

COMPANY LAW

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Chapter 6

Finance¹

References to the “Act” and to the “BCA” are to the *Business Corporations Act*, S.B.C. 2002, c. 57, as amended.

[§6.01] Introduction to Methods of Finance

The three common methods of financing (also known as capitalizing) a corporation are by

- shareholder loan (debt finance);
- share sales (equity finance); and
- corporate borrowing.

In addition, a company can raise money by making profits, but this method involves skills beyond the scope of this chapter.

1. Shareholder Loan (Debt Finance)

The simplest method of capitalizing a company is by shareholder loan; the principal shareholder loans the bulk of the money needed to capitalize the company and subscribes for shares with only a nominal value. There must be at least one common share subscribed for in every company.

(a) advantages

The investment is easily repaid to the shareholder by a simple cancellation of debt as opposed to a reduction of share capital by the redemption or repurchase of shares. Another attraction of debt financing relates to corporate bankruptcy; a shareholder who has financed by way of a shareholder loan will rank at least equally with all other unsecured creditors, instead of below them as a common or preferred shareholder would do. Moreover, a shareholder who makes a loan to the shareholder’s company can always take security from the company and thereby rank above unsecured creditors. However, if any major loan or credit is extended to the company, the outside financier will likely require a postponement of the shareholder security.

(b) disadvantages

In certain circumstances, there may be a detrimental tax consequence to a shareholder who invests in a company by way of a shareholder loan. In the initial phases of a company’s activities, usually there are insufficient earnings to allow the company to pay any interest to the shareholder on the loan. Assuming the small business rate and that the shareholder pays tax at a higher rate, if the company pays tax at approximately 13.5%, then receiving interest is not tax effective for the shareholder since the tax saving to the company is less than the tax cost to the individual shareholder of earning the interest.

When a shareholder borrows money from an outside lender and in turn lends it to the company at no interest, or at a rate of interest that is less than what the shareholder is paying to the outside lender, there is a risk that the interest paid on the outside loan may not be deductible for tax purposes by the shareholder. This is because s. 20(1)(c) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp) stipulates that only interest on borrowed money used for the purpose of earning income from a business is deductible. If the company is not paying any interest to the shareholder, it is difficult to claim that the outside loan was obtained for the purpose of earning income.

Despite the words of the *Income Tax Act*, the Canada Revenue Agency’s Interpretation Bulletin No. IT-533 indicates that a deduction is permitted for the full interest expense incurred when a taxpayer borrows money to be loaned interest-free to a wholly-owned corporation (or in cases of multiple shareholders, where shareholders make an interest-free loan in proportion to their shareholdings) and the proceeds have an effect on the corporation’s income-earning capacity, thereby increasing the potential dividends to be received.

If a shareholder loans money at no interest to the shareholder’s company, there is a danger that if the company cannot repay the loan, the resultant capital loss will be denied. This is because the shareholder did not make the loan for the purpose of gaining or producing income from a business or property (*Income Tax Act*, s. 40(2)(g)(ii)). Based on the Federal Court of Appeal’s decision in *Byram v. The Queen* (99 DTC 5117), the Canada Revenue Agency has stated that it will not deny the capital loss, provided that a clear connection between the shareholder and the corporation’s dividend income can be demonstrated.

¹ **Kathleen Keilty**, of Blake Cassels & Graydon LLP, kindly revised and updated this chapter in January 2009. This chapter was based on an article prepared by Carl J. Pines of Owen Bird for the CLE publication, *Company Law* (November 1987) and was revised annually by the author to January 2006.

2. Share Sale (Equity Finance)

A second method of financing a company is to subscribe for and have the company allot and issue shares. The buyers of the shares provide the capital that the company requires and in return acquire rights with respect to voting, dividends, and the return of their capital, to the extent that these rights are provided for in the company's articles.

(a) advantages

Interest on money borrowed to purchase shares is deductible under s. 20(1)(c) of the *Income Tax Act* since the purchase of shares is generally recognized as being "for the purpose of earning income from property". Anyone who does not qualify under the conditions set out in IT-533, should probably finance by way of share purchase rather than by shareholder loan.

(b) disadvantages

As mentioned earlier, funds loaned by a shareholder to a company are easily repaid by a simple cancellation of the debt. However, money paid for shares cannot be returned to the contributor so easily. One way to return such money is to find a buyer for the shares; this may be difficult when a company has few shareholders. Another way is to have the articles of the company specifically provide for the redemption or repurchase of the shares by the company; however, tax consequences may arise on the redemption or repurchase of those shares, depending upon their value and the attributes of the shares at the time of such redemption or repurchase.

