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Protecting Your Investment in Your Business

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by John Brunt
Originally published in *Blaneys on Business* (December 2011)

One key consideration for any new business -- or any existing business, for that matter -- is the ability to obtain and maintain financing for ongoing operations.

New and ongoing businesses often seek traditional financing, such as loans from banks or other financial institutions. In making arrangements for such loans, the lender requires, and obtains, a security interest over all of the assets of the borrowing business so that repayment will be assured. By doing this, the lender stands in first position among the creditors of the borrowing business (with exceptions for such statutory liens as employee withholdings and HST) and is in the best position to recover fully the amount it has loaned (together with interest and collection costs). This is prudent business practice and has provided secured lenders with consistent recovery of loans for many years.

With this in mind, and knowing that banks and other traditional lenders will not provide any loans to your business without being fully secured, why should you, as the business owner, be any less insistent with respect to your own hard earned money if you are lending it to the business, which is a separate legal entity, such as a corporation? (The security process will not apply in the case of a sole proprietorship where the sole proprietor is funding the business. It works well, however, where a business has been incorporated or where the lender is another individual who may be related to the sole proprietor, such as a spouse, parent or sibling or even a friend.)

The banks, or any other traditional lenders, will always require that they be first in line for repayment should your business fail or require restructuring. After they have been repaid fully, however, there may often be significant assets, including cash, available for distribution among remaining creditors. Being next in line will help ensure some return for you, as the business owner, on many hard years of effort and investment. It will also provide some consolation in otherwise difficult circumstances.

While the concept of being next in line after the bank is simple enough, the actual process sometimes can be more difficult, given the non-arm's length nature of loans by business owners or relatives. This non-arm's length relationship also makes these security arrangements more subject to scrutiny in the event that you are ever required to rely on them to obtain repayment ahead of other creditors. For that reason, these arrangements should be undertaken properly, and at the right time, to ensure that the security can withstand any subsequent attack by other creditors.

When individuals start businesses, they often utilize their own funds to provide some or all of the initial capital. Once the business becomes successful, the business owner, understandably, wants to recover the start-up loan without tax consequences. For that reason, the initial capitalization by the business owner is commonly completed by way of a shareholder loan rather than shares.

Clearly the best time to put security arrangements in place between a business owner as lender on the one hand, and his business as borrower on the other, is at start-up, when there are no other creditors who could be prejudiced by the granting of security and no outstanding liabilities at the time the security is granted. Ironically, although this is the time when the security ultimately could provide the most benefit, it is also the time when lenders/business owners are reluctant to put it in place because it involves some additional start-up costs and because they believe they won't need it. Unfortunately, this is similar to the younger person who declines to put a will in place because he thinks he will not die imminently. In some cases, the end comes prematurely. It is best to be prepared.

Irrespective of the specific circumstances, the security process involves ensuring that the actual loan is properly documented and can be proved. This often involves delivery of promissory notes representing the amounts advanced, together with evidence of the actual transfer of funds from the lender/business owner to the business. Generally, such loans are repayable on demand and interest may or may not be payable, depending on the particular circumstances. If interest is payable, interest payments should be honoured and paid in a timely manner. They should be expensed by the business and accounted for as income by the lender/business owner.

At the time a loan is made, a security agreement is executed by the business in favour of the lender/business owner, granting a security interest in all the personal property and assets of the business. In the event that the business owns or utilizes real property, it might be worth having the business grant to the lender/business owner security by way of a mortgage on the land or a charge of lease. The amount of the loan and the value of the business's interest in real property would have a bearing on whether to go this route. Taking security in real property is often more involved than taking security in the other property of a business. It may have some real value, however, where the location of the business is important to its continued operation.

Once the initial security is in place, it can be maintained and can cover any additional advances made by the lender /business owner, subject, in the case of mortgage, to any upward limit set out in the registered mortgage. The hope, of course, is that once in place, the business will remain successful and the security will never be required.

As we mentioned earlier, it is best to put security in place when business operations begin. If this has not been done, however, all may not be lost. It is possible, subject to the financial condition of the business, to properly structure further loans with security which could also be used to secure the existing loans. It should also be noted that where security is granted by an ongoing business to a related party, it is unlikely to withstand attack from other creditors for a period of 12 months and perhaps longer, depending on the financial position of the business at the time the security was granted. The sooner such arrangements are implemented, then, the better.

We often hear that a business has closed down and left many of its creditors unpaid, only to reopen in the same location shortly thereafter, carrying on the same business, and apparently being operated by the same people. While there are many ways that this can occur, the security granted to a lender/business owner may be instrumental in providing for this fresh start.

While having proper security does not guarantee repayment; should a business fall upon hard times, such security might permit a successful restructuring of the business, which might not have been possible otherwise.

It is your business. It is your hard work that has made it successful. Strong, appropriate security arrangements can provide an additional insurance policy to protect your considerable investment and your future.