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A Model for Small Business Financing: The Canada Development Corporation

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A MODEL FOR SMALL BUSINESS FINANCING: THE CANADA DEVELOPMENT CORPORATION

I. Introduction

Development finance institutions which provide equity capital have been used to stimulate economic growth worldwide.[1] The potential uses for equity development finance organizations in the United States have been recognized.[2] Probably the most dramatic use, and one with broad economic ramifications is the establishment of an equity development finance institution to correct imperfections in the private capital market system of this country. One of the major flaws of the American capital market has been that the supply of capital for new small sized businesses has been artificially scarce.[3]

The failure to adequately direct capital to new smaller sized businesses creates high social costs. Empirical research shows that new small enterprises provide a majority of the new jobs in the United States economy.[4] The evidence available also demonstrates that although the smaller sized business is extremely volatile and therefore presents a greater element of risk to investors,[5] the small firm nevertheless promises a higher expected rate of return than do medium or large firms.[6]

The focus of this Note will be, first to examine the reasons that the private capital market has failed to be an adequate source of

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1. *See* B. Daniels & L. Litvak, Innovations in Development Finance 111 (1974) [hereinafter cited as Innovations in Development Finance]; J. Nyhart & E. Janssens, A Global Directory of Development Finance Institutions in Developing Countries (1967).

2. *Proposed Amendments to the Small Business Investment Act of 1958: Hearings on H.R. 12666 Before the Subcomm. on Capital Investment and Business Opportunities*, 95th Cong., 2d Sess. (1978) [hereinafter cited as *H.R. 12666*].

3. *Proposed Amendments to the Small Business Investment Act of 1958: Hearings on H.R. 9549 Before the Subcomm. on Capital Investment and Business Opportunities*, 95th Cong., 2d Sess. 1 (1978).

4. *See* note 9 *infra* and accompanying text.

5. *See* note 22 *infra* and accompanying text. *See also* H.R. 12666, *supra* note 2, at 11. "[I]nvesting in small companies is a very high risk and difficult business." (Testimony of Russel Carson, member, executive committee, National Association of Small Business Investment Companies). *Id.*

6. *See* note 23 *infra* and accompanying text.

equity capital for new small businesses. Second, this Note will review the structure and operations of the Canada Development Corporation, a development finance institution which makes equity investments in the Canadian economy. Finally, this Note will make recommendations as to how an equity development finance corporation modeled after the Canada Development Corporation, could be established in the United States to increase the availability of equity capital for small businesses.

II. Failures of the Private Capital Market

Small businesses comprise ninety-seven percent of all unincorporated and incorporated businesses in the United States.[7] They generate more than half of all business receipts and employ in excess of fifty percent of the American work force.[8] New small businesses provide both a vital source of new jobs in the economy[9] and the potential for a greater than average return to their investors.[10] Because of the many barriers small businesses face in obtaining needed capital,[11] they are placed in an environment in which it is difficult to exist.[12]

In order to maximize growth potential, an enterprise must be able to obtain different types of capital at various stages in its existence.[13] Initially, a small firm may not generate a profit but will nevertheless require a source of cash flow in order to meet operat-

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7. U.S. SMALL BUSINESS ADMINISTRATION, REPORT OF THE SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL FOR SMALL BUSINESS 1 (1977) [hereinafter cited as VENTURE AND EQUITY CAPITAL].

8. *Id.*

9. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 25 ("66% of the 'replacement' jobs are created by enterprises employing fewer than 20 people. More than 50% are generated by small independent firms. *Fully 80% are created by establishments under four years of age.* Relatively few 'replacement' jobs are created by middle-sized or large firms."). *Id.* (emphasis in original). *See also* M. KIESCHNICK, VENTURE CAPITAL AND URBAN DEVELOPMENT 17 (1979) [hereinafter cited as VENTURE CAPITAL AND URBAN DEVELOPMENT].

10. *See* note 23 *infra* and accompanying text.

11. *See* notes 17-40 *infra* and accompanying text.

12. H. HOVEY, DEVELOPMENT FINANCING FOR DISTRESSED AREAS 18-21 (1979) (prepared for the Northeast-Midwest Inst.) [hereinafter cited as FINANCING FOR DISTRESSED AREAS].

13. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 38. If a young firm is foreclosed from obtaining one of these types of capital, it "can have the same effect as depriving a developing organism of a vital nutrient." *Id. See also* B. DANIELS & M. KIESCHNICK, THEORY AND PRACTICE IN THE DESIGN OF DEVELOPMENT FINANCE INNOVATIONS (Working Papers drafted for the Council of State Planning Agencies) 31-32 (1978) [hereinafter cited as 1978 WORKING PAPERS].

ing costs, engage in research and development or acquire plant and equipment.[14] Equity capital is an ideal type of financing for the young firm because it provides the firm with needed funds but does not impose an immediate repayment obligation.[15] Rather, equity investors expect a *pro rata* share once the firm generates income.[16] Debt financing, on the other hand, requires the firm to make fixed periodic payments of interest and principal regardless of profitability and may be a difficult strain on the young firm's limited funds.[17] Moreover, a young firm may find it difficult to obtain debt financing because it frequently has little collateral with which to secure the debt and has no history of earnings performance on which the creditor can rely.[18]

Although equity capital is an attractive means of financing from the perspective of both the investor[19] and the new business,[20] imperfections in the capital market system have all but eliminated equity investments in small companies.[21] There are four main fac-

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14. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 38. Because it is difficult for small new businesses to obtain capital from outside sources, organizers of these entities are forced to rely on personal savings. In a study conducted on 100 small new firms located in four American cities, it was discovered that 81% of start-up capital for these businesses came from the personal savings of its organizers. Kieschnick, *Policies to Support New Businesses*, COMMENTARY, July, 1980, at 22 [hereinafter cited as *Policies to Support New Businesses*].

15. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 38. Because a return need not be repaid immediately, equity is sometimes referred to as "patient money." *Id.*

16. *Id.* In theory, there is no ceiling on the rate of return of an equity investment.

17. *Id.* Debt is precisely the wrong kind of capital for small young firms. The burden of debt service requirements in a cash crunch frequently makes the difference between survival and failure of the firm. Equity capital, because it is more "patient" than debt financing, would allow a business to survive a shortage of cash and to resume profitable growth. *Policies to Support New Businesses*, *supra* note 14, at 23.

18. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 38. Once the firm establishes itself as a profitable entity, it can then begin to rely on debt to a greater extent. *Id.* To insure continued growth and to avoid cash flow problems, however, the repayment period should be spread out over a sufficiently long period of time, and a reasonable debt-to-equity ratio should be maintained. *Id.*

19. *See* note 15 *supra* and accompanying text.

20. *See* note 23 *infra* and accompanying text.

21. It is alarming that venture and expansion capital for new and growing small businesses has become almost invisible in America today. In 1972 there were 418 underwritings for companies with a net worth of less than $5 million. In 1975 there were four such underwritings. The 1972 offerings raised $918 million. The 1975 offerings brought in $16 million. Over that same period of time, smaller offerings under the Securities and Exchange Commission's (SEC) Regulation A fell from $256 million to $49 million and many of them were unsuccessful. While this catastrophic decline was

tors which prevent small firms from obtaining equity capital: first, the risk associated with investment in a small firm; second, the increasingly conservative investment strategy of venture capital firms; third, the high transaction costs faced by a small new firm that is "going public"; and finally, the increased dominance of the securities market by institutional investors.

Investors are unwilling to provide equity to small ventures because of the high risk associated with the investment.[22] Although small entities tend to offer a greater rate of return on investment than do investments in large corporations,[23] the possible range of returns for any individual investment is much greater for a small venture than for its large counterpart.[24] Because investors tend to be risk-averse,[25] they forego the opportunity to invest in small entities with a high profit potential and choose the more stable investment in a large corporation, although it provides a lower rate

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> occurring, new money raised for all corporations in the public security markets increased almost 50% from $28 billion to over $41 billion.

VENTURE AND EQUITY CAPITAL, *supra* note 7, at 1.

22. Litvak, *New Development Finance Techniques*, COMMENTARY, Apr., 1980, at 18.

23. *H.R. 12666*, *supra* note 2, at 11; 1978 WORKING PAPERS, *supra* note 13, at 80-86. For the period 1972-1976, small corporations significantly outperformed all other corporations with regard to the return they provided on equity investments. During this time period, those corporations which had total assets of less than $1 million had an average annual return on equity of 16.2%; corporations with total assets of between $1 million and $5 million dollars had a rate of return of 14.22%; corporations with assets of between $5 million and $10 million dollars returned 12.3%; corporations with assets between $10 million and $25 million returned 11.76%; corporations with assets between $25 million and $50 million returned 11.2%; corporations with assets between $50 million and $100 million returned 11.5%; corporations with assets between $100 million and $250 million returned 11.58%; corporations with assets between $250 million and $1 billion returned 12.48%; and finally, corporations with assets in excess of $1 billion had a rate of return on equity of 12.88%. *Id.* at 80, 83.

24.
> From the point of view of investors, risk arises because of uncertainty about the rate of return that will result from an investment. A venture with more uncertainty (that is, a larger variance) about the expected rate of return is [a] more risky investment. The expected rate of return is simply the weighted average of all possible outcomes. Two investments may have exactly the same expected rate of return, but will differ in risk because of the dispersion (or variance) in possible outcomes around the expected rate of return.

1978 WORKING PAPERS, *supra* note 13, at 44.

25. *Id.* A risk-averse investor is one who is willing to accept a lower return on his investment as long as the risk of the investment is low. A risk-neutral investor, however, will choose an investment based solely on its rate of return. *See also* THE NATIONAL RURAL CENTER, DEVELOPMENT FINANCE: A PRIMER FOR POLICYMAKERS Part I at 15 (1979) [hereinafter cited as DEVELOPMENT FINANCE PRIMER].

of return. By establishing a mechanism which will pool the risks of small companies, it would be possible to provide the investor with the opportunity to obtain an above-average return while eliminating any excess risk which an individual investment presents.[26] A risk-pooling mechanism would reduce the variability of an individual investor's return by spreading the risk among several investors participating in a portfolio of equity investments in many companies.[27]

The second factor which prevents small firms from obtaining equity financing is the current conservative investment strategy of venture capital firms. This strategy has been reflected by a sparse number of equity investments in young firms.[28] Even when venture capital firms[29] invest in profitable young firms, they cannot realize

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26. 1978 WORKING PAPERS, *supra* note 13, at 46-47. The pooling of investments can actually reduce the variability of an investor's overall rate of return as long as the return on the different investments in the portfolio are somewhat independent. The randomness of the returns of the different investments in the portfolio will cancel each other out, thus reducing variablity.

Capital market theorists divide risk into two categories, systematic and non-systematic risk. Systematic risk is the fluctutation in the return of investments that is caused by swings in the national economy. Pooling of investments will have no effect on eliminating systematic risk. Non-systematic risk, however, is the variability of return on investment that is unique to that investment. It is the non-systematic risks in a portfolio that are offset by holding several investments in a portfolio. *See also* INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 19-20.

