DISASTER LOOMS FOR BUSINESSES!

Bank loans threaten the growth of a business and the family of the principals. However, the extent of this hazard is generally not recognized by the owners of a business. Nor is it recognized by the family members who are assuming that the successful business will continue to provide for their financial security, income and healthcare needs.

This is a major reason why most businesses fail to survive to the third generation.
This is an enormous challenge for financial professionals - one that has been largely ignored. Even the banks' lending money to businesses have failed to sufficiently appreciate the extent of the problem and how relatively easy the terrible loss can be prevented.

Effective solutions can be implemented by a financial consultant, life insurance agent or even by a bank's insurance operation.

WHY A BUSINESS NEEDS LOANS

When a small business is first created, it is often a proprietorship or a two-person partnership. The initial capital contributions are from personal savings and a lot of sweat equity. As the enterprise grows, it needs more and more capital.

But small business owners cannot sell stock, float bond issues, obtain government grants or qualify for non-selective lucrative government contracts. They turn first to family members and then to local banks. Often there is a combination of loan sources.

Well-to-do Uncle Jim may initially loan some cash, but often will lend his credit by endorsing a loan made by a bank. When the business expands, due to successful operations, intra-family loans become impractical.

Bank financing is the only way to expand and fund the following:

- Expanding inventory requirements
- Growing accounts receivable
- New, more expensive equipment
- Raw materials storage
- Research and development
- Royalties or licenses
- Franchise down payments
- Acquisition of other firms
- Opening more locations
- Marketing expenses
- Package design and development

NO ONE READS AGREEMENTS

A business owner is so pleased to obtain critically needed funds from a bank that most details of the loan agreement are ignored. Focus is on just three loan elements:

- Amount of new capital
- Interest rate
- Payment terms

The personality of the typical founder of a business or professional practice contributes to this customary failure to carefully examine all the terms of the loan. A typical founder generally has the following personal characteristics:

- Visionary
- Leader
- Risk taker
- Hard worker
- Mono focused

Business owners want to expand their customer base, offer new products and/or services and occupy more territory. Professional practitioners want to see more patients or clients, delegate minor tasks to an expanded staff, acquire the latest technology, stay at the cutting edge of their profession and hope that a lawsuit does not jeopardize the practice.

WHAT'S IN THE SMALL PRINT

Every bank loan agreement contains a few items easy to identify – the amount of the loan, the interest rate, and the planned repayment such as "$4,800 per month beginning August 15, 20XX."

However, there is extensive text in every loan agreement that includes warnings and loan default terms. The warnings are required since the borrowers (and all guarantors) are giving up protections to which citizens are normally accustomed:

- Right to receive written notices
- Right to object or request court review
- Possession of other assets and accounts

The warnings notify the borrower he or she has given up these traditional legal rights. The agreement includes all the terms, but it does not receive enough attention.

Of even greater consequence are the various loan default terms. There are generally from 11 to 15 conditions in the very fine print of the agreement covering all the events which can cause a loan to be in default – regardless of whether payments have been made on a timely basis.

HERE IS WHAT HAPPENS

Magnum Auto Parts was formed by Bill Smith and Tom Jones as a 60/40 partnership. Bill owned more because he contributed all the starting customers and 60% of the capital. Later Bill and Tom incorporated and eventually they conveyed 10% of the stock shares to Sam Green, their leading sales representative. Stock ownership is now:

- 54% Bill, age 57
- 36% Tom, age 44
- 10% Sam, age 31

Bill has always handled bank negotiations for the enterprise. When the business started a new line for foreign cars at Sam's urging, sales took off and more capital was needed for inventory, an extensive merchant website and purchase of new equipment. Carrying receivables became a major issue, since their customary terms to retail car service shops and distributors was net 90 days and payment from reliable customers often exceeded 120 days.

As they expanded, the loan balance reached $2 million and Bill's wife Grace was required to sign the bank loan as an additional guarantor, along with Bill personally. They were happy to receive the much-needed money. Because this was perceived as "just a bank loan" rather than a "legal instrument", they did not ask their attorney to review the agreement and explain the provisions.

DISASTER STRIKES

Bill then had a stroke. The doctors do not offer any hope of his full recovery and return to work. What is initially considered a medical and emotional issue has now created a financial disaster.

The company has a funded buy/sell stock redemption agreement, but the value has not been updated for four years. A current "fair market" valuation of Magnum Auto Parts is now $3 million. But the agreement is insured for only half that amount – and the coverage on Bill is only $810,000 of life insurance (54% of the outdated $1.5 million value at the time of the buy/sell agreement).

The Friendly Financial Bank now declares the loan to be in default based on the "competency" provision, even though the company has never made a late payment. Friendly wants the full $2,000,000 loan balance paid in full – now!

If Bill dies soon, the company group life insurance of $100,000 will go directly to Grace based on the beneficiary designation. The $810,000 life insurance would go to the Corporation and the bank wants that – plus the balance of the loan, $1,190.000. The bank takes precedence over the non-trusteed buy/sell agreement.

The company does not have the $1.2 million. All its money is tied up in the business. Had Bill, his family or the business had the $2,000,000 in cash, it would not have turned to the bank for funds.

Since Bill's stock cannot be redeemed, Sam and Tom are devastated to learn they will not become the surviving shareholders as they had expected. Grace still has controlling interest of Magnum Auto Parts. They like her well enough but realize that Grace has no business experience.

