Raising Capital

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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 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.