The "paid up capital" of the shares for tax purposes is especially important on a share repurchase or redemption. For example, if the shareholder purchases common shares, to the extent that the amount paid by the company for the shares on repurchase exceeds the paid up capital, the shareholder will be deemed to receive a taxable dividend from the company. Once the shares have been redeemed or repurchased, there is a reduction of the paid up capital in the company. This does not mean that the redemption or repurchase of shares cannot be effected, only that care must be taken at the outset when drafting the articles to provide for it (see s. 77 of the *BCA*). The other main disadvantage to share purchase financing is that shareholders rank below unsecured creditors in the event of bankruptcy.

3. Corporate Borrowing

One of the major reasons that businesses incorporate is the concept of limited liability. A company is a separate legal entity from its shareholders and the potential liability of the shareholders is, in the absence of an agreement to the contrary, the amount they have agreed to pay for their shares. Thus, the optimal financing for any company is to find an outside lender who will loan money to the company directly without taking personal guarantees from the principal shareholders. This maximizes the concept of limited liability. However, lenders typically will not make loans directly to small corporations, or to new corporations, without personal guarantees of the shareholders. This in effect negates the concept of limited liability.

Assuming that a lender is not willing to loan funds to capitalize a company without a personal guarantee, the question then arises as to which of the following methods of financing the company is best:

- direct loan to the company with repayment assured by a shareholder guarantee; or
- loan to the shareholder who in turn makes a shareholder's loan or purchases shares.

Often the lender dictates the terms of borrowing and the shareholder may not have a choice. Assuming a choice, the answer to the question depends on whether the individual or the company is able to make better use of the interest deduction. If the first option is chosen, only the company is able to take the interest deduction. The company benefits only if there are corporate profits. If the second option is chosen, the individual takes the interest deduction, which can be deducted from other income.

4. Procedural Aspects – Overview

In all methods of assisting a company to raise money, including those listed above, a lawyer must observe various formalities. Certain documents must be prepared and procedures followed to ensure that certain financial transactions in which a company is involved are properly effected. In particular, being familiar with the provisions of the articles is very important. These formalities, procedures and documents will be discussed below in relation to each of following three aspects of corporate practice:

- the issue of shares;
- the borrowing of money and the granting of security for repayment; and
- restricted transactions (repurchase of shares, guarantees, etc.).

[§6.02] Issue of Shares

1. Initial Proceedings

When asked to incorporate a company, one of the lawyer's duties often will be to prepare the incorporation agreement, by which the incorporator agrees to subscribe for one or more shares of the company. The lawyer will also prepare the notice of articles which sets out the names of the first directors of the company. The allotment and issue of shares is then usually effected through a directors' resolution consented to in writing or, if the client wishes, by a meeting of the directors.

The process for issuing a share is:

1. The shareholder subscribes.
2. The company approves the issuance of shares and sets the price. Typically it is the directors who have authority to issue shares and set the price for shares, but not always. The lawyer must check the company's charter documents, carefully read ss. 62 and 63, and also always check for any pre-emptive rights of existing shareholders contained in the articles, a shareholders' agreement, or the Pre-existing Company Provisions that preserve pre-emptive rights for pre-existing companies unless or until the company determines otherwise.
3. The shareholder pays fully for the shares.
4. The company creates a "paper trail" for the payment.
5. The company issues the shares, entering the details in the Central Securities Register (s. 111).
6. The company issues a share certificate representing the shares (s. 107).

The issuance or transfer of any shares must also comply with applicable securities laws. For most private companies an exemption from the registration and prospectus requirements of applicable securities laws is available; however, it is essential for lawyers to confirm the availability of an exemption each time a share is issued or transferred. A detailed discussion of the *Securities Act (British Columbia)* is beyond the scope of this chapter.

2. Kinds of Shares

Section 52(1)(a)(i) authorizes the company to create shares with par value and shares without par value. Most BC companies are incorporated having common shares without par value. For particular purposes—such as financial "silent partner" shares or for income tax planning—preference shares having a par value will be authorized. Preference shares may specify that they will rank ahead of the common shares in some respects, for example the payment of dividends or the return of capital on liquidation. The *Act* does not specifically refer to shares as being common, preferred or preference, but rather refers to special rights and restrictions attached to shares (s. 58).

Section 58 contemplates that different classes of shares may be created having special rights or restrictions. The definition of "special rights or restrictions" in section 1(1) is an inclusive one, and thus many different characteristics can be given to shares. The Registrar of Companies office takes the position that rights attached to different classes of shares may be the same except where one class is designated as preferred or preference, in which case some preference must be apparent from the provisions. The different classes are used to achieve certain business or tax planning results and the special rights must be carefully drafted to ensure that the objectives are achieved.

