is pretty simple and every owner hopes that they will be so lucky as to have lots of profits to play with. What to do with a profit, however, is seldom a problem and probably beyond the skill of this writer (if the complete absence of pay cheques from this newspaper are any indication) so we'll concentrate on equity and debt financing.

The simplest form of corporate finance is debt financing. That is when the company borrows money and issues debt instruments in return. Usually the company, especially a new company, borrows from its shareholders, giving a promissory note in return. Most shareholders would prefer that their company borrow from a bank or government agency (preferably without any guarantee from the shareholders) but most of those lenders are not keen to invest in new companies, even with guarantors, due to the rather considerable likelihood that they will never see any of their money again since most new businesses tend to go out of business rather quickly.

When a company borrows from its owners, these shareholders put up the cash that they invest in the company in the form of shareholders loans with only a nominal amount being used to purchase their shares. The shareholder lenders take promissory notes (a promise from the company to pay them back with or without interest) and repayment is made by the company out of operating profits.

This works well as long as the company makes a profit but it also works even when the company goes bankrupt. Then the shareholder who made the loan at least gets to rank equally with other unsecured creditors (assuming they haven't paid themselves back before the company hit the skids, as usually happens).

Of course, if the shareholder who made the loan had the good sense (or followed good advice) and took some security for the loan, then that shareholder is also a secured creditor and would rank ahead of the unwashed masses of unsecured creditors. While this sounds good in theory,

in practice if there is an outside financier like the government or a bank, chances are very good that they have staked their claim on anything valuable or that could be sold. When the regular debtors get their turn at the trough there is seldom much of value left there.

There can be adverse tax effects to a shareholder's loan if, for example, the company pays interest to a shareholder whose marginal rate is greater than the tax rate paid by the corporation. If the shareholder borrows from a bank and then loans the money to the corporation for no charge, they may not be able to deduct the interest paid to the bank as the debt would not have been incurred for the purpose of earning income. However, as always, tax is an area of statute law where logic is often of little assistance. If in doubt, let an accountant figure it out.

Selling shares (or equity financing) is always a good way for a company to raise capital. From the buyer's point of view it is obviously an investment so interest on money borrowed to buy shares or losses incurred on the sale of shares can always be deducted from income. From the seller's point of view the shares are easy to sell but very difficult to buy back. Companies cannot buy back or otherwise deal in their own shares unless specific provisions are made for redemption or repurchase or the assistance of the courts is sought to remedy such defects in incorporation. Of course, another problem for the company is that every time you sell another share you have another owner (read boss) to answer to.

If the company selling the shares is closely held (that is, not traded publicly) sales are often restricted to existing shareholders rather than to just anyone. Often, such restrictions are set out in the Articles or in the Shareholders Agreements.

The best form of financing is to find an outside lender who will loan money to the company directly without taking personal guarantees from the principals. Generally speaking, however, banks and governments will not typically make such loans to small corporations or new venture. Governments sometimes do it but only for excellent supporters of the governing party (Jean Chretien can be such a good friend) or in marginal constituencies where the elections are likely to be close. You can safely assume that this option only applies if you don't need any money in the first place.

No matter which method is chosen, however, it is vital that the various formalities be observed. The correct documents must be prepared and procedures followed to ensure that the financial transactions are effected. Corporations are creatures of paper and they need to be fed the correct amount and type of paper for them to remain healthy. Waiting until the auditor from the income tax department is outside your office demanding to see your records is not a very good idea at the best of times. That's when you wish that you'd hired lawyers and accountants to do it right in the first place.