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Raising Capital for Small Business Corporations

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In conclusion it should be emphasized that there is much more to organizing a corporation than merely being a draftsman for our clients. Ours must be the guiding hand. Our clients may know how to run the business, but the chances are one thousand to one that they don't know how to organize it. That's what they pay us for.

RAISING CAPITAL FOR SMALL BUSINESS CORPORATIONS *

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Since practical considerations dictate that this discussion be limited to some one particular phase of the corporation's functional problems, I have chosen to discuss the financial problems of the small business corporation. I think that for the past several years one of the principal functional problems of the small business corporation has been the raising of additional capital. Just how is the corporation going to expand its business? How is it going to get additional working capital into the organization so that it can meet new requirements of the business? In attempting to answer these questions, I will continue to use the hypothetical "I.C.U. Bathing Company" which Mr. Tull has created for his clients, Mr. Adams, Mr. Beech and Mr. Cook.

The I.C.U. Bathing Company having completed its organization and started business operation, we may suppose that the bath tubs turn out to be not only transparent but also cheap; consequently, it was possible to find a ready market for the tubs. One difficulty developed, however; they were also transparently cheap. Claims started coming into the company that the tubs were not what they were represented to be. They started to crack, and they started to peel. The peeling caused no end of trouble to the bather. Many breach of warranty claims were presented, and I.C.U. Bathing Company was soon in financial difficulty.

After settling all the breach of warranty claims and spending the money necessary to correct the defects and put out a tub that would really work, our friends, Messrs. Adams, Beech and Cook, found that the corporation was without funds. They had also looked forward to being able to expand their business in the future and make a fine going concern of the corporation. The immediate need, however, was for additional funds right away to enable the corporation to meet its pay roll.

* With slight revision, these are the remarks of Mr. Burgess before the Institute on "The Small Business Corporation" at the state bar association convention in Colorado Springs on October 14, 1949, following Mr. Tull's presentation.

In discussing this immediate problem, it developed that two of the incorporators, Mr. Adams and Mr. Cook, could put some more money into the corporation. The other incorporator, Mr. Beech, could not invest any additional funds. So long as Mr. Beech could not put any more money into the corporation, Adams and Cook were unwilling to invest their money in return for additional common stock. They asked if they could just loan the money to the corporation on an open note. We told them that they could do that. It should be remembered at this point that the corporation was set up in such a way that when Adams and Cook make their loan, the note will have to be signed by all three of the incorporators. Ordinarily we wouldn't require that, being content with the signatures of the president and the secretary and the authority of the board of directors.

In any event, the two stockholders, Adams and Cook, do make the loan to the corporation in the amount of $2,500 each, and the corporation is able to meet the current payroll. Now of course, as officers and directors of the corporation, they do have the right and the authority to make such a loan to their company. This helps the corporation out of its immediate difficulty, but it does not take care of the long range financial problems. In order to expand their business and make any substantial amount of money out of the operation of the concern, our clients realize that they must have a larger plant, more machinery, and more production employees.

Sale of Common Stock

After going over the picture rather thoroughly, they believe they need at least $350,000 of additional capital, and so the question arises as to what means they can use to raise the $350,000. They first consider the possibility of a sale of additional common stock. It should be remembered that the articles of incorporation contain no provision for waiver of pre-emptive rights of stockholders, but this isn't too serious a situation because we only have three stockholders anyway. So we discuss the possibility of selling the additional common stock in order to raise $350,000. The stock structure is adequate, providing the stock can be sold at $100 per share, in which case there will be some funds left in the treasury.

If there were more stockholders, the first step that would be necessary would be to hold a special stockholders' meeting for the purpose of amending the articles of incorporation to do away with the pre-emptive right of stockholders to subscribe to the unissued stock. In this instance, however, with only the three stockholders, they may accomplish that purpose by either one of two methods. They may hold their special stockholders' meeting and amend the articles of incorporation to abolish the pre-emptive right of the stockholders; or, since there are only the three of them, they can waive the right to subscribe to the unissued stock without any

amendment to the articles of incorporation, and that may be done by unanimous consent.

If they should elect to amend the articles of incorporation, that may be done by waiver of notice and without a call for the meeting. This may raise a question in the minds of some attorneys, for the statute requires the calling of a meeting of the stockholders for the purpose of amending the articles of incorporation and only after a thirty day notice, both published and personal. Some have taken the position that since the statute so provides, it doesn't make any difference if there is a one hundred per cent approval of the stockholders to the holding of a meeting, the articles can't be amended without following the statute. I take issue with that conclusion, and I take the position that when there is approval of all of the stockholders to the holding of a meeting, they are the only ones who are interested, and they can hold such meeting after waiver of notice and amend the articles of incorporation thereat.

