Equity financing

Legal information for community organisations

This fact sheet covers:
► what is equity financing?
► types of equity
► dividends
► transferring equity
► issuing equity
► governance

Equity financing is a way that people can invest money to receive profit from commercial businesses.

Because of its profit making purpose, it has not always been viewed as wholly relevant to organisations whose core purpose is not about making profit. However, increasingly, investors are looking for socially responsible investment opportunities and not-for-profits themselves are structuring their operations in innovative and efficient ways while still maintaining their core purpose.

What is equity financing?

Equity financing is the way that an organisation raises money by ‘selling’ an ownership stake in itself to a third party. The company (the issuer) issues shares (representing an ownership interest in the company) to investors. The investor then becomes a shareholder of the company.

Equity financing is not limited as a source of fundraising to incorporated companies. For example, where a business is structured as a partnership, it can raise money by bringing on new partners who make a financial contribution to the business in exchange for acquiring an ownership interest in the partnership.

This fact sheet focuses on investing in, and raising finance for, simple private or ‘proprietary’ companies.

From the perspective of an investor, equity financing has three fundamental features:

1. the right to share in the profits of the organisation
2. a claim over the left over assets of an organisation when the organisation is liquidated or wound up (i.e. the assets that remain after the debts of the organisation have first been paid in full), and
3. the right to take part in the governance of the organisation

The nature and scope of an investor’s rights depends on the type of shares the investor holds (see below).
Equity financing vs trading of shares

When a company issues equity (in the form of shares) to an investor, the investor pays the company consideration for those shares. This is called a primary issuance and represents the point in time at which the company raises equity finance. It’s usually the case that an investor pays for their shares in cash, however, (particularly in the case of new companies) it’s not uncommon for investors to be issued shares in exchange for contributing assets or services to the company. However, it’s important to note that, where shares are issued for non-cash consideration, the company has extra notification obligations to ASIC.

After a primary issuance occurs, shareholders may sell their shares to third parties. This is called secondary trading. This is not itself a direct form of financing for the company.

The difference between the primary issuance of the shares and their secondary trading also highlights the difference between the issue price of shares and the market price. The issue price is the price received by the company (or that the company is entitled to receive) from an investor when shares are initially issued. The market price is the price that a third party is willing to pay for the share in the secondary market.

Example

Mary wants to start a new ‘meals on wheels’ service to provide food to elderly people in her village. Mary has decided that this will be a ‘for profit’ business, although she accepts that its principal aim is to provide a social service.

Mary’s neighbours, Sam and John, are also interested in investing in the new business. Sam is a retired taxi driver and John is a property developer. Mary incorporates a new company and contributes $50,000 in cash to the business. Sam agrees to provide driving services to the business for a year without pay. John agrees that he will provide all the fruits and vegetables for the preparation of meals from his farm at no cost for two years.

Mary estimates that Sam and John are each providing approximately $25,000 worth of goods and services to the company. For their contributions, Sam and John will each receive one share representing 25% of the equity in the new company while Mary will retain two shares, representing a total of 50% equity in the company for her $50,000 cash contribution.

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Example

After one year, a new retirement centre opens up in Mary’s village. It’s rumoured that the residents of the village will rely heavily on Mary’s meals on wheels business. Sam’s friend Peter decides that he would like to be involved in the business and approaches Sam to buy his one share. Because of the prospect of more clients, Peter is willing to pay Sam $35,000 for his share. Sam accepts and he receives $35,000. The issue price of Peter’s share remains $25,000, being the initial contribution that Sam made to the company to receive the share. The market price of Peter’s share, at the time of his acquisition is $35,000, representing the amount he paid to Sam.

Is equity financing relevant to not-for-profit and social organisations?

One of the main features of equity financing is distributing profits to investors. So, it’s generally not possible for most not-for-profit organisations to raise funds through this method. In the case of not-for-profits, any profit made must be ‘reinvested’ to further the aims of the organisation, and must not be distributed to members.

However, equity investing can still be an option for social enterprises if it exists as a ‘for-profit’ company. This might be a good option for a social enterprise that wants equity funding from socially-minded investors. While this use of equity financing is still relatively new, it presents a significant opportunity for investors to
make ‘impact investments’ in enterprises that operate in an area that they are passionate about. Such an enterprise could be focused on anything from energy efficiency to poverty or slavery.