The importance of attaching special rights or restrictions is illustrated by the proposition that the rights attached to a class of shares apply equally to all shares of that class. In *Muljo v. Sunwest Projects Ltd.* (1990), 60 B.C.L.R. (2d) 343 (C.A.), a shareholder sought priority over another shareholder based upon historic asset contributions to the company. The articles did not provide for any class of shares to have a priority upon dissolution or winding-up and thus the shareholder's argument was dismissed on the basis of s. 59(3), which provides that every share must be equal to every other share, subject to the special rights and restrictions contained in the articles of a company. It may be that subsections 59(5) and 60(5) have overridden this case in that they provide that special rights and restrictions can be binding on or accessible to only some of the shareholders of a class of shares, however the addition of these provisions should not alter the requirement for such special rights and restrictions to be contained in the articles of a company.

Tax planners have traditionally used par value shares to indicate the amount received as consideration by the company from the sale of those shares. Tax planners also specify par value shares to ensure that paid-up capital is not accidentally increased as a result of a transaction; an increase in paid-up capital may result in a taxable deemed dividend to the subscriber. For this reason, par value shares are often used in “roll over” transactions involving tax deferred transfers of property to a corporation. Care must be taken in such transactions to ensure that a directors’ resolution specifies the exact amount of paid up capital for the shares being issued.

For a more detailed discussion of the various types of shares and some examples of special rights and restrictions see *Practice Material: Company*, Chapter 4, Share Capital.

3. Securities Registers and Certificates

The *Business Corporations Act* combines the register of allotments, the register of transfers, and the register of shareholders into one register known as the central securities register, the contents of which are set forth in s. 111. The central securities register must be maintained at the records office of the company (s. 42(1)(d)) or in any other location in British Columbia designated by the directors (s. 111(4)).

While s. 194(3) of the *Act* provides that a share certificate is evidence of ownership of shares, it is the entry of the holder’s name in the security register which, by definition, results in the person becoming a shareholder of the company, and which gives to that person all the rights that flow to shareholders under the *Act* (see ss. 1(1), 194(3) and (4)).

In share acquisitions where a lawyer acts either as counsel for the seller or the buyer, an exhaustive chain of title examination can be undertaken to establish ownership of the shares by a thorough vetting of the security register and the resolutions/minutes of the directors effecting allotments and transfers. It is good practice to ensure that the security register is noted-up concurrently with the preparation of any documents or instruments to effect share allotments or transfers, even before the resolutions/minutes effecting the allotments or transfers are signed. It is far easier to correct the register for those infrequent share allotments/transfers that do not “complete”, than it is to try to create registers or note-up all transfers years after the fact.

Shares issued by a company may be represented by a share certificate or may be uncertificated shares (s. 107(2)). Unless the shares of which a

shareholder is a registered holder are uncertificated shares, a shareholder is entitled, without charge, to a share certificate certifying the number of shares for which he or she is recorded as owner (s. 107(3)). If the company refuses to issue a certificate, an application may be made to court, under s. 230 of the *Act*, for an order directing the company to comply.

4. Form of Share Certificates

It is good practice to review any form of pre-printed share certificate before using it to ensure that the requirements set out in s. 57 have been met. If there are rights and restrictions attached to the shares—such as restrictions on transfer or preference share rights—the certificates must state the rights and restrictions or they must be attached to the certificate or, as is most commonly done, the certificate must carry a “statement” or “legend”, which indicates that there are special rights and restrictions and that a copy of the full text may be obtained at the registered office or records office of the company.

5. Dating of Share Certificates and Other Formalities

The certificate must state the date on which it is issued (s. 57(d)). Use either the date in the resolution authorizing the issue of the certificate, or an “as of” date. The share certificate cannot be considered as issued until an appropriate director or officer has signed it (s. 110). In public companies, signatures are mechanically reproduced and a counter signature endorsed on the certificate by the transfer agent (s. 110(b)).

6. Lost Share Certificate

Section 109 states that s. 92 of the *Securities Transfer Act* applies to lost or destroyed share certificates. Under s. 92 of the *Securities Transfer Act*, a company must issue a new share certificate to the owner who claims that a share certificate has been lost, destroyed or wrongfully taken, if the owner:

- makes the request for replacement before the company receive notice that the lost, destroyed or wrongfully taken share certificate has been acquired by a protected purchaser;
- provides the company with an indemnity sufficient in the company’s judgement to protect the company from any loss that they may suffer by issuing a new certificate; and
- satisfies any other reasonable requirements imposed by the issuer.

The usual practice is to obtain a statutory declaration as well as an indemnity from the person who requests the replacement certificate.

7. Price for Shares

Section 64(3) provides that a share is not fully paid for until the company has received full consideration for it in past services performed for the company, property or money. Under s. 63(2)(b), par value shares must be issued at a price set by a directors' resolution and equal to or greater than the par value. Where shares are without par value, s. 63(1) requires that the issue price be set in the manner contemplated in the articles, or if not contemplated in the articles, by a directors' resolution (or special resolution for pre-existing companies).