Having thus amended the articles, we are ready to sell the common stock. In all probability, however, our clients find that when they go out to reliable stock brokers they can't sell the stock because they don't have sufficient assets upon which to warrant its sale. People just aren't going to buy that additional common stock based upon the use of the funds received for the erection of a larger factory and the purchase of additional machinery.

PROMISSORY NOTES SECURED BY TRUST DEED

Passing on to the next possibility of raising their finances, we discuss a program for the issuance of promissory notes secured by a deed of trust on the then existing assets and on the building which is to be erected. In carrying out this proposal, it is possible to use the usual form of deed of trust and the ordinary form of promissory note. But here again if our clients are going to sell $350,000 worth of additional securities, there are some complications in getting the public to buy those notes. We may then consider the plan of creating notes which have some special privileges in order to make them salable.

In the first place, the notes may be issued and the deed of trust recorded with all of the notes payable to one individual. Then he, in turn, as the holder of all of those notes, can renegotiate them as they are sold to the public so that, for the purposes of the deed of trust, there is but one holder of the notes. Instead of the holder issuing participating notes, he can simply re-indorse, without recourse, the notes as they are sold.

Now that would be the case if a regular deed of trust to the public trustee was used. Of course, it is possible to use a deed of trust to a private trustee and then have all the promissory notes payable to that private trustee who could, in turn, either endorse those notes over in series without recourse or issue participating

notes to the public. In either the private trustee deed of trust or in the public trustee form, there will be the necessity of a provision for a receiver's clause and for attorney's fees in the event of foreclosure of the deed of trust.

As a part of the whole deal there could be included a chattel mortgage on all the furnishings and machinery of the plant as additional security for the loan. Or if that is thought undesirable, there might be an agreement on the part of the corporation, separate from the deed of trust itself, that all of the machinery and equipment will be held as a part of the security for the loan and will not be encumbered during the period in which the deed of trust is on record.

In such an issue as this, the notes probably all will be payable on or before a date certain. In other words, there will not be any series of due dates on the different notes, not because that isn't wholly proper, but because the notes would undoubtedly be less salable if some purchasers were given a preference by having their notes come due earlier than those of the purchasers of other notes in the same series.

The notes will also contain a special recital that they are one in a series of a $350,000 issue and that they are secured by a deed of trust and by a chattel mortgage. They will provide for interest payable on certain definite dates, semi-annually or annually, and probably they will provide for a call of the notes, either as to part or all of them, at any time after issuance. If they are called up, the chances are they will have a premium interest if called earlier than the certain date after the issuance of the note.

Now, here we get into some of the possibilities of additional provisions in a note issue. For example, the notes may themselves embody an agreement between the corporation and the holder that there will be a sinking fund set-up for the retiring of those chattel notes. As an additional advantage to the purchaser, the notes also may contain some conversion privileges, and the basis of that conversion will be set out definitely in the note. In this particular instance, there being at this time only common stock, the notes may provide for conversion into common stock in whole or in part at a value of one hundred dollars per share on the common stock. Of course, the advantage of this to the purchaser is that, if the corporation prospers, when the notes are called, the holder can transfer to the common stock and obtain permanent securities in the corporation. Some of those additional privileges may be necessary in order to market the notes to the public.

First Mortgage Bond Issue

Another method of raising capital which is quite similar to the method just described is the first mortgage bond issue. The primary difference is that a mortgage bond issue requires a private

trustee, and the mortgage agreement between the private trustee and the corporation will set out more in detail the agreements between the corporation and the holders of the note than will a deed of trust form. Moreover, on a private trustee deed of trust or on a mortgage, there are the additional provisions instructing the trustee as to when he shall foreclose and as to the rights of the holders of a percentage of the securities to demand foreclosure upon default. The sinking fund provisions may also be in a first mortgage bond issue, as well as all the other matters I have referred to as applicable to a deed of trust securing a chattel note issue.

PREFERRED STOCK ISSUE

Another very common method of raising capital which our clients will surely want discussed is by a preferred stock issue. There are any number of types with various characteristics. If our clients desire to go into a preferred stock issue, they must amend their articles of incorporation and provide in detail for all of the characteristics that the preferred stock will contain. The amendment to the articles is the agreement between the holders and the corporation as to the rights, privileges, and liabilities that are contained in the preferred stock issue. But before determining how to amend their articles of incorporation, they must first determine what type of preferred stock they are going to issue, the characteristics that it is going to have, and just what the rights of the holders are going to be.