A not-for-profit organisation may also want some form of equity investing in the way it structures its own operations. For example, a not-for-profit may start a specific project which is expected to generate profit. It may be beneficial for the not-for-profit to set up a private subsidiary company in order to develop the project.

This scenario may become more complex if, for example, it partners with another not-for-profit organisation in pursuing the project. In these instances, it would be helpful to understand the basics of equity investing to make sure that the economics and governance of the project are effectively structured for all parties.

### Related Not-for-profit resource

For more information about social enterprises and funding opportunities, see our Social Enterprise Guide on our social enterprise webpage.

### Example

Alice runs a not-for-profit business selling clothes to low-income families in her community. Alice decides to investigate exporting her clothing to poor communities in other countries.

Jeff runs a for-profit transport and logistics company throughout the Asia Pacific region. Alice and Jeff decide to work together on the project.

They will start a new company and each will own 50% of it. Alice will contribute some cash as working capital and contribute clothing into the new company. Jeff will contribute no cash but will provide three years of free shipping and transportation. All profits made by the company will be divided 50/50. Alice will use them to reinvest in other not-for-profit projects. If Jeff receives an amount exceeding the costs of transportation, he will invest the excess into a local orphanage that he sponsors in the region.

### Debt vs equity financing

The main alternative to equity financing is debt financing. Debt financing refers to the borrowing and lending money. A provider of debt finance becomes a creditor of an entity, whereas the provider of equity finance becomes a shareholder or an owner of an entity.

### Related Not-for-profit resource

For more information about the differences between debt and equity financing, see our fact sheet on debt financing on our new funding webpage.

### Types of Equity

#### Classes of shares

Unless the constitution (see below) of a company specifies otherwise, each share issued by a company has the same economic and governance rights.
A company may decide to issue only one type of share that gives a shareholder particular rights. However, a company can alter this default position by providing certain shareholders with greater rights over governance or a greater right to share in the economics of a company. The mechanism through which this can be achieved is the creation of different classes of shares.

Creating classes of shares can give effect to differences in:

- the quantum and right to receive dividends
- the priority of the claim on the residual assets of the company, and
- voting rights

The law does not prescribe any characteristics that specific class must have. Rather, a company has relatively broad discretion to create different classes, provided this is consistent with the company’s constitution or a requisite number of shareholders allows this to happen.

**Note**

Every company will need to have at least one class of ordinary shares that has an uncapped right to the remaining assets of a company on winding up.

**Tip**

Although the law is not overly prescriptive with respect to the creation of different classes of shares, it does require a company to make clear disclosures about its classes. See section 254X of the Corporations Act 2001 (Cth) (Corporations Act) and guidance from ASIC.

**Ordinary Shares**

The basic type of shares issued by a company are called ordinary shares. Ordinary shares don’t have a set dividend rate and upon winding up, have a claim on the remaining assets of a company along with the other ordinary shareholders after amounts are first paid to creditors and preference shareholders. In principle, ordinary shareholders are entitled to vote on all shareholders matters (on a one vote for one share basis). However, it is possible for a company to create different classes of shares within ordinary shares.

**Preference Shares**

The term ‘preference share’ is not defined under law and is simply a share that has a priority right over the right to receive dividends or the claim over the residual assets of the company.

Although preference shares can carry voting rights, it is usually the case that preference shares do not carry voting rights or only carry a limited right to vote on a handful of fundamental corporate matters (for example, changes to the equity structure). The reason for this practice is that the restrictions on voting (ie. participating in the governance of a company) are viewed as a trade-off for enjoying priority over economic rights (ie. dividends or ranking of their claim on the assets).
Cumulative vs non-cumulative

A preference share that has a priority right to receive dividends usually expresses that right as a fixed % of the issue price of the shares or an amount per share (i.e. cent per share). Typically, in the event that the company does not have enough funds to pay the fixed dividend, then the unpaid amount accumulates and is later paid when the company next has enough funds to make the payment. This is typically referred to as a cumulative preference share.

On the other hand, a non-cumulative preference share does not have the right to receive dividends that were not paid from a prior period. These are typically structured so that if the company decides to pay a dividend, then the preference share will receive its dividend in priority to other shareholders. However, if a company chooses to not pay a dividend or does not have enough funds to pay a dividend, then the preference shareholder’s right for dividends for that period is lost.