Section 72(1) of the *Act* provides that on the issue of shares without par value, an amount equal to the issue price for those shares is added to the capital of a company, unless the shares were issued for property, in which case it is an amount not greater than the issue price for those shares. Section 72(2) provides that additional amounts can be added to the company's capital by a directors' resolution or ordinary resolution. Section 72(3) states that when par value shares are issued an amount equal to the aggregate of their par value is added to the capital of that class or series.

8. Non-Cash Consideration for Shares

Where the number of shares issued by a company increases without a corresponding increase in the value of the assets of the company, the value of the existing shares will be diluted. Thus, where shares are to be paid for by way of consideration other than cash, s. 64(4) requires that the value of property or past services be an amount set by resolution of the directors that is in all the circumstances of the transaction no greater than fair market value. While it is sometimes difficult to determine the fair market value of non-cash consideration, the evil which the section was intended to prevent is far worse; for example, the allotment of shares in exchange for past services or property which have no relation whatsoever to the "fair" value of shares.

The language of the resolution authorizing the issue of shares for a non-cash consideration should fully describe the nature of the property or past services exchanged for the shares and must set out a determination by the directors of the money equivalent received by the company. It is also advisable for the directors to fix the fair market value of the consideration at the actual fair market value, rather than at some other value, for both tax and business reasons.

In *Pioneer Distributors Ltd. v. Bank of Montreal* (1994), 97 B.C.L.R. (2d) 143 (S.C.), a complicated restructuring was challenged on the grounds (among others) that the fair market value of the property exchanged for the shares had been incorrectly determined by the board of directors. In the circumstances of this case, the judge held that it was nearly impossible to set an accurate amount as being fair market value within the normally accepted meaning of the concept and agreed to a range of error, which was significant. However, an important factor in the case was that no member of the public could become a shareholder or a creditor as the company had been established to assist in the restructuring of a corporation.

9. Limitation of Liability

Under s. 87(2) of the *Act*, the liability of a member for a share held is limited to the amount actually agreed to be paid for the share.

10. Payment for Shares/The Paper Trail

Section 64(2) requires that every share must be fully paid for before it is issued. The *Act* provides that each director is to be jointly and severally liable to compensate the company and any shareholder for any loss sustained by reason of an allotment or issue in contravention of s. 63(2)(b) or s. 64 (s. 154(2)). While section 64 does not purport to say that shares issued in contravention are a nullity (*Davidson v. Davidson Manufacturing Co. (1977) Ltd.* (31 August 1978), Vancouver C776454 (B.C.S.C.) endorsed in *Oakley v. McDougall* (1987), 37 B.C.L.R. 31 (C.A.)), non-payment for shares before they are issued may render the allotment and issue of the shares invalid. Consequently, it is good practice to provide a proper "paper trail" in the directors' resolution that allots and issues the shares, that is, acknowledgment of receipt from or on behalf of the applicant for the shares of all consideration receivable by the company in full payment for the shares. It may help to prepare and sign an application for the shares indicating that a cheque in payment is attached and to remind the client to deposit the cheque that was drawn to pay for the shares into the company's bank account.

11. Partly Paid Shares

Before 1973, shares could be issued before the company received the full consideration for them. This resulted in what was known as partly paid shares upon which "calls" or "assessments" could be made. Sections 88 and 89, which preserve the concept of partly paid shares, only apply to companies incorporated before 1973.

12. Commissions and Discounts

Subsection 67(1) authorizes payment of a reasonable commission or the allowance of a reasonable discount to a person in consideration of the person purchasing or agreeing to purchase or procuring or agreeing to procure, purchasers of its shares. Directors who vote for or consent to a resolution authorizing a commission or discount contrary to s. 67 are jointly and severally liable to the company to make good any loss or damage s. 154(1)(b).

13. Restrictions on Subsequent Allotments

When allotting shares at any time following the initial issue of shares, the lawyer must ensure that all sections of the *Act* (as well as the articles) respecting subsequent allotments are complied with.

Section 41(1) of the *Company Act* provided that, before allotting shares, the directors had to offer them *pro rata* to all members as a pre-emptive right. There is no similar requirement under the *Act*; however, the *Business Corporations Act* contemplates that the pre-emptive right will continue to apply to pre-existing companies unless the articles state otherwise: see the “Pre-existing Company Provisions” (PCPs in Table 3 of the Regulations). This shows the importance of using a properly prepared set of articles, particularly for public companies.

Many companies have similarly worded provisions in their articles to ensure that each shareholder will not suffer dilution of his or her percentage equity without having the opportunity to preserve it by subscribing for more shares.

The PCPs establish a minimum period of seven days within which shareholders can accept their entitlement. The usual practice in allotting shares in companies in which the shareholders are not quarrelling is to provide for a waiver of the right to receive the *pro rata* entitlement every time shares are allotted. A general waiver is prohibited (PCP – P13, but a specific waiver is permitted under P14) and the *pro rata* entitlement rules do not apply to public companies. Care should be taken in the form of a waiver; a signed waiver referring to a specific allotment at a specific price and referring to ss. 40(1) and (4) of the *Company Act* has been judicially approved (*Milburn v. Copperbank Resources Ltd.* (1975), 58 D.L.R. (3d) 138 (B.C.S.C.)).

