BEFORE YOU BUILD – IS THE FOUNDATION SOLID?

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A solid corporate structure is necessary to build small and medium enterprises (SMEs). I have encountered clients who have not paid attention to the basics, including details of incorporation, what shares can be issued, and the shareholder agreement. At the beginning, when everything is running smoothly**,** these details may not seem important, but if partnerships become toxic, or major disagreements about the future of the business or what is appropriate risk arise, these basics of the corporate structure and operations become important.

Most start-ups are incorporated either provincially or federally. Make sure your incorporation is suitable for your current operations. If you have expanded across Canada, the benefits of being federally incorporated should be considered. Articles of incorporation can be amended at any time as your circumstances change.

At this point, specifics should be decided, such as the type of shares to be issued, and how many. There are two basic types of shares, common and preferred, and each type comes with a different set of benefits. With appropriate agreements in place, changes to the share structure are possible. For example, two founders can agree that an infinite number of shares can be issued and issue 1000 shares to each. Common shares carry a vote (usually one vote per share) and you now have two founders who each own half the company. If a new investor comes in, they will be issued with shares in exchange for investment. Depending on the specifics, the new shareholder may or may not dilute the founders' ownership. The new shareholder will have a vote in accordance with the number of shares they own. A company in Ontario must have directors, or at minimum one director, drawn from common shareholders.

Most companies also provide for the issuance of preferred shares. Preferred shares can be very useful. There are two key characteristics of preferred shares. They have no vote and they have a preferred position in a bankruptcy. Traditionally, they carry a dividend, if agreed to by the company. There are many types of preferred shares, including perennial (no time limit for shares), term (time limit for shares), and convertible (the most interesting, because the investor has the choice of receiving a dividend or converting the preferred shares to common shares at a previously agreed upon point in time). Preferred shares are often used to recognize the investment contributions of family members, who are often early investors in a company started by a cash-poor family member. It should be noted that dividends are taxed in a more desirable fashion than interest. Dividends show on the equity side of the balance sheet, not as a debt, making preferred shares a desirable option for financing. Every SME should ensure that they have the option of issuing both common and preferred shares.

Often overlooked in the rush to scale a company is the shareholder agreement (this only applies to companies with more than one shareholder). I often hear the excuse, “We’re too busy,” or “Shareholders are family members so we don’t need an agreement.” The need for a shareholder agreement only surfaces when disagreements arise and there is no process in place to resolve different viewpoints. A shareholder agreement protects both the company and the shareholders by regulating the management of the company, protecting shareholder rights, setting out processes and procedures, and dealing with shares, especially pricing. Most importantly, the shareholder agreement sets out resolution mechanisms for settling disputes among shareholders, especially helpful in situations when no-one has a majority vote. The best time to create a shareholder agreement is before any shares are issued. The agreement can be drawn up at any time, but it is obviously more difficult if the shareholders are in the middle of disagreements.

A shareholder agreement helps shareholders and directors navigate uncharted waters and unforeseen problems, including setting out the rules for selling or transferring shares. In the absence of a shareholder agreement, the Ontario Business Corporation Act applies for an Ontario company, and a federally incorporated company is governed by the Canada Business Corporations Act. A shareholder agreement is like any other management tool. It establishes guardrails for growth and change.