27. 1978 WORKING PAPERS, *supra* note 13, at 45. Spreading risks over a large population effectively lowers the potential loss (or gain) any individual faces. *See generally* INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 20; DEVELOPMENT FINANCE PRIMER, *supra* note 25, part I at 15; FINANCING FOR DISTRESSED AREAS, *supra* note 12, at 53. The Council of State Planning Officials has suggested that a "National Venture Capital Mutual Fund" be created, which would serve as a risk pooling device used to stimulate added investment by venture capitalists in new small businesses. FINANCING FOR DISTRESSED AREAS, *supra* note 12, at 53.

28. *See* note 32 *infra* and accompanying text. According to the Small Business Administration Task Force:

> Most venture capital firms have adopted a policy of staying away from start-ups and have put their available capital in safer and more liquid investments. The Task Force believes this steady shift towards a more conservative investment policy comes from perceived difficulty in recycling investment funds as restrictions on the access of small and growing business to the public securities markets has become more costly and difficult.

VENTURE AND EQUITY CAPITAL, *supra* note 7, at 7.

29. It should be noted that in addition to venture capital firms, small business investment companies also specialize in investing in small companies. *See* The Small Business Investment Act, 15 U.S.C. § 661 (1976). In 1977 approximately 300 Small Business Invest-

the appreciated value of their investment because the equity interest in such firms is usually not marketable.[30] Because it is so difficult to sell equity investments in small firms to secondary buyers, venture capital does not provide an adequate source of funds for small corporations.[31] By 1975 only five percent of venture capitalists' investments went to start-ups of new ventures.[32]

The third factor inhibiting equity investment in small firms is the high transaction costs incurred by a small firm when it goes public.[33] The high costs of registration will very often be the single factor which prevents a small company from issuing securities on the public market. A review of six of the smaller offerings by companies with assets of less than five million dollars in 1976 shows an

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ment Companies (SBIC's) with a total private capital of $400 million were in operation. Turner, *SBICs, MESBICs and Conflicts of Interest*, 36 FED. B.J. 185, 187 (1977). There has been a recent trend, however, for SBIC's to provide debt rather than equity to small businesses. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 12.

30. VENTURE CAPITAL AND URBAN DEVELOPMENT, *supra* note 9, at 49-50.

> Venture capitalists are the sector of the capital markets most oriented to financing new companies. When they invest in a new company, they typically provide equity in order to have the possibility of high returns to cover losses on many of their investments. While the definition of equity is the right to a share of new income, very few young firms pay out any of their net income as dividends to stockholders, choosing instead to retain the earnings for investment. Hence the venture capitalist who has invested equity does not reap the high return through dividends but by selling, at some future time, his shares — his right to future income. In the late 1960's, venture capitalists were able to sell their shares in young companies at high multiples of their initial investment because many firms they had financed were able to 'go public.' This means that the firm sold its shares to a large number of investors who then were able to trade them on 'public' stock exchanges such as the American Stock Exchange or the New York Stock Exchange. This mechanism provided the liquidity needed for the venture capitalist to reap a profit.
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> For most of the last decade, an extremely small number of companies has been able to go public for a number of reasons:
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> *First*, investors are more concerned about risk than a decade ago. *Second*, the stock market is generally lower, which means that investors will pay a lower price for the right to share in earnings of *any* company. *Third*, a number of investment bankers who specialized in helping young companies go public have failed or been acquired by larger firms. Hence, *most young companies are deterred from going public at all. For those few firms who do go public, capital is significantly more expensive than a decade ago.*

Id. (emphasis in original).

31. *H.R. 12666*, *supra* note 2, at 12.

32. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 7.

33. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 39-42.

average registration cost of $122,350.[34] The high cost of registration[35] will have a greater adverse affect on a small company seeking to obtain capital through the issuance of securities than it will for a large corporation. The small firm suffers a greater burden than the large firm because the costs associated with registration represent a higher percentage of the small firm's total underwriting proceeds.[36]

Finally, the increased dominance of the securities markets in this country by institutional investors has also made it less feasible for small businesses to "go public" as a means of financing operations or expansion.[37] The institutionalization of the stock market has put a small business which wishes to obtain capital in the market in the position of having to appeal to a professional investor with vast sums of money and limited time to review investment choices.[38] In addition, the institutional investors handling pension funds must abide by the strict standards of the 1974 Employee Retirement Income Security Act ("ERISA").[39] Fear of possible liabil-

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34. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 4.

35. Green & Brecher, *When Making A Small Public Offering Under Regulation A*, 26 PRAC. LAW. 25 (1980). Regulation A, 17 C.F.R. §§ 230.251-.262 (1980), which applies to the sale of securities up to $1.5 million, exempts a small company from many of the comprehensive registration procedures required of large firms. Regulation A allows for simplified documentation, the use of unaudited financial statements and processing by a regional office of the SEC rather than by the main office in Washington, D.C. Even those companies which are eligible to make a public offering of securities under SEC Regulation A incur significant transaction costs. The cost to the company of a Regulation A offering is normally 20% of the funds raised at the offering. Green & Brecher, *supra* at 30.

36. INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 39-40. During the years 1971-1975 the costs of registration represented 13.74% of the proceeds obtained for an issue of common stock between $500,000 and $1 million, while for the same time period the cost of registration only constituted 3.95% of the proceeds for an issue between $100 million and $500 million.

37. *Id.* at 40. The SBA Task Force discovered that institutional investors accounted for 70% of the volume of trading on the New York Stock Exchange in 1977. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 4.

38. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 14; FINANCING FOR DISTRESSED AREAS, *supra* note 12, at 15.