Participating vs non-participating

A participating preference share allows a preference shareholder to receive a preferred dividend before the payment of any dividends to ordinary shareholders and then also receive a further dividend along with the ordinary shareholders. A preference share that does not have this right is referred to as a non-participating preference share i.e. it is limited to receiving a fixed % dividend in priority to the payment of ordinary dividends.

Redeemable vs non-redeemable

If a preference share is redeemable, then the company may redeem it (buy it back) by paying back the initial issue price to the shareholder. The redemption can happen at a set time, when particular event happens, at the option of the company or the option of the shareholder. Importantly, the redemption amount ‘repaid’ to the shareholder is typically the issue price (i.e. the amount that the initial shareholder paid in exchange for the shares being issued to it) and the amount is paid to the then current shareholder.
If a preference share is non-redeemable, then the shareholder will only be entitled to the return of their initial capital investment on a winding up of the company.

**Convertible preference shares**

A preference share can be structured to convert into an ordinary share after its issue. The conversion can happen at a set time, at the option of the company or at the option of the holders, subject to the terms and conditions of their issue. These are known as convertible preference shares.

**Example**

Lisa’s small entertainment business has been performing very well for four years now. She has managed to sign contracts with five children’s day-care centres to provide entertainment at all of their events and is therefore able to make a consistent profit.

Luckily for her, at the time she issued the new preference share to the investor, she inserted an option for the company to convert the preference share into ordinary shares after three years provided that the investor had been paid dividends equal to the amount of their initial investment plus an additional 20%. This is achieved in year four and so the preference shares are converted into ordinary shares and both Lisa and the investor now receive dividends on an equal basis.

**Dividends**

The main way that investors earn income from an equity investment is by receiving a dividend. Dividends are the distribution of ‘profits’ by a company to its owners. The basic principle is that dividends are a distribution of a company's excess cash flows, after it has first serviced its operating expenses and debt obligations.

Normally, a company’s board of directors has the right to decide the amount of dividends to be paid, the time for payment and the method of payment. This is because it is generally accepted that the directors are in the best position to determine how much of a company’s profit to distribute to shareholders and how much to retain within the company for future business use. A dividend does not necessarily have to be a cash payment, although this is most often the case. It can also be paid in the form of a further issue of shares, the grant of options, or the transfer of other assets.

**Note**

Section 254U of the Corporations Act specifies that the power to pay dividends will by default rest with the directors unless a company’s constitution specifically provides otherwise.
Companies usually pay dividends twice in a year – an interim dividend and a final dividend. If the constitution of the company provides for the declaration of dividends, the company incurs a debt payable to the shareholder when the dividend is declared. If the constitution of the company does not specify that a dividend can be declared, then directors will announce that a dividend will be paid and specify a date for payment. In this case, the dividend only becomes a debt when the time for payment arrives and the decision to pay the dividend can be revoked at any time before then.

Legal test for the payment of a dividend

Under section 254T of the Corporations Act, a company must not pay a dividend unless each of the following three tests are satisfied:

1. **Balance sheet test** – the company’s assets exceed its liabilities immediately before the dividend is declared and the excess is enough for the payment of the dividend,

2. **Fairness to shareholders Test** – the payment of the dividend is fair and reasonable to the company’s shareholders as a whole, and

3. **No material prejudice to creditors test** – the payment of the dividend does not materially prejudice the company’s ability to pay its creditors

Note

Even if a company satisfies the tests to pay a dividend, it doesn’t have to pay a dividend. In very limited cases, with very specific fact sets, courts have found that the non-payment of dividends was a breach of the law. An example is where a majority shareholder uses their control over a company to consistently stop dividends from being paid. This has been held to be a form of oppression on the minority. But these cases are rare, and are highly technical such that they should not be relied on as the basis of expecting dividends to be consistently paid.
Practical considerations in relation to these tests