14. Transfer of Shares

Many of the provisions of the *Act* dealing with the transfer and transmission of shares were repealed in conjunction with the coming into force of the *Securities Transfer Act*, which now generally governs the transfer of securities, other than transfers effected under ss.227, 291 or 300(7) (s. 106.1). The *Securities Transfer Act* establishes a complex scheme for the transfer of, and taking security in, share certificates and other securities. A discussion of the taking of security interests in shares and other securities is beyond the scope of this chapter and will not be addressed.

Section 17 of the *Securities Transfer Act* provides that a person acquires a security if they are a person to whom a security is delivered. Delivery of a certificated security to a purchaser occurs when:

- the purchaser acquires possession of the security certificate;
- another person acquires or acknowledges holding the security certificate on behalf of the purchaser; or
- a securities intermediary, such as a clearing agency or a brokerage, acquires possession of the security certificate, in registered form, and the security certificate is registered in the name of the purchaser, payable to the order of the purchaser, or specially endorsed to the purchaser (*Securities Transfer Act* s. 68(1)).

Delivery of an uncertificated security occurs when the company registers the purchaser as the registered owner, or another person either becomes the registered owner on behalf of the purchaser or, if previously registered as the owner, acknowledges that they hold the uncertificated security on behalf of the purchaser (*Securities Transfer Act*, s. 68(2)).

Sections 71 through 76 of the *Securities Transfer Act* deal with the endorsement of securities. An endorsement may be in blank or special (*Securities Transfer Act*, s. 71). A special endorsement is an endorsement which specifies to whom the security is to be transferred or who has the power to transfer the security (*Securities Transfer Act*, s. 71(3)). An endorsement may appear on the share certificate or as a separate document (s. 1(1)). Most share certificates contain such an instrument on the reverse.

An endorsement of a security does not constitute a transfer until the delivery to the purchaser or the purchaser’s agent of:

- the security certificate on which the endorsement appears, or
- both the security certificate and the

document on which the endorsement appears, if they are separate documents (*Securities Transfer Act*, s. 73).

If a share certificate in registered form is delivered to a purchaser without the necessary endorsement, the purchaser has an enforceable right to the shares represented by the certificate, as against the transferor and has a specifically enforceable right to have the necessary endorsement supplied, but is not protected against other adverse claims to title in the shares (*Securities Transfer Act*, s. 74).

According to s. 86 of the *Securities Transfer Act* a company must enter the name of the transferee in the company's securities register upon receiving a share certificate with a request to register a transfer, in the case of a certificated share, or upon the receipt of an instruction to register an uncertificated share, provided the conditions of s. 86(1) of the *Securities Transfer Act* have been met. If a company has a duty to register the transfer of a share under s. 86(1) of the *Securities Transfer Act*, the company is liable to the person presenting the certificated share or instruction for registration, or that person's principal, for any loss resulting from an unreasonable delay in registration or the failure or refusal to register the transfer (*Securities Transfer Act* s. 86(2)).

As explained later, the articles of most private companies contain restrictions on transfer, which require that the shares must first be offered to existing shareholders. Shareholders' agreements will typically contain similar restrictions on transfer and may require either the shares to be offered to the parties to the shareholders agreement or the consent of the parties to the shareholders' agreement to be obtained prior to the transfer of shares. Usually, in non-contentious situations, an application to transfer is prepared which includes a waiver of this requirement.

15. Restrictions on Share Transfers

When preparing the documentation to provide for a transfer of shares, the lawyer must ensure that all sections of the *Act* are complied with and that all provisions in the articles dealing with the transfer of shares are complied with.

The articles of most private companies prohibit the transfer of shares except with the approval of the directors. This restriction is required in order for the company to avail itself of the "private issuer" exemption under applicable securities laws. The restriction also ensures that those who own the company can limit shareholders to the people of their choice (for example, an astute business acquaintance but not necessarily his or her spouse or children). A restriction on transfer effectively

precludes a shareholder from selling his or her shares to an unknown or disliked buyer. The authority for the directors having the absolute right to refuse to approve a transfer of shares, if there is a properly drawn provision in the articles, is well rooted in Canadian and British case law.

It is important to be thoroughly familiar with a company's articles, not only to be aware of the restrictions on transfer, if any, but also to be cognizant of other peculiarities in the articles that might have an impact on corporate finance. This is particularly true when the corporate records have been transferred from another lawyer's office, as the articles in use in BC are not consistent on these matters.