39. 29 U.S.C. §§ 1001-1381 (1976). *See* Little & Thraikill, *Fiduciaries Under ERISA: A Narrow Path to Tread*, 30 VAND. L. REV. 1 (1977); Weiler, *Fiduciary Provisions of the Employee Retirement Income Security Act of 1974*, 36 LA. L. REV. 897 (1976); Note, *Economic Analysis and the Prudent Man Rule Under ERISA: Efficiency Versus the Public Interest*, 7 LOY. CHI. L.J. 683 (1976) [hereinafter cited as *Prudent Man Rule Under ERISA*]; Note, *Fiduciary Standards Under the Employee Retirement Income Security Act of 1974*, 63 GEO. L.J. 1109 (1975). State pension laws controlling local pension funds may also impose

ity under ERISA has prompted institutional investors of pension funds to concentrate their assets in larger companies with proven earnings and proven liquidity of investment.[40]

III. The Canada Development Corporation

In 1971 the Canadian government pursuant to the Canada Development Corporation Act[41] ("CDC Act") established the Canada Development Corporation ("CDC").[42] CDC's purpose is to "help develop and maintain strong Canadian controlled and managed corporations in the private sector of the economy and [to] . . . give Canadians greater opportunities to invest in the economic development of Canada."[43] CDC is designed to achieve four objectives:

> (a) to assist in the creation or development of businesses, resources, properties and industries of Canada;
> (b) to expand, widen and develop opportunities for Canadians to participate in the economic development of Canada through the application of their skills and capital;
> (c) to invest in the shares or securities of any corporation owning property or carrying on business related to the economic interests of Canada; and
> (d) to invest in ventures or enterprises, including the acquisition of property, likely to benefit Canada. . . .[44]

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barriers to a small business seeking equity capital. A state restriction which forbids investment of state pension funds in the stock of small firms further reduces the supply of capital available to these firms. CAL. GOV'T CODE § 53216.1 (West Supp. 1981). Under California law state pension funds may only be invested in the common stock of a corporation with total assets of at least $100 million and only if "[s]uch corporation has paid a cash dividend on its common stock in at least 8 of the 10 years preceding the date of investment, and the aggregate net earnings available for dividends on the common stock of such corporation for the whole of such period have been equal to the amount of such dividends paid, and such corporation has paid an earned cash dividend in each of the last three years." *Id.* § 53216.1 (b), (d). *See also* N.Y. RETIRE. & SOC. SEC. LAW §§ 177, 177b (McKinney Supp. 1981); PA. STAT. ANN. tit. 16 § 11659 (Purdon Supp. 1981).

40. VENTURE AND EQUITY CAPITAL, *supra* note 7, at 14. *Prudent Man Rule Under ERISA*, *supra* note 39, at 701. "The new prudent man requirement has engendered a conservative reaction to investment of equity portfolios because of the fiduciary liability which results from imprudent investment of plan assets." *See* Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340 (1980).

41. Canada Development Corporation Act, Can. Stat. ch. 49 (1971).

42. *Id.* § 4. "Such persons not exceeding eighteen as may be designated by the Governor in Council together with such persons as are shareholders of the company from time to time are hereby incorporated as a company with share capital to be known as the 'Canada Development Corporation.' " *Id.*

43. *Id.* § 2.

44. *Id.* §§ 6(1)(a)-(d).

The CDC Act provides that these objectives are to be carried out with profit maximization in mind.[45]

Consistent with the nationalistic focus of the CDC Act,[46] shareholders and directors of CDC must be either Canadian citizens or residents.[47] The CDC Act establishes investigative procedures by which CDC's board of directors may determine whether an existing shareholder, a subscriber of shares, or an individual to whom shares are to be transferred fulfills that requirement.[48] If the residency or citizenship requirement is not met, shares owned by the individual in question will be deemed to be held in contravention of the corporate charter and that person will thereby be stripped

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45. *Id.* §§ 6(1)d, (2). The CDC may make investments so far as it is practical and profitable to do so. Furthermore, CDC is authorized to have a capital structure consisting of (a) two hundred million shares of no par value common stock; and (b) one billion dollars of preferred shares with a nominal or par value in any multiple of five dollars not exceeding the par value of one thousand dollars each. The preferred shares may be issued in one or more series. *Id.* § 9(1)(a)-(b).

46. For a discussion of the political mood of Canada which led to the creation of CDC and for an in depth analysis of the structure of CDC see Couzin, *The Canada Development Corporation: A Comparative Appraisal,* 17 McGill L.J. 405 (1971).

47. Canada Development Corporation Act, Can. Stat. ch. 49 § 20 (1971). The board of directors may prescribe rules for determining when a person is to be considered a resident of Canada. *Id.* § 20(3). Although an individual may be either a Canadian citizen or resident in order to become a CDC shareholder, an individual *must* be a Canadian *citizen* to be eligible for the position of CDC director. *Id.* § 12. In addition, the majority of the members of the board of directors must at all times be residents of Canada. *Id.* Until otherwise changed through an amendment to the CDC's by-laws the board of directors shall consist of not less than 18 or more than 21 directors. The exact number within this range shall be fixed from time to time by the board. *Id.* § 11.

48. *Id.* § 16(2). Upon a request of the board of directors, shareholders may be required to submit a declaration regarding (a) the shareholders' direct or indirect ownership of CDC shares; (b) whether the shareholder and any person in whose right or for whose use or benefit the shares are held are Canadian citizens or residents; (c) whether the shareholder is "associated" with any other shareholders; (d) whether the shareholder is a Canadian citizen; (e) whether shareholders which are corporations or trusts are Canadian residents; and (f) other matters which the board deems to be relevant. In addition,

> [w]here a declaration has been requested by the Board from a shareholder under this section and the shareholder fails or neglects to submit to the Board a declaration satisfactory to the Board within thirty days of the day that the declaration was requested by the Board, the shares of the company held by such shareholder shall be deemed to be held in contravention of the charter of the company until a declaration satisfactory to the Board has been submitted.