| Balance sheet test | • Assets and liabilities are to be calculated in accordance with applicable accounting standards, even in the case of small proprietary companies that don’t have to prepare audited financial accounts.  
• The balance sheet test is to be applied on an individual company (rather than ‘whole of group’) basis. That is, a company in a corporate group which fails the balance sheet test may not pay a dividend even if the group as a whole has excess assets over liabilities.  
• The balance sheet test is applied when a dividend is declared, not when it is paid. Where a company’s constitution does not provide for the declaration of dividends, a dividend is taken to be declared when the directors *decide* to issue a dividend. |
|---|---|
| Fairness to shareholders test | • This test is a particularly important consideration where a company has multiple share classes and shareholders. In these instances, it must decide which classes to pay a dividend to (and how much to pay).  
• The fairness to shareholders test is applied when a dividend is paid, not when it is declared or decided to be paid. |
| No material prejudice to creditors test | • The payment of a dividend which results in a company becoming insolvent is an example of a dividend failing to satisfy the ‘no material prejudice to creditors’ test.  
• Similarly, payment of a dividend would likely fail this test where such payment creates serious doubt as to the ability of the company to pay its debts as and when they fall due.  
• The no material prejudice to creditors test is applied when a dividend is paid, not when it is declared or decided to be paid. |

**Note**

A company pays tax on its profits, before it distributes those profits as dividends. As dividends also constitute income for the recipient, they are, on the face of it, susceptible to be taxed again. In most countries this is considered to be unfair as the same underlying economic activity that generated the profit for the company ends up being taxed twice (once at the company level and once at the investor level).

Therefore, many countries have devised mechanisms to provide relief to investors from double taxation of dividends. In Australia, the investor receives a ‘tax credit’ along with the dividend. The tax credit can be offset against other taxable income.

The [moneysmart website provides a simple example](https://www.moneysmart.gov.au).  

**Transferring shares**

The sale and purchase of shares between shareholders is not in itself a source of financing for a company. However, in practice, the ability of one investor to sell its shares to another has a significant impact on the initial investors’ appetite to invest. This is because the ability to sell shares represents a further opportunity (aside from dividend payments) for an investor to get a return on their investment.
Investors are likely to look much more favourably on a situation where they are able to sell their shares freely. At least theoretically, an investor should not care whether they realise a return on investment through receipt of dividends or realise a return though sale of shares.

However, in the real world, a number of factors mean that this is rarely the case. For example, there is almost always a material difference between the way in which dividends are taxed versus the tax treatment of the proceeds of a sale of shares. Second, it is not always the case that the market value of shares exactly matches the residual asset value. Finally, parties will factor in issues like general economic factors, industry performance and financial projections in valuing shares. This means that a third party's valuation of shares may be less than the residual asset value.

In principle, investors will want to retain maximum flexibility to sell their shares where possible. Where an investor perceives that there are restrictions on their ability to sell their shares (either because they are prohibited from doing so or there is no market for them), they are likely to require a greater return on their investment. This could be in the form of asking for a greater share of a company in exchange for the money that they provide, or otherwise asking for the share to be structured as some type of preference share.

**Note**

The law is not prescriptive about when a shareholder can sell its shares. Generally, a company or fellow shareholders in a small company may want to place limitations on share transfers because they would not want unknown third parties participating in the affairs of a company. If this is the case, restrictions on transferring shares would be placed in a company’s constitution or a shareholders agreement.

In any company, and particularly small companies where shareholders are involved in management, it is also very important to steer clear of insider trading laws.

In summary – a person with information that is not generally available to the public, and which would have a material effect on the price or value of the shares should not buy or sell those shares. The consequences of breaching these laws include heavy fines and possible criminal liability so it's important to get legal advice if in any doubt.
Issuing equity

Power to issue shares

As discussed above, the ability to issue equity is relevant for any business that has structured itself as a proprietary company, even if it’s pursuing social objectives. The main limitations on the ability to issue shares are generally set out in the constitution of a company, which may contain provisions that mean there are restrictions or conditions on share issuances. The general power to issue shares covers the issuance of ordinary shares, preference shares and bonus issuances.

Disclosure documents

As a general rule, the law tries to ensure that companies that issue shares make available all relevant information about the company to potential investors. The aim is to make sure that investors are not misled into making an investment that they otherwise would not make. Because of this, some types of share issues require the company to provide a disclosure document.

