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Discussion

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Discussion After the Speeches of Mr. Bodurtha and Mr. Robinson

**QUESTION, Mr. Stayin:** Mr. Bodurtha said that we ought to have the owner of this company try to maintain control of the company. We also heard that if the venture capitalist does not get the majority of the shares, then he will tie you up with the loan documents to such an extent that he will at least have a veto power. For the novice entrepreneur, what is the likelihood of being able to maintain a majority of the shares?

Suppose you have already borrowed $1 million; you have the operation set up and have done the basic work, but you need to spend $4 million more to get the equipment that will process and make your product. You are up against the wall. Unless you get the $4 million, you will not be able to operate. You find a venture capitalist who says, “Well, you have a good idea. We ought to go ahead with this.” What is your bargaining power?

**ANSWER, Mr. Bodurtha:** My experience has been that there are only a few venture capitalists around who will not insist on control of the business. You will probably have to give up voting control unless you can finance your arrangements through more traditional methods.

If you are buying machinery and equipment, which has real value as a hard asset, and your bankers can take the security interest, you may be able to preserve control of your business as long as it is running smoothly. But I guarantee you that in any sort of start-up situation they will insist that if there is even a hint of default or violation of a working capital ratio or a negative covenant in your loan documents, then they will want to be able to control the board.

It is an extraordinarily difficult situation, particularly for the entrepreneur, who is by his very nature someone who wants to work for himself. However, the solution to this situation is not clear.

**COMMENT, Mr. Robinson:** It is not much different in Canada, but what we have been able to do occasionally is joint venturing on a contract basis, where you don’t have a corporation, you just have an agreement that there is a license that will be used for purpose X. The person with the invention hangs on to that, and the side of the joint venture with the capital and the production or marketing expertise fulfills its obligations under a simple contract. You don’t lose your equity that way, but it is not easy.

**COMMENT, Mr. Bodurtha:** There are venture capital funds of operating businesses, several in Cleveland in fact, which are not so profit motivated that they need a 30% return, given the risk. They are more
interested in having a stable laboratory for developments which relate to their businesses. Even if they insist on voting control, they usually leave the entrepreneur alone. Sometimes they are willing to invest capital, but in effect they will tell you that they don’t want to be bothered with the day-to-day running of the business or the Board of Directors.

**QUESTION, Professor King:** My experience has not been that I had relatives or friends wishing to give me money to put in business — sometimes the reverse. In the unlikely event that a friend or relative wants to invest in a Canadian company that is promoting inventions, does he get the same protections that a Canadian investor would have? In other words, you have a Canadian inventor with a relative in the United States who wants to invest money in Canada. Are there any problems with his investing in that area?

**ANSWER, Mr. Robinson:** No, now that the Investment Canada Act has been stripped down there is no problem due to nationality unless it is a named cultural industry, of which there are very few — book publishing, films, music. There are no restrictions at all on new direct investment, only on acquisitions. As you know from the Free Trade Agreement, the threshold is now very, very high for U.S. acquisitions. The protections are the same, but those may be very slim if the money goes into a private company. In fact, there are no protections if the investment is done under one of the capital exemptions I mentioned previously. There is a real oddity in our securities law, because if you give somebody a piece of paper telling him about his investment, then that is deemed to be an offering circular and the rights that would exist in a true public issue, the right of recission and the right of an action for damages for misrepresentation will arise. Conceivably you could take the investor’s money and not give him any piece of paper, and there would be no offering circular, so the protections wouldn’t arise.

**QUESTION, Professor King:** I have two questions for Jim Bodurtha. First, on the S-corporations, there is a limit of thirty-five shareholders. Suppose you have a partnership that wants to invest in an S-corporation, does that count as one or multiple persons in the S-corporation?

Second, there is a very low U.S. corporate tax rate now, a limited tax rate for individuals, relatively speaking. If the tax rate went back up to its previously high level, would your approach be the same from the standpoint of utilizing an S-corporation?