Id. § 16(3). Shares will also be deemed to be held in contravention of CDC's charter if, after 60 days following the purchase or other acquistion of any shares, the stock certificate has not been presented to CDC for transfer into the name of the beneficial owner. *Id.* § 17(6). *See also id.* § 16(5)-(6).

of his voting rights.[49] In addition to a loss of voting rights, shareholders holding stock in contravention of the corporate charter may be given notice to dispose of their shares to someone qualified to hold voting shares.[50] In lieu of such disposition, CDC may at its option redeem and cancel the shares.[51]

Although CDC is designed to encourage investment participation by the citizens and residents of Canada, the federal government is intended to be the largest single shareholder.[52] This is evidenced by the fact that individual shareholders are prohibited from holding in their own name or for their "use or benefit" more than three percent of CDC's outstanding voting shares.[53] On the other hand, the government is permitted to own ten percent or more of CDC's outstanding voting shares.[54]

Even the government, however, has limits on its ability to invest in CDC. If at any time the total number of voting shares of CDC held by the government of Canada exceeds ten percent of the outstanding voting shares, then CDC may at its sole option redeem for cancellation any number of those shares in excess of the ten percent figure.[55] Although this measure provides CDC with a means of limiting the Canadian government's control over it, the CDC Act provides

> [s]o far as it is in the public interest to do so, the Minister of Finance shall

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49. *Id.* § 19(1).

50. *Id.* § 21(1)-(2). The type of notice required to be given to the shareholder will be prescribed by the by-laws of the corporation but in no event will the shareholder have less than 60 days to dispose of his stock.

51. *Id.* CDC may redeem shares held in contravention by depositing the redemption price, *see id.* §§ 21(6), 22, in a special bank account and then, to effectuate the redemption, CDC must give the shareholder notice that those shares were redeemed. *Id.* § 21(2)(a)-(b). If CDC discovers that any shares which are held in contravention have been in contravention for ten years (or less, if specified in the by-laws), then CDC must redeem the shares. *Id.* § 21(5).

52. The CDC Act provides that the Minister of Finance is authorized to subscribe for or purchase up to $250 million worth of shares of CDC for the government of Canada. *Id.* §§ 35(1)(a), 36(1)(a). The federal government is also authorized to make loans to CDC with a maximum outstanding balance of $100 million. *Id.* § 37(1)-(2).

53. *Id.* Schedule I § 2(1).

54. *Id.* § 36(1). The Canadian government is expressly authorized to own in excess of 10% of the total issued and outstanding voting shares of CDC subject to certain conditions. The government's right to own up to 10% of the issued and outstanding shares of the CDC is unrestricted. *Id.*

55. *Id.* § 36(1)(b).

> endeavor to maintain the percentage of voting shares of the company held by Her Majesty in right of Canada at any time at not less than ten per cent of the total number of issued and outstanding shares of the company; and the Minister of Finance shall not dispose of any voting shares of the company if the disposition would reduce the percentage of voting shares held by Her Majesty in right of Canada to less than ten per cent of the total number of issued and outstanding shares of the company.[56]

In addition to insuring that the Canadian government be the single largest shareholder of CDC, the Act created a special relationship between the government and CDC's board of directors. The Minister of Finance has the option to forego voting the shares he controls for the government, regardless of the government's holdings in CDC, and may instead appoint a maximum of four directors to the board.[57] Whenever the government of Canada owns more than fifty percent of the outstanding shares of CDC, the Deputy Minister of Finance and the Deputy Minister of Industry, Trade and Commerce automatically become members of the board *ex officio*,[58] a solely advisory position.

The House of Commons debates regarding CDC, conducted just prior to its enactment reflect that Canadian economic development was only one of several reasons for establishing CDC.[59] Opponents of CDC were suspicious that any concern for economic development would be subordinated to an interest in profit maximization[60] for the benefit of CDC's shareholders.[61] Nevertheless, the CDC Act was enacted largely because of the Canadian government's fear of

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56. *Id.* § 42(3).

57. *Id.* § 40.

58. *Id.* § 41. Members of the board *ex officio* are not entitled to vote at board meetings, but this provision does enable the government to have an additional means of overseeing their investment and an opportunity to provide input and ideas. If the Deputy Minister of Finance or the Deputy Minister of Industry, Trade and Commerce is unable to serve as a board member *ex officio*, then the minister of the department concerned shall appoint a replacement from within the department.

59. 3 Parl. Deb., H.C. 6384-85, 6391 (Can., 1971).

60. For a discussion regarding the inconsistency of CDC's professing profit maximization and Canada's economic development as simultaneous objectives, see D. Laprés, *The Canada Development Corporation: A Proposal To Reconcile Its Conflict of Objectives*, 9 J. INT'L L. & ECON. 507 (1974).