Grace had been of the impression she would be paid 54% of $3,000,000 (the current value of the business) or $1,620,000 plus the group life coverage of $100,000. She believes she can count on the earnings from $1,720,000, which at 5% would provide her an income of $86,000.

She does not have the amount the bank is seeking - $1,190,000. There is a residence with a small mortgage and some inherited farmland, but no cash and very little securities. She asks Tom and Sam, “Where is Bill’s salary check and are you going to continue my health coverage on the group medical plan?”

The Friendly Financial Bank is not very happy and is seriously and secretly considering attaching all the other company accounts – such as payroll, credit card receipts, and a small reserve account. The fine print from the loan agreement empowers these actions, which the bank can do instantly, without notice.

Employees are getting nervous because they have heard about the non-paid bank loan, and they are spending as much time on gossip as on their work duties.

Sam, who is a great sales representative, is considering a position with a competitor and his first move would be to solicit all the customers of Magnum Auto Parts. Tom is under a lot of stress and his former jovial personally has disappeared.

WHAT’S THE SOLUTION?

Can this disaster be solved today? The answer is NO unless the sky starts dripping a lot of $100 bills.

Could it have been solved a month ago, while Bill was in good health? YES. What would have been required?

1. A regular, periodic recalculation of the business valuation by a qualified financial consultant would have pointed out the shortfall. Had the company retained the services of a financial consultant, this would be reviewed annually. The business could have adjusted the buy/sell agreement to the current value of $3,000,000. The existing life coverage could have been leveraged to start the additional insurance required. This would solve the business succession problem for Tom, Sam and all the employees.

2. The company could have covered Bill, Tom and Sam for critical illness in the amount of $1 million each – for less than $1,000 per month. As soon as Bill’s stroke was diagnosed, the company would have received the $1,000,000, which would have temporarily funded payment of Bill’s salary to Grace and continued medical coverage.

3. Some of the critical illness coverage could have been paid to Friendly Financial Bank, thereby encouraging their cooperative attitude.

4. The Friendly Financial Bank could have been requested to modify the loan terms in exchange for a full assignment of a new life insurance policy on Bill. Modestly improved loan terms would have provided the cash flow for the required $2,000,000 of coverage on the bank loan. The remaining balance of the bank loan would be paid in full upon Bill’s death!

THE IMPACT OF PLANNING

Had the above steps been taken, the following would have been the result:

- Grace would have the full income she expects. The company could have provided short-term medical protection for Grace under a simple employee agreement.

- Tom and Sam would now be the full owners. Based on prior share holdings, when Bill's shares are redeemed, Tom will own 78% and Sam will own 22% of the shares.

- Sam would own 22% of a company worth $5,000,000 (since the bank loan had been fully paid) – for a grand total of $1,100,000. He is not going anywhere now.

- Friendly Financial Bank would be happy to have been paid off in full. In fact, it would now be willing to consider some new financing for Magnum Auto Parts.

- Because there are no bank loan payments to be made, the company would instantly be substantially more profitable.

- Customers, suppliers and vendors would all feel assured that Magnum will continue in business.

IGNORING REALITY

Business owners and professional practitioners focus on the everyday aspects of operation. There are many challenges and economic changes to keep them occupied. That's why the corporation needed a financial consultant in addition to their attorney and accountant. The professional consultant's duties would include the following:

- Assess these business exposures.
- Analyze and quantify the risks.
- Develop creative financial solutions.
- Initiate the legal documents required.
- Monitor the continuously changing company circumstances.
- Coordinate the business ownership and succession with the personal retirement and estate plans for all the shareholders.

SUCCESS IS ACHIEVABLE

Every small business or professional practice was established because the founder saw an opportunity and a challenge. A successful transition of the business – to family or non-family operators – is very achievable. It requires a seven-step process that is apart from the services of attorneys and accountants, although it must coordinate with their skills and services:

- Introduction – to the needs and solutions
- Information – family and financial facts
- Confirmation – verification of critical data
- Preparation – analysis and priorities
- Plan Delivery – presenting the solutions
- Implementation – legal and financial instruments
- Monitoring – company and funding changes

NATIONAL CONSEQUENCES

Since the end of World War II, there has been a steady shift of employment in America, with consistent growth of employment in the government sector and in the number of retirees. However, the private sector still drives the economy of the US – as it does in nearly every other country.

The percentage of employees working for large companies has steadily declined – while the percentage of those working for small and medium sized companies is constantly increasing. The future of the U.S. economy and society is that these businesses must continue to thrive. Never has there been such a strong need for financial services!

As a business grows its financial exposure compounds. The owners or executives are attentive to business and marketing risks – but often ignore opportunities to assure business continuity. In the next 15 years, nearly every business owner currently ages 55 will have to consider a business transition - stimulated by disability, death or retirement.

LOCAL IMPLICATIONS

Developing a financial analysis for a local business is complex but the benefits and rewards are substantial. While the business owner(s) focus on running the enterprise, a consultant gathers and organizes the facts, measures the risk, prepares alternate solutions, encourages effective funding and coordinates the implementation with the attorney, accountant and banker for the business.

To start and grow a business or a professional practice is not enough. There must be plans for succession, continuity and asset protection.