16. Transmission

"Transmission" refers to the process by which shares are involuntarily transferred, such as occurs following the death or bankruptcy of a shareholder. Section 118 sets out the items that the company must ask for when the personal representative, for example the executor, requests a transmission of shares. One practice is to transmit the shares into the name of the executor first, and later, when the estate is settled, transfer the shares to the beneficiary. Alternatively, it is possible for the company to transmit the shares to the executor and then immediately transfer the shares to the beneficiary, in one resolution. The important thing to note is that the company is bound to record the transmission provided that the requirements of s. 118 are met, while the transfer of the shares to the beneficiary is subject to all the usual procedures for, and the usual restrictions on, the transfer of shares of that company.

17. Conflicts

Practitioners must be careful when taking instructions from majority shareholders that they do not act in such a way as to prejudice or oppress minority shareholders. The best interests of the company are not necessarily those of the majority shareholders and the first duty of the company's lawyer is to the company. In fulfilling this duty, a lawyer must make sure that all the directors are properly advised so that they may make informed decisions. Where the situation becomes litigious, the company's lawyer must be vigilant in acting only for the company; see *Mottershead v. Burdwood Bay Settlement Company Limited*, [1991] B.C.W.L.D. 2113 (S.C.).

[§6.03] Borrowing and Granting of Security

1. Introduction

Those lending money to companies usually retain a lawyer to assist in preparing the security documentation. The lender's lawyer should ensure that the company has the power and capacity to borrow and should prepare proper security documents, which contain all of the necessary provisions to permit the lender to enforce its security. The borrower's lawyer is usually retained because the borrower wishes to ensure that the lender is not getting more security than was agreed upon. Whether one is acting for a lender or a borrower, the subject of opinions becomes very important and will be discussed under a separate heading later.

2. Capacity to Borrow

Before the 1973 revisions to the *Company Act*, a company's memorandum set out elaborate objects and generally adopted all of the powers given to companies by s. 22 of the *Companies Act* then in force. The 1973 revisions to the Act supposedly cured all problems pertaining to the power to borrow for the purpose of carrying out a company's objects because every company was (in theory) given the power and capacity of a natural person (s. 30). However, when preparing security documentation for lenders, there are two anomalies to note. Under s. 33 restrictions can be placed in the articles regarding the business to be carried on by a company as well as on its powers.

3. What the Lender's Lawyer is Looking For

The lender's lawyer will

- conduct searches at the Corporate Registry and Personal Property Registry, and obtain certified copies of the articles and notice of articles;
- peruse the searches to note any existing charges on assets which he or she is instructed to charge;
- obtain instructions as to whether any encumbrances which exist will be "permitted" or must be discharged or postponed to the charge he or she is preparing;
- peruse the memorandum: if the company is a pre-1973 company, the lawyer will decide whether it has the power and capacity to borrow; if there are restrictions and he or she has doubts, the lawyer may request that the memorandum be "rolled-over" to eliminate any capacity problems;

- peruse the articles looking specifically for a power in the directors to borrow and the restrictions, if any, on execution of documents and use of seal; and
- prepare an enabling resolution sanctioning the borrowing.

This will all be done even though s. 421 states that no person is deemed to have notice or knowledge of the contents of any document concerning the company by reason only that the document has been filed with the Registrar of Companies (that is, at the Corporate Registry). The procedures are undertaken because they have evolved as being prudent practice in lending situations. Also, in lending situations, extensive communication between the lawyer and the loan officer is not the norm; in other words, there may be knowledge of certain matters pertaining to the company not known to the lawyer or the person giving instructions, but known to the person who approved the transaction on behalf of the lender.

4. Opinions

The lender's lawyer will usually require that the borrower's lawyer provide an opinion. The lender's lawyer will rely on this opinion to some extent in giving an opinion to the lender. The borrower's lawyer's opinion is usually drafted by the lender's lawyer to include statements that the company is duly incorporated, validly existing and in good standing, and has the power and capacity to borrow; that all steps have been taken to authorize the borrowing; and that the security documents have been validly executed and delivered and are binding on the company.

The practice in Vancouver with regard to the borrower's lawyer's opinion is not uniform. Some lenders' lawyers feel that such opinions are superfluous, in that the lender's lawyer has done all the background investigation to assure himself or herself of everything expressed in the borrower's lawyer's opinion. One reason for asking for such opinions is to involve a lawyer in the transaction who will be present when the documents are executed, explain them to the client and ensure that they are properly executed. Efforts at establishing a uniform approach to the form and content of such opinions have been undertaken by a committee established in part by the CBABC and the Law Society and reference should be made to "Legal Opinions: Standard Form Security Instruments" prepared by the Solicitors Legal Opinion Committee, and produced in *Benchers Bulletin*, November 1989 at page 7 and subsequent updates to such forms.

5. Registration of Charges

Registration of charges is governed by the *PPSA*, which is discussed in detail in Chapter 3 of the *Practice Material: Commercial Law*.

