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COMMERCIAL & CORPORATE LAWYERS



“Exotic and other interesting types of Loan arrangements”

Presented by
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Tom has over 30 years' legal and business experience including:

- ✓ Previously working for local law and major national firms
- ✓ Being the national operations manager for a financial advisory IT platform provider
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- ✓ Owning and managing an IT consultancy business
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Tom is also a regular publisher of articles and is one of Australia’s leading presenters of legal seminars to and for various professional bodies, associations and government authorities on a wide range of business law and professional development-training topics including:

WA Department of Commerce	Institute of Public Accountants	CPA Australia
Chartered Accountants Australia & NZ (CAANZ)	Governance Institute of Australia	Mortgage & Finance Association of Australia (MFAA)
Law Society of WA	National Electrical & Communications Association (WA)	City Insolvency Discussion Group
Innovation Centre of WA	Australian Hotels Association (WA)	Forum for Directors of Indigenous Organisations (FIDO)
LegalWise CLE	Small Business Development Corporation	Stirling Business Centre
The Tax Institute	Australian Institute of Conveyances (WA)	Institute of Certified Bookkeepers
Western Suburbs Business Association	Business Foundations Inc	WA Business Assist
Strata Community Association of Australia	Real Estate Institute Western Australia (REIWA)	Australian Institute of Business Brokers (AIBB)

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Undocumented Loans

- If one party informally lends another party money without specifying any terms in writing or there is any other evidence to the contrary e.g. provision of goods as security, any representations made etc), then what are the terms of that loan?
 - It is simply a debt, repayable immediately upon demand (i.e. at call)

- Importantly, there will be no other terms and conditions applying to such a loan e.g.
 - For the Lender/creditor –there will be no ability to recover interest, no ability to obtain security for payment ;and
 - For the Borrower/debtor no ability to defer repayment.

Undocumented Loans (cont'd)

- In addition to the common situations where parties lend money to friends and family on an undocumented basis (which we discuss further in this seminar) there is also the situation where parties go into start a business venture through either, say a company or a unit trust and they ‘informally lend money’, to help with its initial working capital requirements.
- Is that actually:
 - a loan and therefore repayable at call by the new entity; or
 - is it a capital contribution?
- If it is the latter, obviously it is not a debt (it will be for the issue of either new share or unit capital) and will therefore have very different legal, tax and financial circumstances surrounding such.
- Hence why it is critical that, in addition to any relevant balance sheet, those parties always have a clear set of minutes and a Share Issue/subscription Agreement in addition to an appropriate Shareholders Agreement when setting-up say a company.

Vendor Finance

- How much?
- Usually no more than 10% of purchase price and commonly much less (but for the Seller, ensure that its not a nominal amount too)
- Up-front and refundable until/if settlement?
- Single or 'phased deposit(s)'?
- Vendor Finance Arrangements (VFA):
 - Firstly, why!?
 - How much a part of the purchase price (and whether a Deposit has also been paid).
 - Also recommend the VFA term be shorter and rate of interest be higher than commercial lending rates, and maybe an 'early repayment' incentive provision.

Vendor Finance (cont'd)

- VFA must be as a full written loan agreement with term, interest rate, repayment schedule, warranties, insurances & certificates of currency, access to premises, provisions of financials, verification and audit, plus securities!
 - (e.g. PPSR over all of the business assets i.e. an ALLPaP. Not just over, say, stock etc)
 - plus consider third party-guarantees (with securities too?)
- Where does VFA 'rank' with other financiers and secured creditors?
- 'Irrevocable Privacy Disclosure Consent' from Buyer/Borrower whilst any monies is still owing to Seller/Lender under VFA Loan Agreement (including surviving upon material default or termination)
- To the VFA Seller: Do you just want your money or the (probably trashed) business back if the has Buyer defaulted?
 - i.e. Retirement vs. Reversion back into the business!?

Limited recourse borrowing arrangements for SMSFs

- Anything but a standard form of property purchase agreement!
 - Is it a 'compliant property' acquisition?
 - Have they actually got a investment strategy?
 - Is there a proper SISA-compliant lease in place?
- Commonly now involves not just the SMSF as the Buyer but also the members as Guarantors...
- Members need to understand the effect of, if the 'limited recourse ' loan guarantee is called upon, that they may have to pay towards such and this may be deemed breaching their excess Contribution Cap limits...
- 2 distinct phases and transactions involved:
 - the first environment involving the acquisition in a bare trustee/custodian capacity; and
 - the second upon completion of the loan, and it Vesting for nominal duty ultimately upon the SMF itself.

‘Mum & Dad’ to their new business entity

Very commonly individuals personally-borrow money and then loan that money on to their new entity to say: buy a business, acquire equity, help provide a loan for working capital to help privately fund their business etc.

However, I still find it very rare that (despite their being a ‘bank’ for their business entity and usually seeking their accountant’s advice) individuals act like a bank and put in place the requisite finance document and security arrangements from the outset.

Further, I can absolutely assure you that a ‘loan’ merely written into a balance sheet has zero security effect...

