

H G & G U P D A T E

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What You Should Know Before Lending Money to a Business

How to ensure that in the event of bankruptcy your loan to a business will be considered a loan rather than a contribution to capital.

A loan to a business may result in at least partial repayment in the event of a bankruptcy.

It is not unusual for an individual to loan money to a company with which he or she is associated or to make a loan to a friend's or a family member's business. After the loan is made, the unexpected occurs, and the business suffers a financial reversal and is forced by circumstances to file a bankruptcy petition. To complicate the lender's difficulties, the Trustee in a Chapter 7 Bankruptcy (a liquidation) or the Debtor's or Creditor's Committee in a Chapter 11 proceeding (a reorganization) objects to the allowance of the claim for the loan, contending that the claim should be recharacterized as a capital contribution and therefore disallowed.

General Overview

If the loan is determined to be a capital contribution, the debt to the lender will be extinguished. In making this determination, the Bankruptcy Court will weigh substance over form and apply several factors in determining whether the loan should be recharacterized as equity. Most of the factors consider whether the transaction bears the earmarks of an arm's length transaction. The more the transaction bears the attributes of an arm's length transaction, the more likely the court will treat the loan as a loan and not a capital contribution. No one factor is controlling but some factors are more important than others. One important factor is whether a disinterested lender would have made a similar loan under similar

circumstances. One important factor is the sufficiency of the capitalization of the business at the time that the loan was made.

The test for whether a business is deemed undercapitalized is whether a reasonably prudent person with a general knowledge of the particular trade and its hazards determines that the business' capitalization is insufficient to support it. Undercapitalization is demonstrated by either showing (a) insufficient capital to make a similar business viable, or (b) inadequate capital to obtain an equivalent advance from an informed outside lender. However, undercapitalization standing alone is not sufficient to justify recharacterization of a loan as equity.

Factors To Be Considered

There are no fewer than 14 different factors applied by the courts to determine whether a loan should be recharacterized as equity.

Factors considered by the courts are as follows:

1. Availability of outside financing (third party lender test);
2. Name given to the debt instrument;
- 2a. Existence of a written document providing for payment of interest and a maturity date;
3. Capitalization;
- 3a. Adequacy of capitalization, and whether ultimate failure due to undercapitalization;
4. Arm's length nature of the transaction;
5. Intent of the parties;
6. Nature of relationship between lender and shareholders of the business;
7. Enforcement of collection after default;
8. Source of payments for repayment;
9. Use of proceeds of loan;
10. Entries of a loan on the parties' books (how debt treated in business records of both parties);
11. Subordination to other debts;
12. Actual or partial repayments;
13. Amount and degree of the lender's control over the business and his or her participation in its management;
14. Timing of advances or loans.

Factor 1—Availability of Outside Financing

A major test used by the courts is the ability of the business to obtain similar financing from a disinterested lender. If outside financing is available, then the advance is deemed an arm's length transaction, and the advance should be treated as a loan. The court will consider if a bank or other commercial agency would have been willing to lend funds to the company on similar terms. If the business lacked the financial strength (capitalization) to obtain an equivalent credit from an unrelated third party, then the tendency is for the court to find the transaction to be an equity or capital contribution.

Factor 2—Name Given to Debt Instrument

The court is not bound to treat the advance as a loan, even if the documents memorializing the transaction state that it is a loan. On the other hand, if there is no instrument evidencing a loan, with a maturity date and specified interest payments, the court will automatically recharacterize the transaction as a capital contribution.

Factor 2a—The Existence of a Written Document Providing for Interest and a Maturity Date

The fact that a note contains repayment terms and a maturity date or is a demand note is not binding on the court. The court will determine whether the interest rate is reasonable. However, if the note lacks repayment terms, a maturity date and reasonable interest, the transaction will be deemed a capital contribution.

Factor 3—Capitalization Undercapitalization can be demonstrated either by (a) an initial capital insufficient to make a similar business viable or adequate to support operations, or (b) insufficient capital for the company to borrow similar sums. During startup, the issue is whether the initial capital was sufficient to acquire capital assets and to provide a sufficient amount of working capital on hand to cover pre-opening expenses and initial operating deficits. If there is a high ratio of debt to equity, the advance is more likely to be treated as equity.

Factor 3a—Whether the Ultimate Financial Failure was a Result of Undercapitalization

Courts tend to find that a transaction was a capital contribution where the ultimate financial failure was a result of undercapitalization.

Factor 4—Arm's Length Nature of the Transaction

The more that the transaction bears the attributes of an arm's length transaction, the more likely the court will find that the transaction is a loan.

Fourteen different factors are used to determine if a payment is a loan.

Factor 5—Intent of Parties Generally, a court will look behind the form of a transaction to determine its substance. Nonetheless, if a transaction is referred to in documents as an investment or an equity purchase, a court will find that the transaction is a capital contribution.

