MONEY IN THE BANK: GUIDANCE FROM B.C. COURT OF APPEAL ON CHARACTERIZING FUNDS AS AN INVESTMENT OR LOAN

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The decision of the British Columbia Court of Appeal in *Broer v. Multiguide GmbH*, 2023 BCCA 134, provides a useful case study on whether a court will consider an investment in a company to be an equity contribution or loan. In particular, this case illustrates the circumstances in which a court will consider parties' conduct subsequent to the injection of funds into a company in determining the true nature of the contribution.

Facts

In November 2014, the plaintiff, Multiguide GmbH ("**Multiguide**"), and RTB Safe Traffic, Inc. ("**RTB**"), formed Multiguide Technologies Inc. ("**MTI**") to sell and service pay-and-display parking metres (the machines that print the receipts people display on their dashboards when parking) in North America.

Multiguide and RTB each owned a 1/3 interest in MTI, along with a third party, Robert Ziola.

In December 2014, Multiguide and RTB each advanced €100,000 to MTI (the "**Advances**"). The ultimate dispute in this case was whether these funds were equity investments or shareholders loans.

Multiguide identified its wire transfer as "Initial equity capital Multiguide GmbH". The contribution was initially reported in Multiguide's ledger as "Participation in Stock Corporations". Additionally, on the day of the transfer, Multiguide sent an email to RTB's corporate controller with the subject line: "Equity contribution to MTI".

In March 2015, MTI's external accountant sought clarification on whether the Advances should be recorded as loans or capital on financial statements. Multiguide responded that it "thought this was an equity input, but according to our lawyer this may be a loan." In response, the accountant then recorded each Advance as a loan on the draft financial statements, indicating that the record could be rectified after. The draft statements were subsequently sent to the principals of the parties as directors of MTI.

In April 2015 at MTI's AGM, the shareholders approved and signed the financial statements for MTI, in which the Advances were characterized as "Loan from shareholders." Several days later, Multiguide emailed its accountant stating that its Advance was a shareholder loan.

Concurrently, the business relationship between the parties deteriorated and they agreed to separate their interests. Multiguide demanded repayment of its Advance from MTI on the basis that it was a shareholder loan.

Trial

At trial, Multiguide alleged that the Advance from Multiguide to MTI was a shareholder loan, which became due and owing upon Multiguide's demand for repayment. In contrast, MTI argued that the Advance was an equity contribution.

Multiguide and RTB Germany provided evidence that they both initially understood their Advances to be equity. The Court found that the contemporaneous documentation was consistent with this understanding.

Despite the initial understanding between the parties that the Advances were equity contributions, the trial judge ultimately found that the Advances were properly characterized as shareholder loans.

The trial judge found that while it was true that the parties' initial understanding of the Advances was that they were equity contributions, this was not the result of a negotiated mutual intention, but was simply due to their previous business experience in Germany, whose law requires minimum equity contributions in order to form a company.

The evidence revealed that the parties had entered into discussions to clarify the nature of the Advances following injection of the funds, and circulated several draft shareholder agreements dealing with the characterization of the Advances, but no final agreement was executed.

Additionally, the trial court found that the testimony of Multiguide and Mr. Ziola, who had provided evidence in favour of the parties having agreed to characterize the Advances as loans, was more reliable than the testimony of the defendants.

Ultimately, the trial judge relied on the characterization of the Advances as loans in the financial statements of MTI and the subsequent lack of any effort to re-characterize the Advances as equity contributions, as evidence of the parties' intention that the Advances were properly characterized as shareholder loans.

RTB and MTI appealed the trial decision on the basis that it was improper to consider the parties' conduct following making the Advances and that the trial judge placed undue weight on MTI's financial statements in determining the nature of the Advances.

Analysis

The Court of Appeal unanimously dismissed the appeal. In its decision, the Court of Appeal set out the legal principles applicable in determining the true substance of a transaction.

The starting point will be whether there is any written agreement formalizing the parties' intentions with respect to the transaction at issue. If the agreement is unclear, or if there is no written agreement, the court will consider all the surrounding circumstances, including the facts at the time of the transaction and, importantly, the events following the transaction.

The Court of Appeal stated that in this case, the absence of a written agreement between the parties meant that it was appropriate for the judge to consider the parties' subsequent negotiations. Interestingly, as a general principle, the Court of Appeal noted that in cases where an oral contract is at issue, there is greater latitude to consider the surrounding circumstances as contractual interpretation must occur in the absence of the words of the agreement, the key interpretive tool in the construction of contracts.

The Court of Appeal noted that consideration will generally need to be given to all of the surrounding circumstances when characterizing an advance as a loan or capital contribution, not only words used in documentation surrounding the transaction (note that this does not mean a written agreement specific to the transaction, which will still take precedence over extrinsic evidence).

The reason for not limiting the analysis to a review of the transaction documentation is that this would "rubber stamp" the determination of a single party to the transaction (i.e. just because one party says in a document that the transaction was a loan, does not on its own establish that the advance was in fact a loan).

Rather, the Court of Appeal stated, quoting from *U.S. Steel Canada Inc., Re*, 2016 ONSC 569 at para 168:

> *The determination of whether a particular claim is to be treated as debt or equity must address not just the expressed intentions of the parties as reflected in the transaction documentation but also the manner in which the transaction was implemented and the economic reality of the surrounding circumstances.*

In the circumstances of this case, it is perhaps surprising that the finding that both parties indicated at the time of their Advances that they considered the funds to be equity contributions was not determinative. The trial judge placed considerable weight on the parties' conduct following the Advances, including the recording of the Advances as loans and the failure to re-characterize the loans as equity contributions. Further, the trial judge questioned the reliability of the defendants' testimony in favour of the Advances being equity contributions.

The Court of Appeal determined that the trial judge's consideration of the parties' subsequent conduct was appropriate based on the lack of a written agreement and conflicting evidence. Ultimately, the Court of Appeal deferred to the trial judge's findings of fact that the balance of the evidence available, including the parties' conduct following the transaction, favoured a determination of the advances being loans rather than equity.

Takeaways

This case provides the most recent authority in British Columbia on the legal principles used to characterize the nature of a transaction, with the following points of particular relevance:

1. Parties considering injecting funds into a company should always use a clearly drafted agreement outlining the nature of the contribution.
2. Where no written agreement exists, significant uncertainty can exist in the nature of a transaction.
3. A court tasked with distinguishing a loan from an equity investment in the absence of a written agreement may properly take a very broad approach in its consideration of the surrounding circumstances. The stated intention of the parties at the time of the contribution or the documentation surrounding the transaction is not necessarily determinative.
4. Somewhat contrary to the current approach to contractual interpretation (and in particular, as set out by the Supreme Court of Canada in *Sattva*, which directs courts to have regard for the surrounding circumstances known to the parties at the time of formation of the contract),[1] when characterizing a transaction in the absence of a written agreement, courts may place greater weight on parties' conduct following a transaction than the circumstances that existed at the time of the transaction.

by Carina Chiu, Gray Morfopoulos and Jia Hwang (Temporary Articled Student)

[1] *Sattva Capital Corp v Creston Moly Corp*, 2014 SCC 53 at para 47.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.