Example:

1. Mum and Dad are directors and shareholders (say through a family trust) of a newly-formed Company and they wish to buy a business with the Company.
2. They use their home as both a source of equity to obtain a loan from a bank and establish a personal line of credit.
3. Mum & Dad then effectively:
 - on-lend this money to their new Company (i.e. an entirely separate entity but they think “Well, it’s my company too. So, what do I need to worry about..?”) to buy the business
 - yet their informal/undocumented loan is not secured against their buyer Company...

* However, the last thing you want to see is that later on down the track other parties (e.g. overdraft financiers, a lessor, franchisor, suppliers etc) have subsequently secured priority on the Company over and ahead of Mum and Dad.

‘Mum & Dad’ to their new business entity (cont’d)

4. Therefore, there needs to be:
 - a relatively simple yet nonetheless, written, Loan Agreement and at the very least it should clearly specify:
 - i. the amount of money advanced (and when),
 - ii. the commencement date and term of the loan,
 - iii. the interest rate (at least as high as their bank is charging them personally),
 - iv. whether it is a principal & interest or interest-only loan,
 - v. the manner of repayment of the interest and principal
 - vi. effects of default and termination
 - vii. any special conditions (obviously there are number of other highly-recommended provisions that should go into a good, contemporary commercial loan agreement).
 - with an incorporated General Security Agreement (“GSA”) over the all the ‘personal property’ in the Company

‘Mum & Dad’ to their new business entity (cont’d)

- A. (i.e. all the non-land assets that it will be buying present and any assets it may also acquire/own in the future (e.g. cash, goodwill, debtors, IP etc...)) under the Personal Properties Securities Act. This is known as ‘all present and after-acquired property’ (“AllPAP”) and was formerly known as a ‘fixed & floating charge’.
- B. Alternately, if the particular asset the Company was going to buy was land (i.e. real property) then they would still need a Loan Agreement but this time they would have a Mortgage as the security instrument. Of course, you can have both a GSA and a Mortgage, depending on the assets of the Company.

between Mum and Dad (Lenders) and their New Company (Borrower) asap!

With all the relevant information provided an experienced Securities Lawyer can have the required Loan Agreement and GSA prepared usually within the day; subject to complete instructions. And, once signed or electronically accepted by the parties, to properly register it on the Personal Properties Securities Register ("PPSR"), it can be done in much less than an hour.

- 7. Pro tip: Make sure that all loan documents are signed and the security interest registered on the PPSR at or even just before the loan advance!
- 8. Lastly please note that trying to retrospectively formalise and ratify any such loan security arrangement, once the Company is already in financial distress and/or technically-insolvent, may be ineffective. I usually call that situation a need for ‘fiscal palliative care’. Please don’t go there.

Mum & Dad to their children

- Commonly parents may want to, if they can afford, to financially assist their children.
- Important for them to understand that it needs to be a formal written loan agreement between the parties.
- Equally important to understand that it is almost impossible to prevent a family law claim against an affected child even if the loan is written secured by mortgage and serviced i.e. interest in principle regularly paid by that child.

NOTE: there is a material difference between undocumented loans from, say, a parent to child. It may be deemed (an unrecoverable) gift pursuant to the principle known as the “presumption of advancement”.

Reverse Mortgages / 'Equity Release' Loans

- A Reverse Mortgage (or 'equity release loan') allows you to borrow money using the equity in your home as security.
- The loan can be taken as a:
 - lump sum;
 - a regular income stream;
 - a line of credit; or
 - a combination of these options.
- No income is required to qualify. Interest is charged like any other loan, except the client does not have to make repayments while they live in their home – materially, the interest compounds over time and is added to the loan balance (interest is capitalised).
- The client remains the owner of their home and can stay in it for as long as they want.
- Unlike traditional Mortgages, with a Reverse Mortgage regular loan repayments are not required...

Reverse Mortgages / 'Equity Release' Loans (cont'd)

- However, the loan must be repaid in full including interest and fees, if the client (or their Executor or Power of Attorney, as the case may be):
 - sells their home;
 - dies; or
 - in most cases, moves into aged care.
- Since September 2012 there are statutory 'No Negative- Equity' provisions pursuant to the National Consumer Credit Protection Act.
- To offer reverse mortgages, mortgage brokers must also be accredited (Previously AEQAL and now MFAA) and provide a 'reverse mortgage information statement'.

Reverse Mortgages / 'Equity Release' Loans (cont'd)

- Risks of Reverse Mortgages:
 - Interest rates are generally higher than average home loans. If the client fixes their interest rate, then the 'break costs' of a Reverse Mortgage can be very high.
 - The debt can rise quickly as the interest compounds over the term of the loan. Consider; house prices fall and/or variable interest rates go up = rapid deletion of equity in home.
- The loan may affect:
 - pension eligibility
(note: should be advised to consider obtaining appropriate Licensed Financial Planning advice); and
 - estate planning wishes
(note: should consider reviewing their current Will and Power of Attorney, if any...)
 - future aged care or other financial needs.
- Lastly, if is another party (such as a non-owner spouse or carer family member) lives with owner, that person may not be able to stay when the owner dies.