61. 3 Parl. Deb., H.C. 6377 (Can., 1971). "The corporation is to make profits. Its objectives are not compatible with national objectives and national purposes. The government is hamstringing the corporation from the beginning. . . . The objectives of the corporation cannot be reconciled with the national interest." *Id.* (statement of Max Saltsman). *See also id.* at 6382-83, 6385.

and desire to eliminate foreign domination of Canadian resources and industry.[62] The debates also pointed out that offering CDC stock to Canadians would help to alleviate the shortage of investment opportunities available to them.[63] Members of the House hoped that CDC would reduce the short supply of domestic investments.[64] In 1973 CDC made its first major effort to reduce foreign control of Canadian resources.[65] CDC focused its efforts on Texasgulf corporation,[66] a Texas-based international mining firm whose principal business is base metal mining in Canada.[67] In 1975, CDC entered into a $114 million agreement with Tenneco Inc., another American corporation, to purchase from Tenneco several of Tenneco's Canadian oil and gas holdings.[68]

Shortly after its enactment, CDC's chairman tried to give Canadians an indication of CDC's investment plan by announcing six major areas of investment concentration. The chairman stated that CDC would concentrate its investments in oil and gas; health

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62. *Id.* at 6384-85 (statement of David Lewis).

63. *Id.* at 6378 (statement of Max Saltsman). Mr. Saltsman noted: "There is a great need for publicly traded stocks in Canada. . . . There is also a great deal of investment money in Canada, but it is not being invested in this country because the stocks are not available. . . . There is twice as much money available as there are stocks."

64. *Id.* at 6391 (statement of P.M. Mahoney).

65. Canadians' concern over the high level of foreign investment in Canada led to the passage of the Foreign Investment Review Act, Can. Stat. ch. 46 (1973), *as amended by* The Immigration Act, 1976, Can. Stat. ch. 52 (1976). For a discussion of the above-mentioned legislation, see Note, *Canada's Foreign Investment Review Act Revisited*, 4 FORDHAM INT'L L.J. 175 (1980).

66. Texasgulf's management was opposed to CDC's effort to obtain Texasgulf shares and in hopes of frustrating CDC, Texasgulf sought a preliminary injunction restraining CDC from proceeding with the tender offer. The injunction was denied and CDC was allowed to purchase the Texasgulf shares. Texasgulf, Inc. v. Canada Dev. Corp., 366 F. Supp. 374, 430-31 (S.D. Tex. 1973).

67. Meyer, *The CDC Bid for Texasgulf: Bold, Yes; Inept, Too*, EXECUTIVE, Sept., 1973, at 47. At the time CDC made the offer to purchase Texasgulf shares, Texasgulf derived 68% of its revenue from Canadian operations. CDC bought ten million shares of Texasgulf from American shareholders for a purchase price of $271 million and thus gained significant control of the corporation. CANADA DEVELOPMENT CORPORATION, INFORMATION STATEMENT 2 (Oct. 16, 1980) [hereinafter cited as INFORMATION STATEMENT]. Fellows, *Well, Full Marks to the CDC for the Old College Try*, EXECUTIVE, Sept., 1973, at 47.

68. *What CDC Will Buy In Its $114 Million Deal*, Financial Post, Nov. 22, 1975, at 23. Among the assets obtained in this transaction were a 50% interest of the producing oil and gas properties operated by Tenneco's subsidiary, Tenneco Oil and Minerals Ltd. and a 100% interest in the Canadian oil and gas properties of two other Tenneco companies, Kern County Land Company and La Terre Petroleum of Canada, Inc.

care, including pharmaceuticals; petrochemicals; mining pipelines and related transportation; and the venture capital industry.[69]

In the venture capital industry CDC has played an important role in making equity capital available to Canadian small business. CDC's investments in the venture capital industry only represent eight percent of the company's long-term investments as of December 31, 1979.[70] Nevertheless, CDC has built "the largest single pool of venture capital financing available in Canada."[71] CDC's 1977 Annual Report stated:

> Our catalytic function in encouraging the survival and growth of profitable small businesses throughout Canada is particularly significant during a period in which the venture capital industry has shrunk, making it difficult for entrepeneurs with fresh ideas to fulfill their potential.
>
> The CDC directors decided as early as 1972 to stimulate Canadian enterprise by providing small firms with start-up capital to support their product development and market expansion.[72]

CDC's initial venture capital investments were made directly in three venture capital firms which acted as intermediaries for supplying equity capital to small businesses.[73] CDC's management realized that by making investments in venture capital enterprises, CDC would be stimulating the growth of small businesses without having to review numerous individual requests for small[74] amounts of financial aid.[75] To date CDC has invested in six venture capital

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69. *CDC Begins to Flex Its Muscles*, CANADIAN BUS., Oct., 1972, at 4.

70. INFORMATION STATEMENT, *supra* note 67, at 2. CDC's total long-term investments were $782.3 million (valued at cost as of Dec. 31, 1979).

71. [1977] CDC Ann. Rep. 11.

72. *Id.*

73. *Id.* CDC's initial capital investment in these three firms, Venturetek International Limited, Ventures West Capital Ltd., and CanWest Capital Corp., amounted to $10.4 million. INFORMATION STATEMENT, *supra* note 67, at 3-4. These venture capital firms have invested in more than 25 entities in such diverse areas as word processing, oil and gas exploration and the soft drink industry. *Id.*

74. Canada Development Corporation Act, Can. Stat. ch 49 § 6(2)(b) (1971). The CDC Act provides: "[T]he company shall, so far as it is practicable to do so . . . invest, in the shares of corporations in each of which, in the opinion of the Board of Directors of the company, the real value of the stockholders' equity after investment by the company will be, or is likely to become, one million dollars more." *Id.* This section of the CDC Act effectively limits the size of target companies in which CDC may invest. Therefore, CDC must use intermediaries if it wishes to make equity capital available to corporations in which equity investments would be less than one million dollars.