However, companies are not required to produce a disclosure document where:

- shares are issued to existing shareholders and executive employees of the company, or a subsidiary company, or
- shares are issued to members of the public and the issuance falls into one or more of the following categories:
  - issuance for no consideration
  - small-scale offers where fewer than 20 persons subscribe for less than $2 million worth of shares in any rolling 12-month period
  - where the people who subscribe for the shares are ‘sophisticated investors’, meaning:
    - the investor pays at least $500,000 for the shares; or
    - the investor is a ‘high net worth individual’, being someone with net assets of at least $2.5m or gross income of at least $250,000 per year (note these thresholds change with time but are correct as at December 2017), or
    - the offer is made through a financial services licensee, who in turn must satisfy themselves that the end investor has the experience to assess the merits of the offer, the value of the securities, the risks of the investment, the investor’s own information needs and the adequacy of the information given by the person making the offer, or
    - ‘sophisticated investors’, which is broadly defined but includes banks, life insurance companies or general insurance companies and the trustees of superannuation funds which have net assets of at least $10 million and other fund managers who control at least $10 million

Importantly, a proprietary company can only raise funds from:

- existing shareholders and employees of the company or a subsidiary company, and
- the general public, provided that the fundraising does not require a disclosure document (as outlined above)

This means that a proprietary company is limited to approaching a smaller group of investors to raise equity finance. Furthermore, the Corporations Act provides that a proprietary company must have no more than 50 non-employee shareholders.
Related resources

There are a number of transactions relating to the shares in a company that must be notified to ASIC. This includes specific details on the issuance of new shares, creation of new classes and transfers of shares.

The forms to be submitted are available on the ASIC website. The following provides a good summary of the notifiable events and the associated forms.

Governance and equity

Directors of companies (those that form the governing body of the company) have a legal duty to act in good faith, in the company’s best interests, and for a proper purpose.

Governance refers to the mechanisms in a company that regulate its internal affairs, including:

- the structure and powers of the board of directors and members
- directors’ duties and liabilities, and
- access to company information

Governance document

A proprietary company can be governed by the Replaceable Rules or a constitution, or a combination of both.

The replaceable rules are a set of rules in the Corporations Act that can be used to manage a company. The replaceable rules cover the basic processes and functions of internal governance, including voting, the appointment and powers of directors, inspection of company books, processes for directors’ meetings and shareholder meetings.

A constitution is a document that sets out rules and procedures specific to a company, and is taken to be a contract between the company and each shareholder, director and secretary, and between a shareholder and each other shareholder. A constitution must be consistent with the Corporations Act, which provides that the following matters must be decided by shareholders at a general meeting:

- altering the company’s constitution
- reducing the company’s issued share capital
- consolidating or subdividing the company’s shares, and
- changing the company type (e.g. changing from a proprietary limited company to a public company)

A company with a sole director or sole member does not need to follow the replaceable rules or have a constitution. If a further director is appointed, or the company issues equity to another shareholder, then the company must adopt a governance document.

Board of directors

Under the Corporations Act, the board of directors is responsible for managing the company. Every company must have at least one director. Proprietary companies must have at least one director who ordinarily lives in Australia. In a small company pursuing a social objective, it is likely that the board may only consist of the founder of the company and a friend or family member.

The constitution usually sets out how long the directors are to remain in office. This period can be indefinite, however directors usually serve three or four year terms.

The functions of the board are usually set out in the Board Charter or the company’s constitution and include such matters as:

- setting the strategic goals of the company
- monitoring management performance and business results
- approving annual budgets and major business decisions, such as expenditure, refinancing and restructuring, and
• managing shareholder communications

Note
‘Director’ is defined broadly in the Corporations Act and extends beyond directors who are validly appointed, including:

• De facto directors – people who are not validly appointed as directors but actually act in the position of a director.

Amy sets up a company called Kids Shine Pty Ltd that runs neighbourhood groups for children struggling at school. Amy’s husband Paul was not formally appointed as a director by the company and never signed an employment contract with the company. However, Paul attends all board meetings, votes on matters considered by the board and executes documents as a director of the company. Paul would be considered by law to be a de facto director.

• Shadow directors – people who provide instructions to the appointed directors, which the directors are accustomed to act upon.

Amy’s sister Collette was a former director of the company and one of the founding members. Despite being a former director, Amy invites Collette to attend all board meetings. Collette has a lot of knowledge about the company, and the directors regularly turn to her for her thoughts on particular issues. The directors generally act on her recommendations. Collette would be considered by law to be a shadow director.