Before the *PPSA* came into force, mortgages, debentures and other security instruments executed by companies were filed with the Registrar of Companies, unless the charge pertained solely to motor vehicles, in which case it was filed at the Central Registry. Since charges registered under the old system are continued perfected under the *PPSA*, documents filed with the Registrar of Companies are still important to determine priorities and the capacity of a company to incur debt.

One of the most significant practice differences resulting from the *PPSA* is that the Personal Property Registry is a notice registry rather than a document registry. Thus, the document creating the security is not registered, but notice of the document and the collateral charged are registered.

Another important practice point resulting from the *PPSA* is the ability of a company to grant a purchase money security interest (PMSI). A PMSI creates a priority over all charges previously granted with respect to goods, which are acquired by use of this security interest. Thus, the PMSI concept permits borrowers to finance specific acquisitions in the face of previously granted security agreements, without seeking the security holder's permission. Note, however, that general security agreements may contain covenants by the company not to create indebtedness by a PMSI, with the result that if the lender's consent is not obtained the company may be in default under the general security agreement.

6. Debentures

Before the *PPSA*, it was the practice of lenders to require a corporate borrower to grant security over its assets by way of fixed and floating charge debentures. Since the *PPSA*, the practice has changed and at present, almost all lending institutions in British Columbia use general security agreements rather than debentures as means of obtaining a fixed and floating charge on a borrower's assets. Debentures are still widely used in public offerings of secured debt and in other situations where there are multiple lenders. In these cases, the debentures are commonly issued under a trust deed that contemplates that the lenders will act in concert, through a trustee.

[§6.04] Restricted Transactions/Loan and Financial Assistance

1. Introduction

Notwithstanding the natural person concept inherent in s. 30, a company can undertake a number of transactions only if certain qualifying tests have been met. Otherwise, such transactions are prohibited. While the *BCA* has eliminated many of the restrictions found in the *Company Act*, it is instructive that the former restrictions be identified so that there is an understanding of the case law in the area and the problems formerly faced by practitioners.

The *Company Act* imposed a solvency test which prohibited the giving of financial assistance if the company were insolvent or if giving the financial system would render it insolvent. That provision was not carried forward into the *BCA*.

One of the most confusing provisions of the *Company Act* was s. 103 which was a general prohibition against giving financial assistance; this included giving a loan, giving a guarantee or providing security. In particular, the rule prohibited a company giving assistance to someone for the purchase of shares of the company or for any other purpose unless there were reasonable grounds for believing the financial assistance was in the best interests of the company. While there were a number of specific exceptions, these were cumbersome and difficult to work with.

The elimination of these issues does not mean that directors need not be concerned to inquire as to the benefits to the company or its solvency before authorizing financial assistance. Directors still need to consider their obligations under s. 142 to act in the best interests of the company. For example it is difficult to conceive of a circumstance where financial assistance would be in the interests of the company if giving it would render the company insolvent.

The *BCA* has eliminated many of the restrictions found in ss. 102 and 103 of the former *Company Act* in an effort to provide for more flexible financing arrangements and eliminate "red tape".

2. Reasons for Restrictions

The underlying reason for restrictions is that those lending money to or investing money in companies ought to be protected against the company embarking on transactions that are not undertaken for the purpose of earning profits. Under the *Companies Act* in force before 1973, companies were generally prohibited from purchasing or "trafficking" in their shares.

3. Authority for Purchase or Redemption of Shares

A company may only purchase or redeem its shares if

- the shares have a right of redemption attached to them (s. 77(a)); or
- the company is authorized by its articles to purchase its shares (s. 77(b)), and

if the applicable solvency test set out under sections 78 or 79 is met.

4. Solvency Test

Sections 78 and 79 prohibit the redemption, purchase or other acquisition of shares if the company is insolvent or if the redemption, purchase or acquisition would render the company insolvent. Insolvent means the inability of the company to pay its debts as they become due in the usual course of business (s. 1(1)).

When the date that the purchase is approved is not the date that the purchase is affected, the question arises as to when the solvency test is to be applied. In *Nelson v. Rentown Enterprises Inc.* 96 D.L.R. (4th) 586 (S.C.), a corporation agreed to purchase its own shares in exchange for certain land and premises. At the time that the purchase was entered into, the corporation was solvent; however, prior to the closing of the transaction, the corporation became insolvent. The question before the court was whether the solvency test in the equivalent sections of the *Canada Business Corporations Act* was to be applied at the time of entry into the agreement or at the time of completion. The court held that the solvency test must be applied at both dates, that is when the agreement was made and also at the time of performance. The court reasoned that the limitation on the corporation's power to purchase its own shares was intended to protect creditors and other shareholders from share purchase arrangements that may prefer one or more shareholders in an insolvency situation. The finding that the solvency test must be applied at both dates has been upheld in British Columbia in *Lin v. Lee*, [1996] B.C.W.L.D. 2010 (S.C.), which also held that a redemption agreement made at the time the company is insolvent or which would render the company insolvent, is intrinsically illegal and cannot be interpreted in any other way, regardless of whether the parties are unaware of the contravention at the time. The *Lin* case may have been reversed by the effect of s. 78(3), but once again the obligation of directors to act honestly and in good faith and in the best interest of the company embodied in s. 142 results in personal exposure to the directors even though s. 78(3) would have saved what was otherwise an invalid transaction.

