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Business succession - managing loans

Helping business clients plan their exits...

In the current economic climate, we are finding more advisers moving into business succession planning to help clients in partnerships plan for their involuntary exit by putting insurance funding in place for death, TPD or trauma.

A critical part of this process lies in supporting it with a legal agreement to ensure the equity changes hands when the insurance is paid out. Here at Irongroup, we not only work with the clients to prepare the Buy Sell Agreement, we can also work with the Advisers to sort out some of the financial issues including what should happen to loan accounts. This review focuses on some of the common problems and solutions involved in managing those loans.

Case Study: Mark & Steve

Mark & Steve have been in business together for almost 10 years. They have worked hard and it has grown steadily. They have agreed on a plan which is being funded by insurance and implemented with a Buy Sell Agreement. The Adviser has identified the insurance funding they need to cover the business value and an amount for CGT. The next question is - how do they want to handle their outstanding loans?

External Debt

Scenario 1: Debt owed to a bank with guarantees in place

The business has a $500K overdraft, for which the bank required Mark & Steve to sign personal guarantees. Let's say Steve dies and his estate receives his insurance payout. The Buy Sell Agreement ensures Steve's share in the business passes over to Mark (at no cost), with Steve's estate liable for any CGT payable on the transfer of those shares. (That was also covered by insurance funding). But what happens to the debt owed to the bank?

Depending on the bank's loan agreement, the bank could call up the loan as a result of the death. However even if it doesn't, Steve's executor still has a problem because she can't wind up the estate until the guarantee is extinguished. Potential problems all round. Does the business have enough money to repay the loan? Probably not. Does Mark have enough money to repay it himself? Possibly not. So how can you help sort this out?

Loan accounts	Most common solutions
External debts	**Key person policies – owned by the business**
Unpaid distributions	**Loan forgiveness clauses in Buy Sell Agreement**
$ borrowed for working capital	**Key person policies – owned by the business**
$ loaned to business owners	**Extra insurance cover – usually self-funded**

Most common solution: What most clients do in this scenario is have the business take out key person policies on both Mark & Steve (for say Life & TPD) for the full amount of the debt (plus extra for CGT on TPD cover). So if Steve dies, the business receives the $500K, the loans are repaid and the guarantees are extinguished.

Are you looking to extend your service offering? Want to grow revenue? Email info@irongroup.com for information on our Alliance Partner advice model to find out how we can help you achieve these goals.

Internal Debts - business owes money to the owners

Scenario 2 Unpaid distributions

As a business grows it often needs working capital so whilst a distribution may have been declared, no money may have been taken. These debts can build up and are often known as beneficiary loans - here the business owes both Mark & Steve $400K each.

Let's say Mark suffers a TPD, receives an insurance payout which triggers the Buy Sell agreement and he exits the business. But what happens to the $400K beneficiary loan owed to Mark? Mark still has a right to the funds and could sue the business. Can the business afford to repay it?

Most common solution: The business can take out key person insurance to cover this but clients usually choose to forgive these particular loans. We ensure this is covered with 'beneficiary loan forgiveness clauses' in our Buy Sell Agreements.

Scenario 3 Money borrowed for working capital

Rather than borrow from a bank, the business borrows from Mark & Steve. Mark provided $250K from his own funds and Steve $350K from his funds.

Let's go back to the scenario where Steve has died and the Buy Sell Agreement has been triggered. Steve's estate receives the insurance and pays the CGT and his share in the business transfers over to Mark.

What happens to the $350K Steve is owed? The business will either have to fund it from retained profits, borrow it or Mark could fund it from his own assets. Are the clients happy with this possibility? Usually not.

Most common solution: When money has been lent to the business from personal funding, the clients usually want to see it being repaid when they exit. So again, key person policies (usually owned by the business) could be written to cover these amounts.

Internal Debts - the owners owe money to the business

Scenario 4 Money loaned to business owner

Turning the above scenario around this time, Steve & Mark have each borrowed $250K from the business to buy holiday homes. Again Steve dies, the insurance is paid to the estate, CGT paid and his shares transfer over to Mark. The business however is still entitled to the $250K from Steve's estate. What now?

Most common solution: These amounts are usually added to each individual's Life & TPD policies. So if the business is worth $1m, Steve & Mark would each have $500K cover for the business value, $150K for possible CGT and $250K for these loans - total cover of $900K.

Whilst these are some of the more common solutions to these issues, we discuss all options with clients, and of course where extra insurance is required, with their Advisers, when liaising with them to prepare their Buy Sell agreement.

Irongroup Lawyers' service options for Advisers

1. Referrals

If your clients need estate planning or business succession advice, email their name & phone number to **referrals@irongroup.com** & we will contact them obligation free to discuss our fixed fee services.

2. Irongroup Lawyers training for Advisers

We offer lunchtime seminars or full day workshops. For more information visit **www.irongroup.com**

3. Irongroup Lawyers Alliance Partner advice model

If you want to grow your practice by offering an in-house estate planning or business succession planning service you may like to consider licensing our system. Email us on **info@irongroup.com** or call 03 8621 9000 for more information.