Factor 6—Nature of Relation Between Lender and Shareholders of the Business

Where a loan to a business is equal to the business' existing deficits, the transaction is likely to be found to be a capital contribution. In addition, the ratio of debt to equity is a significant factor in determining whether a contribution will be considered debt or equity. The larger the proportion of debt to equity, the more likely that a Court will consider a particular contribution to be a contribution to equity rather than a further loan. Where the ratio of debt to equity was more than 20 to 1, the transaction was found to be a contribution to equity. Banks generally loan funds where the debt to equity ratio is at least 1 to 1; 4 to 1 is acceptable for an ongoing enterprise in its early stages; but 5 to 1 or 8 to 1 is a highly leveraged transaction, so that a further contribution will be determined to be equity.

Where shareholders make loans in proportion to their capital investments, their contributions will be considered capital contributions. If their loans are disproportionate to their equity interests, the contributions are more likely to be considered a loan.

Factor 7—Restrictions on Right to Enforce Collections

Courts have held a transaction to be an equity contribution where the note does not provide for a maturity date or it restricts the right to repayment after a default. If after a default, no demand for payment is made, or the obligation is not extended in writing, then the transaction will also be deemed an equity contribution.

Factor 8—Sources of Payments for Repayment Where the source for the repayment of a loan is not dependent upon the ultimate success of the business, the transaction is a loan rather than a capital contribution. Of course, if the loan is to be repaid only from future profits, the transaction is in fact a capital contribution.

Factor 9—Use of Proceeds If the proceeds of the transaction are employed to purchase core assets or to pay past debts which are the equivalent of operating deficits, the transaction is considered a loan.

Factor 10—Entries of a Loan on the Parties' Books

Courts generally find a particular transaction to be a loan when reflected as such on the books of the business and on those of the creditor who made the loan.

Factor 11—Subordination to Other Debts

Where a shareholder subordinates his funds to a bank or to another creditor, the transaction is likely to be deemed a capital contribution.

Factor 12—Actual or Partial Repayments

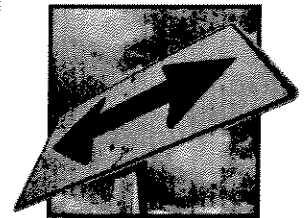
An actual or partial repayment tends to reflect the existence of a loan. If no repayments have been made, courts tend to recharacterize the loan as equity.

Factor 13—The Amount and Degree of Lender's Control

The more the lender controls the business, the more likely the court will find the transaction to have been an equity contribution, particularly where the lender receives management rights after the loan is made.

Factor 14—Timing of Advances

If the loan is made at the time of the formation of the business, the loan will usually be treated as equity. If the loan is made on a short term basis to meet unforeseen needs, its loan status will be maintained. However, if the loan is long term and used to purchase capital assets or to fund operations, the transaction is usually deemed a capital contribution.



Conclusion

The courts consider many factors in determining whether a loan will be treated as a loan or as equity or a capital investment. Not all factors are considered in every case. Different court decisions consider and stress different factors. Applying varying factors to actual factual situations makes predictions difficult.

Generally, a court is more likely to find the advance to be a loan and not a capital investment where the business at its beginning is adequately capitalized for its foreseeable capital needs and the ratio of debt to capital is two to one or lower. The debt should be evidenced by a standard loan document, such as a promissory note, with a fixed maturity date and a reasonable interest rate. Ideally, the loan should not be subordinated to any other debts, and there should be no restriction on the right of the lender to enforce collection. The proceeds of the loan should not be used to acquire capital assets. The loan should not be made by multiple shareholders in proportion to their stock holdings. Moreover, the bookkeeping records of the lender and borrower must reflect a loan. The loan should be made some significant time after incorporation and comparable financing from an outside lender should have been available. The shareholder-lender should not use the business for individual purposes adverse to the interest of the business and its creditors.

Conversely, the court is more likely to treat the advance as a capital contribution where the corporation is undercapitalized; the ratio of debt to equity is higher than two to one; there is no note or debenture; there is no agreement to repay the loan and no fixed maturity date or agreement to pay interest; the loan is not repaid; the loan is

subordinated to other debts; there are restrictions on the lender's right to enforce collection; the proceeds of the loan are used to acquire capital assets; the loans are proportional to stock holdings; the loan is secured by a lien on all assets; the loan is to be repaid only out of net income; the bookkeeping records of the lender and borrower do not reflect the loan; the loan is made near incorporation; outside financing was not available; the shareholder uses the corporation for individual purposes adverse to the interest of the corporation and its creditors; and undercapitalization is the cause of financial failure of the corporation.

A bankruptcy court will not automatically conclude that a transaction is a loan even where the lender believed he or she was making a loan. Therefore, the loan should be carefully structured and documented. For more information, for an analysis of your loan transactions, or to properly structure and document a loan you might be thinking of making, please contact Gary Sachs or one of the other partners of our firm.

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The firm conducts a general commercial practice.

Our principal practice areas are:

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts, foreclosures)
- estate planning
- trust and estate administration
- general litigation and alternate dispute resolution
- matrimonial and family law
- taxation
- bankruptcy and creditors' rights

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.