75. *CDC Begins to Flex its Muscles*, CANADIAN BUS., Oct. 1972, at 4.

firms.[76] In addition, the president of CDC has indicated that CDC intends to promote actively the formation of a number of new venture capital firms thoughout Canada.[77]

Initially, CDC was funded solely by government investment. It was not until several years later that CDC sold any of its shares to Canadian investors.[78] The first sale of CDC shares involved a private placement of $100 million in 1974.[79] It was not until 1975, however, that CDC made its first public offering of CDC shares. That offering, which realized more than $141 million was at the time the largest equity issue that had ever been underwritten in Canada.[80] The dollar volume of the 1975 issue was surpassed on October 15, 1980 when, CDC engaged in an underwriting of $310 million of preferred shares.[81]

Prior to the 1980 issue, private Canadian investors owned 34.2% of the voting rights in CDC.[82] As a result of the 1980 issue, however, this ownership has increased to a majority of 50.1%.[83] Although private investors have a technical majority of voting shares, because the government remains the largest single shareholder,[84] it

76. INFORMATION STATEMENT, *supra* note 67, at 3-4. *See also* note 73 *supra*. *See* Address by H. Anthony Hampson, President and Chief Executive Officer, Canada Development Corporation to the Canadian Club of Edmonton, Alberta at 3 (May 28, 1980).

77. Address by H. Anthony Hampson, President and Chief Executive Offficer, Canada Development Corporation to the Canadian Club of Edmonton, Alberta at 3 (May 28, 1980).

78. INFORMATION STATEMENT, *supra* note 67, at 5.

79. *Id.* In March 1974, CDC issued 10 million shares of 5.75% class A preferred stock to a number of financial institutions and business corporations for $100 million.

80. *Id.* On October 1, 1975, 1,416,644 shares of class B preferred stock were issued to investors through a public offering for $141,664,400. An additional 8,713 class B shares were subsequently subscribed for. In April of 1975, 48 common shares were issued in exchange for four class B preferred shares. The exchange marked the first time common shares were held by a non-governmental investor. During the years 1977 and 1978, an additional 132 common shares were issued on conversion of class B preferred shares. In 1979 CDC made a distribution of 1,447,690 common shares to the holders of class B preferred stock. During the same year 1,476 common shares were issued as a result of additional conversions of class B preferred stock. *See also* Jamieson, *By Gosh But (Second Time Around) The Price was Right*, Financial Post, Sept. 6, 1975, at 13.

81. [1980] CDC THIRD QUARTER REP. 3. CDC tried to promote the expansion of its shareholder base during this offering by establishing a widespread sales network and an installment purchase plan for small investors. *Id.* The purchase plan was used by 1,930 investors who purchased 251,000 shares.

82. *Id.*

83. *Id.*

84. *See* notes 51-53 *supra* and accompanying text.

is likely that the government will still maintain effective voting control.[85]

IV. An American Model of CDC

An equity development finance corporation similar to CDC in structure and organized to combat imperfections in the capital market would provide a viable solution to the problem small American businesses face in obtaining equity capital. There are several features of the CDC, however, which would be inapplicable in an American version of the CDC and therefore ought to be eliminated. First, because an American equity development finance entity would be primarily concerned with providing small new businesses with equity capital and not with eliminating foreign ownership of American resources and industry, the American counterpart to the CDC would not require that shareholders and directors be American citizens or residents. Second, although American venture capital firms have an adequate supply of funds, they have failed to make significant investments in small new businesses.[86] Therefore, the American counterpart to the CDC should invest directly in these small new businesses and thus eliminate the CDC's intermediate investment in those venture capital firms which in turn invest in the small new businesses.[87]

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85. A shareholder can exercise substantial control over a corporation even if the shareholder owns less than 50% of the outstanding shares. The notion that providing for government ownership of no more than 49% of a corporation voting stock will protect the private investors is fallacious. *See, e.g.*, Alaska Renewable Resources Corporation, ALASKA STAT. § 37.12.080(2) (1980), which states that in providing financial assistance this development corporation may not "invest in more than 49 per cent of the outstanding corporate stock or other corporate obligations issued by an applicant." *Id.*

In Berk, *Control In Corporate Law*, 58 COLUM. L. REV. 1212 (1958), it is noted that

> Control is a function of the ownership of voting stock. There are two discernable types, absolute or outright control, and working control. 'Absolute control' exists when a majority of such stock is held by a single owner or by a few stockholders who by agreement or tacit consent act together. The same situation in fact exists where a very large minority is so held, while ownership of the majority is dispersed among many small holders. Fifty-one per cent of ownership of the voting stock in a single hand or compact group constitutes absolute control. Forty per cent ownership may be no less absolute if the remaining sixty per cent is split among hundreds or thousands of small stockholders.

Id. at 1213. *See also* Santon, *The Developing Duties of Controlling Shareholders and Appropriate Restraints on the Sale of Corporate Control*, 4 J. CORP. L. 285, 287 (1979).

86. *See* notes 28-32 *supra* and accompanying text.

87. The venture capital industry in the United States has an adequate supply of funds

An American equity development finance corporation formed to stimulate small business growth could alleviate the conditions which lead to market failure by making the needed equity investments previously unavailable to young ventures.[88] Once the inapplicable features of CDC are eliminated from the American model, the four previous barriers to investment in small business could be eliminated. First, an equity development finance corporation whose shares are offered to both the public and private sectors would be able to make investments in a large number of small companies, thereby pooling the risk of each individual investment and thus spreading the risk among all the investors in the development corporation. Risk-pooling would minimize the risk faced by an individual investor who invests in one small company.[89] At the same time, investors would be able to enjoy the above average returns associated with small entities.[90] Second, because an American equity development finance corporation would be a large, publicly-traded issue, it would also eliminate the liquidity problems which exist with investments in small companies.[91] An investor would be able to invest in small ventures by using the development corporation as a conduit and enjoy the marketability of his shares in the development corporation.[92] Third, the size of the development corporation might render it an attractive investment opportunity for institutional investors.[93] Finally, because the American equity development finance corporation would specialize in making numerous equity investments in small companies, economies of

but have chosen to limit the extent of their equity investments in new small companies. *See* note 28 *supra* and accompanying text. An American version of CDC would need to invest directly in small companies in order to insure that the shortage of equity capital available to small businesses is alleviated.

