The C & D Newsletter

Citron & Deutsch
A Law Corporation

Published by:
RICHARD K. CITRON
DAVID R. DEUTSCH
MICHELLE LeCOLST-JOHNSTON
Attorneys

CAPITAL STRUCTURE OF A NEW CORPORATION

The founders of a new corporation must address the crucial issue of structuring the capitalization of the corporation. After determining the amount of money the corporation will need for fixed assets, materials and operating expenses, the founders must then decide whether to finance the corporation with debt or equity, the proportion of debt and equity, and the rights, preferences, privileges and restrictions of the stock. This Newsletter shall discuss the advantages and disadvantages of debt vs. equity, and the various features of each.

Debt Financing.

Advantages. From the corporation's point of view, the principal advantage of debt over equity is that the corporation can deduct interest payments on the debt contributions. For the investor, debt has the following advantages: (a) the time and amount of repayment can be specified; (b) the repayment of principal is not a taxable event; (c) debt has repayment priority in liquidation over equity contributions; and (d) there is less risk of vicarious liability for corporate obligations under an "alter ego" theory.

Disadvantages. The principal disadvantage to debt is that the corporation has to make fixed periodic payments of principal and interest, thus draining the corporation's cash flow, and a fixed repayment upon maturity, without regard to the corporation's financial strength at that time. In addition, institutional leaders will ordinarily require the founders to subordinate their debt to institutional financing, and may refuse to loan money to the corporation at all if there is a large amount of debt to private parties since institutional lenders typically enforce minimum debt to equity ratios. Finally, if the corporation is thinly capitalized, that is, if the debt to equity ratio is too high, the Internal Revenue Service may recharacterize the debt as equity. In such event, all prior payments of interest to the shareholders will be treated as non-deductible shareholder dividends. This typically results in a substantial corporate tax deficiency for all tax years not barred by the statute of limitations. The reclassification of debt as equity may also terminate S corporation status because an S corporation is only permitted to have one class of stock. For the investor, the principal disadvantage of debt financing is the inability to share in the profits of the corporation.

Equity Financing.

Advantages. From the investors standpoint, equity financing's principal advantage is that it permits the investor to share in the growth of the corporation. Stock ownership also gives the investor voting rights to determine matters of significance in the corporation. For the corporation, equity financing: (a) gives the corporation a greater equity base, permitting it to increase its credit rating and borrowing capacity; and (b) avoids the problem of subjecting the corporation's capital from demands for repayment at inconvenient times.

Disadvantages. The principal disadvantages of equity to the shareholder are that: (a) there is no fixed time or amount for repayment; (b) repayment of equity as a dividend to the shareholder is not deductible to the corporation, and is fully taxed to the shareholder as ordinary income; and (c) creditors have priority over shareholders in liquidation.

Types of Equity Securities.

In general, there are two types or classes of stock - common stock and preferred stock. All shares within a particular class of stock must have the same rights, preferences, privileges and restrictions. Most start up companies have a single class of stock. However, in certain circumstances, such as when there are several initial investors, but a small group of insiders (for example, family members) requires voting control, the creation of two classes of stock may be indicated. The participation of venture capitalists may also create the need for two classes of stock. An S corporation may have only one class of stock.

Common Stock. Common stock has unlimited voting power, no fixed dividend, is not subject to mandatory redemption by the corporation, and is entitled to share in the proceeds from corporate liquidation only after all creditors and holders of preferred stock have been paid.

Preferred Stock. Preferred stock has certain rights, preferences, privileges or restrictions which distinguish the shares from common stock. There may be more than one class of preferred stock, each with its own rights, preferences, privileges or restrictions. Preferred stock is useful for allocating control between owners who will be active in managing the corporation and owners who are investors only. The following illustrate some of the possible features of preferred stock:

Voting Rights. Preferred shares may carry full voting rights equal to the common shares, the right to vote only on specified matters such as dissolution or the issuance of a new class of shares, or contingent voting rights which are activated only upon specified events. Typically, contingent voting rights give the preferred shareholders the right to elect some or all of the directors when the corporation fails to pay dividends for a stipulated period.

Dividend Preference. Preferred stock generally has a fixed, preferential dividend payable at specified periods (usually quarterly). The dividend may be: (a) "cumulative" or "noncumulative", with cumulative preferred stock being entitled to be paid the full amount of the dividend for all previous periods before the common stock is entitled to receive any dividend; (b) "participating" or "nonparticipating", with participating preferred stock being entitled to further dividend distributions after payment of the preferred stock dividend; or (c) any combination of the foregoing.

Liquidation Preference. Preferred stock typically is given the right to receive a specified amount per share in any distribution of assets on dissolution of the corporation, prior to any distribution to shareholders holding common stock.Redemption Provisions. Preferred stock may be redeemable at the option of the corporation, upon the occurrence of specified events or a specified period of time, or at the option of the shareholder. In order to establish an orderly and regular program for redeeming shares, the corporation may establish a "sinking fund", which is a separate corporate account in which funds are set aside for the specific purpose of repurchasing preferred stock.

Conversion Rights. A conversion right gives the holder of the preferred stock the right to convert the preferred stock into a fixed number of shares of common stock. Typically, the conversion right contains protection against dilution by providing that the amount of common stock acquired upon conversion is adjusted if the common stock is split, reclassified or changed, or there is a new issuance of common stock at a price less than the fair market value thereof, or less than the conversion price.

Other Rights or Restrictions. Preferred stock may have "preemption rights", which are rights to purchase new securities before they can be sold to anyone else, and may be subject to restrictions on who may hold preferred stock, or restrictions on transfers of shares.

Summary.

The capital structure of a corporation is one of the most important decisions faced by the founders of the corporation. The determination of whether debt or equity is preferable, and the types, features and proportion of each, depends upon a variety of considerations, including the availability of funds, the desires of the investors, the cost of financing, the distribution of corporate control, and tax considerations. Generally, the corporation's attorneys and accountants assist the founders in determining the most advantageous financial structure of the corporation.

This complimentary newsletter is intended to provide general information. Because of the complexities and constant changes in the law, it is important to seek professional legal advice before acting on any of the matters covered herein.