Although it is not usual or customary, they may amend the articles of incorporation to provide for a no-par preferred stock issue as well as a par issue. Here, again, it is no doubt advisable to suggest to them that a par value preferred stock issue is the advisable one. The preferred stock will of necessity carry a definite dividend right. It may also be cumulative or non-cumulative. It is only infrequently that we ever hear of a non-cumulative preferred stock, primarily because the public is not interested in buying preferred stock unless they know that their dividends are going to be cumulative and that they are going to have a prior right to receive those dividends before creditors and before the payment of any common stock dividends.

Ordinarily, there is some provision for a sinking fund for the retirement of preferred stock, and as a usual rule, whether it is for preferred stock or whether it is for the notes or the mortgage bonds, the sinking fund is provided for out of a percentage of the net earnings. This may not seem entirely satisfactory to the holders of the notes or the holders of the preferred stock, but at all times we must look to the ability of the corporation to continue its future operations. If there is a set amount provided for a sinking fund, it may take all of the earnings of the corporation for the first two or three years, leaving nothing for operational capital. Where-

as, if the provision is for a percentage of the net earnings, then the sinking fund can be taken care of, and at the same time the corporation will have working capital out of the balance of the net earnings.

There is an additional feature to preferred stock that sometimes is used and that is quite advisable for salable purposes. That is making the preferred a participating stock. Ordinarily, when we set up a participating preferred, it is provided in substance that after the payment of the dividends on preferred stock and after the sinking fund requirements have been met, the preferred stock shall share in the dividends declared equally with the common stock, share for share. In other words, it gives the preferred stock a double-barreled right in the earnings of the corporation. They first get their dividends in accordance with the preferred stock and thereafter they receive a portion of the balance of the net earnings in accordance with the dividends declared on the common stock. Preferred stock, of course, always implies preferential rights in the event of dissolution, affording the preferred stockholders the right to receive not only the principal of their preferred stock but all accumulated dividends before any distribution can be made to the common stockholders.

The preferred stock will usually contain provision for redemption in part or in whole. If it is in part, ordinarily the redemption is called in by lot. It may also contain the provision that the corporation shall have the right to call for offers to sell the preferred stock to the corporation and that the corporation shall buy at the lowest figure offered. When the call it by lot, there is a premium payment that has to be made to redeem the preferred, usually at a rate of 102% or 103% of par with accumulated dividends. There may be some advantage to the corporation in issuing a call for offers to sell and using the sinking fund to buy the stock which may be offered back to the corporation at par, or perhaps less than par.

The question always arises on a preferred stock issue as to whether or not there are going to be voting rights. There is, I think, no common practice as to voting rights. It usually is provided that in the event of default in payment of dividends on the preferred, the preferred stockholders shall have certain voting rights, share for share, with the common stock, and probably that they shall, at that time at least, be entitled to representation on the board of directors. The articles in the first instance may provide that, upon the preferred stock being isuued, preferred stockholders shall have representation on the board of directors, and, in such case as here, it probably would be necessary to amend the articles of incorporation to increase the directorate so that the preferred stockholders would have representation.

Very frequently, also, it is either advisable or necessary to provide for a limitation of salaries of the corporate officers so as

to protect the earnings for the benefit of the preferred stockholders. That limitation as to salaries may be handled in either one of two ways. The by-laws may be amended so as to limit the salaries to those paid in any one particular year that may be chosen, or there may be an agreement entered into between the corporation and the officers that they will not draw in excess of a certain limited salary so long as the preferred stock is outstanding.

There is one additional matter in connection with the preferred stock I think it advisable to discuss. A single series of preferred stock may be issued, or the preferred stock may be issued in series A, B, and C, according to the amounts of stock which it is desired to have outstanding at any particular time. If a serial preferred stock is desired, there is one set of additional steps to be taken in order to comply with the amendment adopted by the 1949 session of the legislature. That session amended the entire article relating to stock issues. At the end of the amendment they tagged on an additional provision which, in substance, provides that in the event that preferred stock is issued in a series, before the issue is sold to the public there shall be filed, with the Clerk and Recorder of the county and with the Secretary of State, a statement, acknowledged by the president or vice-president and secretary or assistant secretary, setting forth all of the various rights and privileges of the preferred stockholder. That has not been a requirement in the past but should now be borne in mind in connection with preferred stock issues.

SALE OF DEBENTURES

We next discuss the possibility of issuing debentures. That, of course, is a very nice title. It sounds very dignified when one starts talking about debenture issues which are probably salable largely because of their title. They can be called six per cent ten year participating debentures, and the public will be quite enthusiastic about them.