**ANSWER, Mr. Bodurtha:** Let me respond to the first question. Under most circumstances, if you have utilized the partnership as an investment vehicle in the S-corporation, it would not qualify. There are a few ways it might be possible to do so, but by attribution, each partner would definitely be included as a shareholder. There are transition rules for an S-corporation owned by a family so that if there is a death in the family it ends up in a trust. There are also ways to avoid inadvertently
disqualifying yourself. But on an initial investment basis, the best general advice is that they will be counted as individuals.

The second question is what happens if the individual rates go back up and exceed the corporate tax rates? We didn’t talk about that a great deal. Typically, that is a benefit which, when added to the federal tax break, might get you from my hypothetical seven or eight cents per dollar to something a little bit more than that. So it all depends on where the rates are.

Assuming the tax increase moves you back to where the individual rate is higher than the corporate rate, we still need to remember that at that point in time the S-corporation dollars are in fact out of the company. So it may still make sense to be an S-corporation for other reasons, although it won’t be as compelling as it is today and today’s S-corporations won’t be grandfathered from changing tax rates.

**QUESTION, Mr. Allen:** I think it was Mr. Barton who suggested that in Canada there may be more of a tendency for these companies to be motivated by going public in venture capital operations. I don’t think he was suggesting that it was easier. I think he was just suggesting that that was the motivation, one of the prime reasons for setting these things up in Canada.

I might also add, having had some experience with Les Barton’s operation and knowing that it is based in Canada and is very interested in Canadian investments, that probably about 75% of its investments are in the United States, primarily in California, Massachusetts and Texas because of the dearth of these investments in Canada. It is interesting to note that the chart in the conference materials dealing with the search for financing indicates that California takes 39% of this money in the United States, so perhaps that is one explanation.

The question that I had was really for Michael Robinson. Having enumerated a wide range of financing arrangements of government programs, do you see these as representing subsidies which could become the substance of severe challenges and the possible countervailing duties?

**ANSWER, Mr. Robinson:** The short answer is yes. In Canada we tend to do our subsidizing very publicly. In the United States it is done very cleverly and secretly and buried in budgets so it can never be found. But our politicians, whenever they want to hand out some money, want to have their picture on the front page cutting a ribbon and saying that this is going to do wonderful things for exports. Meanwhile, somebody down in the United States makes a note to get that guy as soon as that product comes south of the border.

I think these government financing programs will be challenged. I have advised my clients that there is a risk that when a product developed with aid from the Ontario Technology Fund hits the U.S. market we may find that there is some material injury there. We are going to have a subsidy claim against us.
QUESTION, Mr. Reifsnyder: I have a question for Michael Robinson. You mentioned that, in Canada, either the government or the venture capital market was the source of development funds. You also mentioned that when the government tried to take a 25% ownership interest, people were outraged and that was ultimately defeated. Were there reasons for that other than the non-traditional aspect of it? Were there specific problems with it? Might that not be an alternative source of venture capital if constructed in the right way?

ANSWER, Mr. Robinson: The particular problem with that was that the government had simply announced them as grants and never suggested this at all. Mr. Gow's predecessor, Pat Laval, dreamed up this idea and it makes good business sense. If we are going to pass out all this money, we want royalties. They backed down on the royalties so that the royalties only apply if the production is outside of Ontario. The idea for the super-profit was totally inconsistent with the concept that these are government research grants designed to stimulate employment and production in Ontario. To suddenly say, "Oh, and by the way, we are a participant in your profits if they go above a certain level" made the recipients of the grants cry foul and say, "You changed the rules." But I am sure we will see it again, both at the federal and the provincial level.

COMMENT, Mr. Blackburn: First of all, we are very sensitive, at the federal level, to the possibility of countervail for the sorts of financial intervention in which the Canadian government is involved. The possibility is always there, but it is something to which we are very sensitive. The Defense Productivity Industry Program, to which you referred, is really the only major direct program in which the Department of Industry, Science & Technology remains involved. Because it is in a defense area, it is not subject to the same risks of countervail as similar programs.

I can't speak for the provinces, but the Department of Industry, Science & Technology has moved very determinedly upstream. Our focus is on precompetitive research and development applications, not the traditional kind of direct, firm-specific support that we found in previous programs.