Directors’ duties
Directors, as officers of a company have certain duties imposed on them by law. Most of these duties have been codified by the Corporations Act and include, among other duties:

• Duty to act with care and diligence – directors must exercise their powers and perform their duties with the degree of care and diligence that a reasonable person in their position would exercise in the company’s circumstances.

• Duty to act in good faith in the best interests of the company

• Duty to prevent the company from trading while insolvent – a director is liable for insolvent trading where a company incurs a debt when insolvent, or the incurring of a debt makes it insolvent and there are reasonable grounds at the time for the director to suspect that the company is, or will become insolvent.

Note
The duty to prevent insolvent trading is likely to be of significant concern to directors of private companies with a social objectives given the unpredictability that might exist around resources availability and support for the cause. A company is insolvent if it can’t pay its debts as and when they become payable. Directors must ensure that they engage appropriately skilled people to perform the company’s accounting functions and implement safeguards if the company is exposed to sudden restrictions on cash flow. For more information, see the online guidance from ASIC.

• Duty to act for a proper purpose

• Duty to disclose material personal interests in case of a conflict of interest – a director who has a material personal interest in a matter that relates to the affairs of the company must notify other directors of that interest.
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Duty to retain discretion – as a general rule, the board must retain all of its decision-making power.

Duty to not improperly use position – directors must not improperly use their position to gain an advantage for themselves or someone else, or to cause detriment to the company.

Examples

- Sally sets up a company that runs poverty awareness programs in schools. She becomes one of three directors of the company. At a board meeting, Sally asks the other directors to sign a blank bank transfer form, stating that she will use it to pay the company’s rent for that month. Sally then uses the blank transfer form to transfer $50,000 to her personal account in order to pay her personal credit card debt.

This would constitute a breach of Sally’s duty to act in good faith in the best interests of the company, as well as her duty to not improperly use her position. Despite being the company founder, Sally should ensure that the company’s assets and liabilities remain separate from her personal assets and liabilities.

- At the next board meeting, the directors consider a number of quotes for the purchase of a new company vehicle. Sally encourages the other directors to vote in favour of purchasing the vehicle from Company Carz Pty Ltd. She does not disclose that she and her husband own 70% of shares in that company and that her husband is that company’s Chief Financial Officer.

This would constitute a breach of Sally’s duty to disclose a material personal interest. Sally should have disclosed the nature and extent of her interest in Company Carz Pty Ltd to the other directors before the directors meeting and vote on the transaction only after full disclosure.

Consequences for breach of duties

If a breach of duty causes loss to a company, the director at fault may be liable to compensate the company. The corporate regulator, ASIC, also has the power to investigate breaches of directors’ duties and take enforcement action, as it sees fit. Depending on the type and nature of the breach, the Corporations Act sets out possible penalties for breach of a director’s duty, including:

- a declaration of contravention of the Corporations Act by the court
- pecuniary penalty
- compensation order
- disqualification order, preventing the person from being a director of any company for a certain period, or
- if the breach is intentional or reckless (and therefore ‘criminal’), a fine or imprisonment

A director’s liability for breach can be insured in some circumstances, provided it is not an excluded liability under the Corporations Act. For this reason, companies often purchase Directors and Officers Liability Insurance. This type of insurance is often very expensive and cannot be used to indemnify a director in circumstances where the liability is:

- owed to the company
- arises out of a lack of good faith, a wilful breach of duty or improper use of position, or
- is sanctioned by the imposition of a pecuniary penalty or compensation order

Note

An interest will be ‘material’ if a director has a substantial interest in a matter under consideration and that interest may influence the vote of a director on that matter. For example, a director may stand to gain a benefit (directly or indirectly) from a contract entered into by a company.
Resources

Related Not-for-profit Law resources
The Not-for-profit Law website has further resources on the following topics:

► Fundraising and new funding models
► Governance and legal duties of office holders
► Joint ventures and partnerships
► Debt financing

Resources on equity issuances and equity financing

► Debt vs equity financing

Related ASIC resources

► Director’s duties
► Shares
► Fundraising
► Insolvent trading

Legislation

► Corporations Act 2001 (Cth)