BEYOND BANK FINANCING

by Craig A. Zawada

© 1998 Wallace Meschishnick Clackson Zawada

Are you still shopping for financing the way it was done 20 years ago? You might be overlooking possibilities better suited to your business.

Traditional borrowing is fairly simple. You talk to your banker, who usually asks you to mortgage your assets. If approved, you get a loan for some percentage of the collateral's value. As long as you make your payments, the business remains yours to run.

Traditional financing is still very common, as long as you have "bricks and mortar" to mortgage. The business's assets, however, may not be something you can see or touch. They can include a customer list, a well-known trade mark, goodwill, or plain old knowledge possessed by you and your employees. Bankers have become more sophisticated in dealing with this type of property, but with a few exceptions, it is not their role to provide risk capital. Some or all of your financing may have to come from another source.

That other source is often equity capital. Unlike debt financing, where you only have to pay principal and interest to a creditor, equity financing creates more owners. At this point, many entrepreneurs recoil in horror. "I've put too much into my business to start giving it away", they say. Well, if you are sophisticated enough to know the options, you may not have to worry.

Friends and relatives, business acquaintances, venture capital funds, government programs, suppliers, customers and even some chartered banks are all sources of equity financing. Some programs are product or industry specific. The key point is this: don't sell yourself short when shopping for financing. Small business owners are often grateful to find any source of funds, and take the money on whatever terms are dictated to them. Remember that the lender is benefiting too. You should not automatically give up your rights without asking if you can get away with less.

For corporations, equity financing is accomplished by issuing new shares. Most share issues are private placements, where only one or two new shareholders are coming on board. At this level, securities laws are seldom an obstacle, and the terms of the financing are negotiated directly by the parties.

Shares are not indivisible. A share carries with it three basic privileges: the right to receive dividends, the right to vote, and the right to participate in the growth of the company. A share can contain all of these rights, or it may only contain one or two. The choice is entirely up to you.

This flexibility allows you to specifically restrict the rights investors will receive. For example, your investor may be content to put money into your business on the expectation of a huge payout in the future when the business "takes off". The investor is not concerned with short term dividends or voting control. It is very easy to create a separate class of shares that will grow in value along with the entire business, but without votes or the right to receive dividends.

Those three specific rights can be fine-tuned even further. By a contract called a unanimous shareholders agreement ("USA"), the owners can rewrite their obligations, liabilities and powers to suit their purposes. Suppose your new investor does not want to get involved in day to day decisions, but would like a say in major business affairs. The USA can give the investor a vote in certain matters, but all other decisions are left to you.

You can also make the shares retractable or redeemable. Retractable shares may be bought back by the company. Redeemable shares permit the shareholder to force the company to buy the shares. In either case, there may be a time limit to the right, and there may be a specific price at which the shares can be redeemed or retracted. Sometimes the shares will be convertible into debt, which can provide an extra margin of comfort for the investor.

Nor are you stuck with the corporate vehicle, since corporations are not suitable in every case. For one thing, they are relatively public. Returns have to be filed on an annual basis, and anyone can search the registry to obtain information on your business. As well, there are profitability tests that must be met under corporate statutes before certain things can be done.

Many of these problems can be eliminated by the use of business trusts, or other non-corporate structures. The details could fill another article, but the result is you get to draft the rules to fit your goals, rather than have them legislated upon you.

Many people shy away from looking at these alternatives because they assume they are too expensive. This is not the case. For all but the smallest cash infusions, there will always be steps available on a cost-effective basis to maximize the continuing value of the company to you.

You should not overlook the possibility of alternative financing. Otherwise, you risk not getting the funds in the first place. As well, you might be giving away the results of your hard work.

This article was first published in Saskatchewan Business*, Jan/Feb, 1997.*

This article is for general information only and relates only to Saskatchewan law. Specific situations may require different or additional information. Do not act on any information contained in this article without consulting your advisors regarding your specific circumstances. As well, some of the articles are of historical interest only because legislation or case law may have changed.