As a matter of fact, the debenture is very similar in character to the bond. It is not secured by a deed of trust or mortgage. A debenture is a wholly unsecured obligation except insofar as the agreement between the corporation and the trustee may create some security, but there will be nothing of record to show that there is any security behind those debentures. There must, of course, be a trustee agreement between the corporation and the trustee acting under the debenture issue, and that agreement will contain all of the terms and covenants of the issue.

Debentures are usually payable at the end of a certain period of time, such as ten or fifteen years, and they carry a certain rate of interest payable either semi-annually or annually. They may be called prior to maturity, and usually if they are so called, it is at a premium.

Here again, the corporation may include in its agreement with the trustee the provision for inviting offers to sell to the corporation and using the sinking fund for that purpose in preference to paying the premium on the retirement of the debentures in advance. They are ordinarily registered through the trustee, and the trust agreement will contain the protective covenants for the benefit of the holders. We will probably have a limitation of salaries. We will have a limitation as to the payment of dividends on the common and preferred if the preferred is a participating stock. In addition to the sinking fund, we will probably have an agreement with the trustee that none of the assets of the corporation will be pledged or sold so long as the debentures are outstanding, but that in event of such a sale, the entire proceeds will be applied to the reduction of the indebtedness.

As in the case of a bond issue, the indenture will provide for the duties of the trustee in the case of foreclosure or define the rights of the holders of the debentures to demand foreclosure in the event the trustee does not act. There may be a receivership clause also included in the debenture agreement. As to this particular clause, there is undoubtedly some diversity of opinion. It has been said that a receivership clause is of no value in a trustee agreement for debentures because there is no security behind it, and that it would be invalid to place a receivership clause in such a document. I cannot agree with that conclusion for I believe that the corporation, in making its deal with the trustee, can agree to the receivership clause if it wants to, and that such agreement becomes a part of the contract and is fully binding.

There may be any lesser or greater number of covenants in the debenture issue than those which have been mentioned so far, depending upon what seems to be the requirements of the public in buying any particular type of security.

Marketing Securities

In any event, having covered the various means of obtaining additional money for the corporation, I want at this time to put in a plug for security dealers. It is always well to bear in mind that whatever type of security is discussed with a client and whatever type he finally decides he would like to use, before determining the course to be followed, it is advisable to consult a reliable security dealer and find out just what the public is interested in buying. If possible, obtain an underwriting agreement with that security dealer so that when the articles of incorporation are amended and the securities are ready to be sold, the security dealer will offer it to the public.

It is always well to bear in mind, and I find that sometimes we fail to do this, that the Securities and Exchange Commission is very much interested in what you are doing. The State Securities Com-

mission office is also considerably interested in what you are doing. It would take much more space to discuss the various requirements of the Securities and Exchange Act and the State Securities or Blue Sky Act. But to emphasize the necessity of getting in touch with the SEC and the State Security Commissioner, we may consider these situations. Suppose our issue is over $300,000, as it was in our hypothetical case, and we are going to make a general offer to the public by means of the mails or the radio or general newspaper advertising. That issue must be registered with the Securities and Exchange Commission.

If, on the other hand, our sales are all within the state, we are not going to use the mails, and we are going to do no advertising whatever, then we are not required to register. If the stock sale is under $300,000 and we are going to offer it to the public with advertising and radio, we don't have to register it, but we do have to file a letter of notification with the SEC's Denver office. That letter of notification is on a form provided by the SEC and is fairly simple to make out. If the securities are other than stocks and there is no offering outside the state and no use of the mails or advertising by radio, we need not file any letter of notification.

There are many refinements to these various regulations. I am not purporting to tell you that what I have now said covers them. The important thing to remember is that in starting on any type of finance structure and new issue, it is well to be cognizant of the SEC regulations.

So far as the State Security Commission is concerned, the size of the offering is immaterial. If the security is to be offered to fifty or more persons, the prospectus must be filed under the Blue Sky Law and approved by the State Securities Commissioner. There are other provisions as to waiting periods under the SEC and the State Securities Act and the filing of material, particularly with the SEC, on any advertising you are going to do.

That, in general, covers the picture of what securities can be used, how they can be set up, and the filings with the SEC and the State Securities Commission.

MEDICS BEGIN THIRD RADIO SERIAL

"Dr. Tim, Detective" is the title of the Colorado State Medical Society's new 13-week radio series. The program, a 15-minute weekly feature similar to the bar association's "You and the Law" series, got under way on KVOD, Denver, and 11 other stations during the last week of February. The KVOD broadcast time is 8:30 every Wednesday evening.

This is the third year that the medical society has had such a program. The bar association hopes to get its second edition of "You and the Law" on the air waves by April or May.