Convertible Note

- A convertible note is a form of short-term debt instrument that may convert into equity, typically in conjunction with a future financing round.
- In effect, the investor would be loaning money to a start-up and instead of a return in the form of principal plus interest, the investor would receive equity in the company.
- The primary advantage of issuing convertible notes is that it does not force the issuer and investors to determine the value of the company when there really might not be much to base a valuation on – in some cases the company may just be an idea.
- That valuation will usually be determined during the ‘Series A’ financing, when there are more data points off which to base a valuation.
- The form of a Convertible Note Agreement can take many different iterations i.e. there is no such thing as a 'standard' convertible note. TIP: If the investor ‘lender’ is possibly going to be a Shareholder, then also make sure that the Shareholder Agreement is understood and agreed at the outset.

Convertible Note (cont'd)

When evaluating a convertible note, there are a few key parameters that must be kept in mind:

➤ Discount Rate

This represents the valuation discount you receive relative to investors in the subsequent financing round, which compensates you for the additional risk you bore by investing earlier.

➤ Valuation Cap

The valuation cap is an additional reward for bearing risk earlier on. It effectively caps the price at which your notes will convert into equity and – in a way – provides convertible note holders with equity-like upside if the company takes off out of the gate.

➤ Interest Rate

Since you are lending money to a company, convertible notes will more often than not accrue interest as well. However, as opposed to being paid back in cash, this interest accrues to the principal invested, increasing the number of shares issued upon conversion.

➤ Maturity Date

This denotes the date on which the note is due, at which time the company needs to repay it.

Sophisticated Investor Certificates

Under the Corporations Act any person buying securities or other financial products must be given regulated disclosure documents; save for some of the exemptions.

One of the exemptions is the offering financial products to a ‘person’, who is the subject of the current certificate from a “qualifying accountant” certifying they have prescribed net assets or gross income level.

- A person holding such a certificate is a:
 - ‘sophisticated investor’ for the purposes of Chapter 6D if they are offered debt or shares.
 - ‘wholesale client’ for the purposes of Chapter 7 (if they are offered a financial product, other than insurance, superannuation or a retirement savings account product or service) and the financial product is not used in connection with a business.
- A person is only eligible to be the subject of a certificate if they have:
 - a gross income of \$250,000 or more per annum in each of the previous two years; or
 - net assets of at least \$2.5 million (reg 6D.2.03 and reg 7.1.28). Note: companies are included as controlled assets but not trusts*
- Such certificates will be valid for up to 2 years after the date they are issued.

Control is defined as “the capacity of one entity to determine the outcome of decisions about another entity’s financial and operating policies”.

Dealing with SMSF Trustees is likely not to be a control aspect, unless they are the sole director (of the SMSF’s corporate trustee) and member.

Note: since July 2017 ASIC has increased its vigilance to possible inappropriate use of accountant’s certificates to treat investors as wholesale clients.

Retention of Title and Credit Applications

- Commonly clients still think that they may not need to have written, standard Terms of Trade or Terms & Conditions (T&Cs).
 - Too often they mistakenly think a ‘handshake’ will do or that the contracting party’s T&Cs will suffice/protect them....
 - Recognise the dynamic of being either a ‘contract maker’ or a ‘contract taker’
- Related to that very much is whether they wish to have:
 - a ‘retention of title’ (the ‘old’ Rompla clause) provision for those supplied goods/materials (and to be able to recover same, no matter what condition they may be in); and/or
 - simply to get paid for such goods?
- In any event they must have a written agreement so that it complies with the Personal Property Securities Act and is in the form of a ‘General Securities Agreement’.
- Highly preferential to also not just secure over the goods but over all the businesses assets (i.e. personal property) by way of an All Present and After-acquired property (“ALLPaP”).
- Also, should strongly consider “directors guarantees” (and securities) over them as well!
 - Again, it is very important that if you're going to include an additional party (who is not a party to the contract/T&Cs such as a guarantor) then such needs to usually be expressed by way of a deed.
 - Accordingly, the T&Cs document should be properly executed and witnessed as a deed in order to be legally enforceable

Mortgages versus Caveats

- NOTE: one is a registered form of security and the other is merely a ‘notification’ on the title!
- Mortgages need to be registered and therefore the title produced. Note: can be challenging to get such registered:
 - if there is a prior-ranking mortgagee and
 - may need to do and agree a Deed of Priority.
- With caveats need to understand whether:
 - they are ‘subject to’ or an ‘absolute’ caveat; and
 - you have an actual interest in that particular real property in the first instance.
- Namely an instrument (i.e. written terms and conditions, which expressly allows you to at least charge or, more specifically register, a security interest over real property (together with legal costs and interest etc) you're relying on to create a caveatable interest in that real property?
- For example, if there is a debt owed by someone to say the builder who did works on a property that does not in itself create a caveatable interest in the property but merely against the customer as a debtor.
- Hence why you need to have additional provisions for the creation of security interest in addition to the primary obligation to pay the debt (plus costs and interest etc)
- Caveats can also be directed to be withdrawn by prior-registered security holders e.g. mortgagees and they may not be required to provide information (i.e. financial details) as to whether there will be sufficient residual equity in the property to determine whether to release caveat but penalties will apply if still held on!



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