5. Requirement to Purchase Pro Rata

The *Act* continues an important concept from the previous legislation in providing that an offer to purchase shares must be made rateably to every member who holds shares in the class. This concept continues to apply to all pre-existing companies (i.e. companies incorporated prior to the coming into force of the *Act*) until it alters its notice of articles (see the PCPs – Table 3 of the Regulation). For companies incorporated after the *BCA* came into force, the concept, as well as other concepts found in the former legislation (and generally viewed as minority shareholder protections), will be optional and in the hands of the drafter of the articles. Thus most practitioners will have developed an extremely detailed checklist of questions to discuss with clients forming multi-shareholder companies as to whether these protections are to apply to these shareholders or not.

The PCPs also provide that a redemption or repurchase of shares must be made rateably unless the articles provide otherwise, once again showing the heightened importance in the drafting of articles.

The PCPs (and the protective devices) are intended to protect minority shareholders by ensuring that the majority cannot redeem or repurchase significant amounts of equity while leaving the minority shareholders “holding the bag” (*Dusik v. Newton* (1984), 50 B.C.L.R. 31 (S.C.)).

6. Provision of Financial Assistance and Guarantees

One of the most significant changes in the *Act* is the elimination of many of the restrictions contained in the *Company Act* pertaining to a company providing financial assistance. These sections generated more litigation than any other with the exception perhaps of the relief from oppression sections.

The *BCA* provides that a company may give financial assistance to any person for any purpose by means of a loan, guarantee, the provision of security or otherwise (s. 195(2)). Aside from the elimination of a large number of difficult provisions in the former *Company Act*, a major change inherent in the *Act* is the elimination of personal liability for directors if a company provides financial assistance at a time when it is insolvent.

7. Lawyers Obligations when Reviewing Security Documents

Even though the merit of problems found in sections 102 and 103 of the former *Company Act* have been eliminated by the broad sweep of section 195(2) of the *Act*, lawyers should be vigilant in their review of documentation submitted by legal counsel for a lender.

When lenders are taking security that includes the guarantee of another company for the debt, lender's counsel will often prepare a resolution for the company giving the guarantee, which recites that the directors have determined that the giving of financial assistance is in the best interests of the guarantor. This is somewhat of a "hold over" from the provisions of the *Company Act*, which required in certain instances that directors determine that the giving of the financial assistance was in the best interests of the grantor. When acting for a guarantor, one ought to understand the basis for the directors reaching this decision. When the companies are affiliated or associated, the connection is clear; in other cases it is not. The directors cannot conclude that giving financial assistance is in the best interests of the guarantor, unless there are reasonable grounds for believing the financial assistance is in the best interests of the guarantor. In reaching such a conclusion, directors can rely on the protection afforded by the "business judgement rule"; in most cases, the courts will not look behind the business decisions of directors who have acted fairly and reasonably.

8. Disclosure Requirements of Section 195

The *BCA* provides that where a company has provided material financial assistance, the fact must be disclosed if the financial assistance is or was given to a shareholder, a director, an officer or an employee of the company or an affiliate or any of their associates or to any person for the purpose of a purchase by that person of a share of the company or an affiliate (s. 195(3)).

The disclosure must be contained in a "written record" in the company's records office and is to be made before or promptly after the giving of the financial assistance. The written record must be in a consent resolution of the directors, the minutes of a directors meeting at which the giving is authorized or in the minutes of the directors meeting that follows the giving of the financial assistance (s. 195(7)). The disclosure must include a brief description of the nature and extent of the assistance, together with amount of and the terms on which it was given (s. 195(6)).

Section 195(4) sets forth exceptions to the requirement to make disclosure. A company need not make disclosure under subsection (3) in respect of financial assistance that is given:

- a. in the ordinary course of business if the lending is part of the ordinary business of the company;
- b. on account of expenditures incurred on behalf of the company;
- c. to a parent by a wholly-owned subsidiary and vice versa and among certain other related companies;
- d. to employees to purchase or erect living accommodations; and
- e. to employees in accordance with an employee share purchase plan.

It would be prudent to keep a resolution approving financial assistance separate from other resolutions of the directors to preserve the confidentiality of such other resolutions. A court can make an order dispensing with the requirement to make the disclosure where this might involve business details and information that could harm the company.