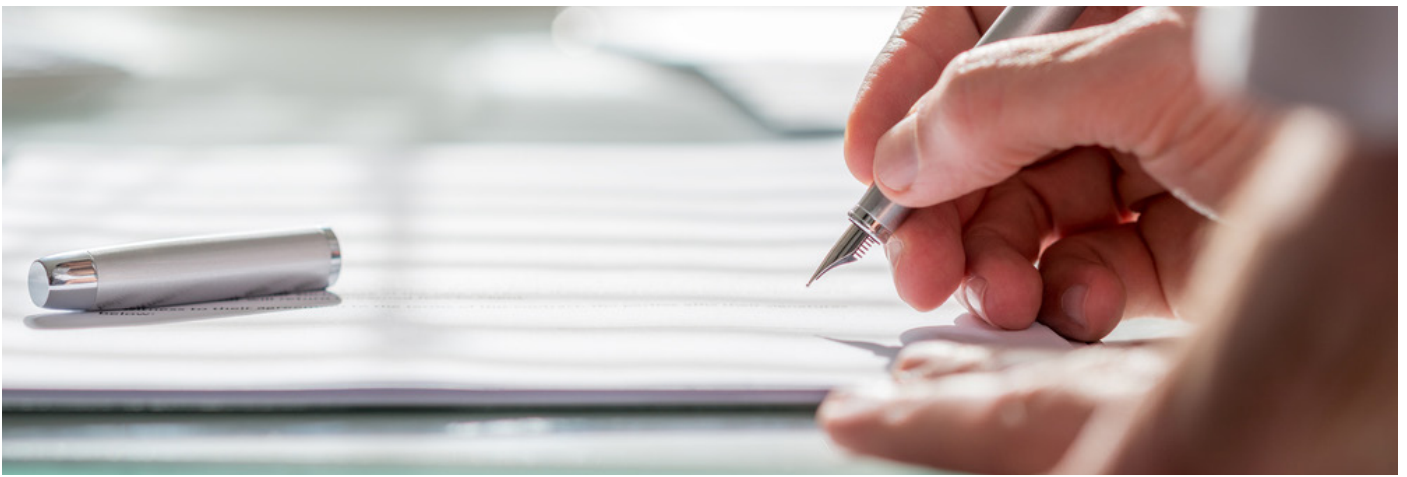


INDUSTRY INSIGHTS

By James Koutsoukos

Securing related-party loans to small businesses – why it's a good idea



Small-to-medium-sized enterprises (SMEs) are often family companies that have just one or two directors or shareholders. When these shareholders, or their family members, advance funds to the business, they often don't realise they can secure the loan, much like a bank does.

This is an area in which the lenders' advisers, such as their accountants or solicitors, have an opportunity to educate their clients.

In the past, when a business asked a bank for a loan to cover potential shortfalls, the bank would traditionally take a security in the form of what was called a 'charge'. Nowadays, any security a bank takes over a company is registered on the Australian Government's Personal Property Securities Register (PPSR).

SMEs are often established, however, with working capital loans advanced by the shareholders, directors or family members. These related parties may also inject additional funds if the business is expanding, investing in new assets or has cash flow deficiencies during its trading period.

Such advances are generally not well documented or secured. It's often just money advanced to the

company, on an ad hoc basis, as and when required.

As long as the business continues to thrive, this unsecured lending is not a problem.

Complications occur, however, when the company becomes financially distressed and enters into administration or liquidation. Secured creditors then have priority to be paid from recovered funds before any other creditor.

This can be a serious problem for related parties.

In many cases, the relations of SME directors are the business's largest creditors. They may have injected more money than anyone else, and so have the most to lose when the company faces financial difficulties.

The role of advisers

At BRI Ferrier, we often encourage accountants, lawyers and other business advisers to inform their clients accordingly.

Advisers should recommend to their clients that if they provide initial funds for a company start-up in this way or advance ongoing capital over a period of time, they should have a loan security agreement in place – a

Securing related-party loans to small businesses – why it's a good idea

formal loan facility between the related party and the company.

This provides the lender with more control and greater security.

If the company's fortunes decline and a liquidator sells the company's assets, the related party may have priority access to remaining funds that may be recovered.

If a director of a small business asks a bank for money, the bank will demand a security, and it shouldn't be any different when an SME's director asks their brother, sister, mother or father. Why shouldn't they take a security?

It's the same principle in both cases.

Accountants and lawyers should also advise their clients that secured creditors have the power to appoint a receiver. If a company is ultimately wound up by the court, the related party (as a secured creditor) can appoint a receiver to recover assets under the security they have taken.

Issues to consider

The first consideration in taking a security is the clear identification of the specific funds advanced. The lender and the business should be able to document a transfer of funds from the lender into the company's balance sheet for a specific purpose, such as acquiring an asset, property, machinery or motor vehicle, or for ongoing working capital.

All parties must be able to see it and trace it.

The security should also be taken at the time of the advance or shortly thereafter.

This is important because, if a considerable period of time lapses between the funds advanced and the taking of the security, and the business subsequently becomes insolvent, a liquidator may overturn the transaction and the loan is deemed to be unsecured.

In addition, if there are numerous advances over a period of time, it's a good idea to create a facility agreement – a line of credit that the business can draw down on from time to time. In this case, the security is

taken at the time the facility agreement is provided.

The process of taking a security

The first requirement is a form of agreement or a document setting out the details of the transaction. This might be a loan agreement or facility agreement that supports the right to register a security.

Then, to take security over a company, a lender has to register the security on the PPSR, within the timeframe prescribed by the relevant legislation.

The agreement will generally outline how one party is loaning or advancing money to another party. It stipulates the amount of money and the details of how, in return, the receiving entity will grant the lender a security over its assets (in the form of a general security agreement to be registered over the company on the PPSR).

It's not dissimilar to taking out a mortgage.



Securing related-party loans to small businesses – why it's a good idea

The lender's accountant or lawyer can prepare and lodge these documents.

Just because a lender has a security, however, it doesn't mean they have to enforce it. If the business becomes insolvent, the secured creditor can choose to allow other creditors to be paid first.

It's ultimately a matter of choice and control. Taking a security provides that choice and control if a business doesn't succeed in the way its directors may have envisaged.

Important notice. The information contained in this bulletin is by way of general comment only and is not intended as a substitute for specific advice that addresses your particular circumstances. You should seek specific advice before acting. The information contained in this newsletter remains the exclusive intellectual property of BRI Ferrier and any reproduction, publication, communication or adaptation of this information, without the prior written consent of BRI Ferrier, will constitute an infringement of The Copyright Act 1968.

About BRI Ferrier

BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

Author

James Koutsoukos
Principal
BRI Ferrier, Melbourne

T: +613 9622 1800
jkoutsoukos@briferriernsw.com.au



For positive solutions to financial difficulties please contact us.

The initial consultation to your client is free, strictly confidential and without obligation.

Sydney

T: 02 8263 2300
info@briferriernsw.com.au

Melbourne

T: 03 9622 1800
info@briferriervic.com.au

Adelaide

T: 08 8233 9900
info@briferriersa.com.au

Perth

T: 08 6316 2600
info@briferrierwa.com.au

Brisbane

T: 07 3220 0994
info@briferriersq.com.au

Cairns

T: 07 4037 7000
info@briferriernq.com.au

Townsville

T: 07 4755 3300
info@briferriernq.com.au

Mackay

T: 07 4953 7900
info@briferriernq.com.au

www.briferrier.com.au