

Know Your Liabilities Before Borrowing

Loans vary and carry different requirements and risks.

Many of you have had the experience of borrowing money, either to purchase an automobile, a house, or some other pricey item. From your perspective, the financing process may seem relatively straightforward: You disclose a great deal of personal financial information about your finances, you sign an ungodly number of documents, and you begin making payments. Actually, consumer financing is a relatively straightforward process, partly because there are strict laws and regulations to which lenders must adhere. These laws include required disclosures regarding interest rates, loan terms, and repayment provisions.

Business financing is another matter. While borrowing from a commercial lender is, in many respects, straightforward, commercial lenders have a great deal more latitude in designing their loan agreements. Likewise, borrowers have the opportunity to negotiate for terms that will fit their business needs.

Commercial loans can take a number of different forms. Businesses might set up a line of credit for working capital. Typically, the line of credit will allow a business to borrow up to a certain amount at any time for any need. The line of credit may carry over from year to year, but it is not uncommon for lenders to require the line to be paid down periodically (for example, once per year). Additionally, lenders frequently will make fixed-term loans for the purchase of equipment or acquisition of a particular asset. Alternatively, lenders may offer a lease/purchase arrangement as a substitute for a traditional term loan.

Most commercial loans will require significant collateral as security for the loan and, frequently, personal guarantees from the business owners. When more than one person owns a business, negotiation regarding the extent of each individual's liability for the loan frequently is required. In the right circumstances, a lender may limit each owner's liability to an amount proportionate to his ownership interest in the business.

From a legal standpoint, there are some key items that require your attention:

- Provide complete and accurate financial information. Obtaining a loan under false pretenses will leave you exposed to both criminal and civil liability.
- Be aware of not only the economic but also the non-economic terms of the loan. Pay particular attention to "loan covenants" that may restrict how you operate your business while the loan is outstanding.
- If you are in business with other individuals, make sure to document your legal authority to enter into the loan agreement on behalf of the business. If you operate outside of your authority as an officer of the business, you may have personal liability.

Sometimes, a business owner who is in search of better loan terms will consider borrowing from individuals instead of a commercial lender. While it is true that you may have

better opportunities to negotiate loan terms, you need to be very careful that your borrowing plan does not violate state securities laws. It may seem odd, but promissory notes issued by a business may be subject to the same state laws that apply to a business' issuance of stock. In fact, in many states there is an initial presumption that promissory notes from a business to a private lender constitute "securities" under state securities law, unless there is evidence that both parties understood the transaction to be simply a loan and that the public is adequately protected from entering into an otherwise "risky" investment.

It may be in your interest to offer promissory notes that are registered as securities. Such debt instruments can sometimes include terms that allow the borrower and the lender to share risk. For example, some debt instruments provide for a lower rate of interest if the interest is paid sooner, with a higher rate of interest if payment of interest is delayed. Other instruments include a share of profits for the lender in addition to the stated interest rate. Many business owners would prefer to give this type of security to a lender instead of stock in order to preserve exclusive ownership.

Sometimes, the only form of business financing available to a business owner is "equity financing." In this case, the business owner sells interest in the business in order to raise capital to grow the business. The disadvantage to equity financing is that the business owner ends up with partners who have a legal right to be informed about all significant business events and the right to have the business operated in their best interests. On the other hand, equity investors clearly accept risk for their investment. If the business fails, you will have no legal obligation to repay the investors.

Whatever financing direction seems right for you, be sure to seek good advice before making any commitments. It is much easier to create a good business deal from the start than to try to extract oneself from a bad deal.

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