88. *See* notes 17-40 *supra* and accompanying text.

89. *See* notes 24-27 *supra* and accompanying text. An investment in an entity such as CDC is very similar to an investment in a mutual fund. *See* Note, *Mutual Fund Advisory Fees — Too Much For Too Little?* 48 FORDHAM L. REV. 530 (1980), describing a mutual fund as "an investment company that purchases securities with the capital contributed by its shareholders. Participation in a fund provides relatively small investors with professional money management and the advantages of a diverse portfolio of securities." *Id.* at 531.

90. *See* note 23 *supra* and accompanying text.

91. *See* note 30 *supra* and accompanying text.

92. [1980] CDC THIRD QUARTER REP. 3. The strong demand for CDC shares by Canadian investors demonstrates the potential marketability of shares in a development finance corporation.

93. *See* notes 37-40 *supra* and accompanying text.

scale and specialization would reduce the transaction costs a small firm encounters when trying to obtain funds.[94]

The potential for high returns and liquidity of investment should attract a large number of private sector investors to an American equity development finance corporation. Because the majority of its funding would come from the private sector, unlike the CDC,[95] the development corporation would not require substantial sums of public money which would otherwise be available for other social programs.[96] The motivation of private investors to maximize profit will also alleviate the fears of small companies that investments by the development corporation will be dominated by political motivations.[97] However, the presence of the government as a shareholder and, through representation on the board of directors, would help to insure that investments are made in a manner consistent with the purpose of the development corporation.[98]

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94. *See* notes 34-36 *supra* and accompanying text.

95. *See* notes 52, 54 *supra* and accompanying text.

96. If the bulk of the funding for the American version of CDC came from the federal government then the issue could be raised whether the government was pursuing a public purpose or simply acting for the benefit of corporate shareholders. *See generally* United States v. County of Fresno, 429 U.S. 452 (1977) (federal property when used for the benefit of private individuals is not exempt from state taxation); United States v. City of Detroit, 355 U.S. 466 (1958); United States v. Township of Muskegon, 355 U.S. 484 (1958); City of Detroit v. Murray Corp., 355 U.S. 489 (1958).

97. *See Policies to Support New Businesses, supra* note 14, at 23, where the author noted:

> Many owners of small firms will object to public investment when it means giving up a share of the business. Since the typical small businessperson is already wary of the public sector, partial public ownership may seem quite frightening. To some extent, these concerns reflect the very real possibility that direct public investment could be manipulated for political reasons.

Id.

98. In theory, the presence of those directors who directly represent the government's interest in CDC would be able to prevent the CDC from engaging in those transactions which are not consistent with CDC's purpose. An example of the American government using representation on a board of directors in order to ensure that an entity conduct its business in a manner consistent with the public interest is the Communications Satellite Act of 1962, 47 U.S.C. §§ 701-744 (1976). For a discussion which criticizes the effectiveness of this device from the government's perspective, *see* Schwartz, *Governmentally Appointed Directors In a Private Corporation — The Communications Satellite Act of 1962*, 79 HARV. L. REV. 350 (1965). Under the Communications Satellite Act of 1962, three out of fifteen board members of the COMSAT corporation are appointed by the President of the United States for the purpose of protecting the public's interest. Although represented on the board, the government has no proprietary interest in COMSAT. *Id.* To avoid this type of representation, the government appointed directors of an American version of CDC should

The president of CDC recently observed that a development corporation motivated by profit has the best prospects for success.

> We make no apologies for our emphasis on profits, for they are essential to generate the internal cash flow and to attract the external capital funds that are necessary for expansion. Moreover, they give the necessary strength to an enterprise in a highly competitive world, are a yardstick of performance, and a guide to efficiency.[99]

V. Conclusion

Traditional private market suppliers of capital have overlooked the investment opportunities presented by new small businesses. Therefore, alternative methods must be devised. Government initiated action to form an American version of the CDC could lead to the creation of a large capital fund available for equity financing in small business.[100] In order to maximize efficiency, the American version of CDC should be operated by those with an expertise in development financing. Furthermore, the American version should be managed with the expectation of earning a positive return on the pool of investments in small businesses.

Marshall A. Heinberg

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have an expertise in financial management in order to insure that they are able to adequately protect the public interest. More recently, the federal government has taken a similar approach in the bail-out of the Chrysler Corporation. *See* Chrysler Loan Guarantee Board, 15 U.S.C. §§ 1861-1875 (Supp. III 1979). In guaranteeing loans and other assistance to Chrysler, a board consisting of the Secretaries of Treasury, Labor and Transportation along with the Chairman of the Federal Reserve Board and the Comptroller General was established to monitor the activities of the corporation. *Id.* § 1862 (Supp. III 1979). Congress believed that this close interaction between the government and Chrysler was necessary to adequately protect the government's interest in the corporation.

99. Address by H. Anthony Hampson, President and Chief Executive Officer, Canada Development Corporation to the Canadian Club of Edmonton, Alberta at 2 (May 28, 1980).

100. *See* INNOVATIONS IN DEVELOPMENT FINANCE, *supra* note 1, at 110-11. "Any [government] that is serious about nurturing enterprises that have been unjustifiably refused funds from conventional sources must provide equity financing. . . ."