

Negotiating Commercial Loans For Closely Held Companies When Credit Is Tight



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With lenders dictating loan terms, closely held companies should focus on key terms in loan documents.

MOST CLOSELY HELD COMPANIES have term loans or lines of credit to fund working capital needs and other capital requirements. In a tight credit environment, closely held companies may find that the number of commercial lenders that are willing to extend or renew those loans is limited. Moreover, lenders have increased leverage to dictate loan terms. With little ability to negotiate loan terms, closely held companies and the attorneys who represent them should think practically and choose carefully in deciding which loan terms to negotiate.

This article highlights the key loan terms that attorneys should discuss with their clients when negotiating loan documents in a tight credit environment. This article assumes that the size and nature of the proposed loan fall within the lender's guidelines for using its standard loan documents to extend the loan. This article does not address asset-based lending arrangements (when loan availability fluctuates, typically based on the value of the company's eligible inventory, accounts receivable, and equipment) or loan terms that not customarily included in most lenders' standard loan documents.

BASIC LOAN TERMS • When seeking a commercial loan, the owners of a closely held company typically focus on the loan's financial terms, including the loan amount, interest rate, repayment schedule, maturity date, prepayment penalty (if any), late charge, and loan fees. To obtain the loan, the company normally is required to maintain its deposit accounts with the lender. These terms usually are reflected in a term sheet or a loan commitment and often are determined before an attorney is involved.

The term sheet typically provides that the company is required to use the loan proceeds for a specific purpose, such as to fund working capital needs or to acquire specific equipment or other property. In addition, the term sheet usually provides that the loan will be secured by a lien on the company's personal property. Sometimes the lender requires a mortgage on real property owned by the company.

Reviewing The Basic Loan Terms

With respect to financial terms, the role of the company's attorney is often limited to discussing those terms with the owners and confirming that the agreed-upon terms are accurately reflected in the loan documents. The company generally has no right to prepay the loan unless the loan documents expressly state that the company may prepay the loan. Therefore, the attorney should confirm that the loan documents state that the company may prepay the loan. The loan documents either should specify the prepayment penalty or should state that there is no prepayment penalty. If the lender requires that the company use the loan proceeds for a specific purpose, the purpose should be worded broadly enough to allow the company to use the proceeds in the manner intended by the company.

Collateral Requirements

The lender determines its collateral requirements based primarily on the attractiveness of the proposed financial terms and the strength of the company and the guarantors. The nature and the

value of the collateral must satisfy the lender's underwriting standards. Consequently, the lender's collateral requirements usually are not flexible.

If the company desires for certain property to be removed from the collateral base, the lender likely will require modifications to the proposed loan terms, such as a higher interest rate or a reduction in the loan amount. Because the cost associated with obtaining mortgages can be significant, the company should avoid mortgaging real property to secure the loan if feasible.

Resolving Lien Conflicts

The company's attorney should work with the company to identify existing liens and mortgages on the company's property. If existing liens and mortgages will conflict with the new lender's proposed liens and mortgages, the conflict can be resolved in one of three ways:

- The company can pay the existing debt that is secured by liens and mortgages. Usually the company pays the existing debt at the loan closing with the proceeds of the new loan. Before the closing, the company obtains payoff letters from its existing lenders. Each payoff letter recites the amount of debt outstanding and states that the lender's liens and mortgages will be released and satisfied when the payoff amount is received by the lender;
- The company can request that the new lender remove the already-encumbered property of the company from the new lender's collateral base. The new lender may grant this request if the value of the encumbered property is small enough that the lender deems the company's unencumbered property to be adequate to secure the loan. If the encumbered property is removed from the collateral base, however, the lender may modify the financial terms of the loan, require additional guaranties, or impose other loan requirements; or

- The company can request that the existing lender subordinate its liens and mortgages to the new lender on terms acceptable to the new lender. The lenders then negotiate an inter-creditor agreement, which governs the rights of the lenders between themselves. Because negotiating an inter-creditor agreement can be costly and time consuming, the company should try to avoid this option.

PERSONAL OBLIGATIONS OF THE OWNERS

• Unless the closely held company is well established with a history of strong profitability or owns valuable property, commercial lenders generally require that the company's owners personally guaranty the loan. If an owner holds most of the owner's assets jointly with the owner's spouse, the lender also may require that the owner's spouse guaranty the loan. In addition, the lender may require that affiliated companies (other companies owned by the owners) provide guaranties or be co-borrowers under the loan.

The lender may require that the company's owners pledge the stock (or membership units) of the company or other personal assets to the lender as additional security for the loan. In most cases, the lender requires that the owners subordinate personal loans that the owners have made to the company to the lender's loan. The lender also usually requires that loans made to the company by affiliated companies be subordinated to the lender's loan.

Personal Guaranties

The lender's guaranty requirements primarily depend on the strength of the company and the guarantors and the available collateral. If one owner of a closely held company has significant net worth, the lender may not require personal guaranties from the other owners. An owner that is providing a guaranty, however, may not want for the other

owners to be relieved of their personal guaranty obligations. In addition, it is usually in the company's best interests for the personal guaranty obligations of the owners to be uniform so that the owners' motivations and interests with respect to the repayment of the loan are aligned.

Most personal guaranties are joint and several and unlimited in amount. The owners, however, may request a dollar amount cap on their guaranty obligations. Alternatively, the owners may request that each owner's guaranty be limited to the percentage of the outstanding debt that is equal to the owner's percentage ownership interest in the company.

Under most guaranties, the lender may pursue all of the guarantor's property to collect on the guaranty. Sometimes, however, a lender will agree to limit its recourse under the guaranty to certain property of the guarantor, such as the company stock (or membership interests) owned by the guarantor or a securities account pledged by the guarantor.

If the owners provide guaranties, the owners should enter into a contribution agreement. The contribution agreement is not delivered to the lender and is not a part of the lender's loan documents. Instead, the contribution agreement is an agreement among the owners that provides that if one owner makes a payment to the lender, each other owner will reimburse the paying owner for his or her proportionate share of the amount paid to the lender. Each owner's proportionate share is equal to his or her ownership interest in the company.

The interests of the company may conflict with the interests of the guarantors, and the interests of one guarantor may conflict with the interests of other guarantors. The company's attorney needs to stay alert for situations in which some or all of the owners should be advised to obtain separate counsel.

Pledge Of Collateral

For larger loans, the lender often requires that the owners pledge their company stock (or membership units) to the lender as security for the loan. It is unusual for an owner to pledge personal assets other than his or her company stock (or membership units) unless the lender has agreed to limit its recourse under the guaranty to specific property of the owner. If the lender agrees to limit its recourse to specific property, such as a securities account, the lender usually requires that the owner pledge that specific property to the lender.

Guaranties By Affiliated Companies

Similar to owner guaranties, whether the lender requires guaranties from affiliated companies largely depends on the strength of the company and the other guarantors and the available collateral. Sometimes an affiliated company has made a loan to the closely held company, leases real property to the closely held company, or has other relationships that intertwine its operations with the operations of the closely held company. In those circumstances, the lender may require that the affiliated company guaranty the loan or be added as a co-borrower under the loan.

Subordination Agreements

If an owner or an affiliated company has made a loan to the closely held company or leases real property to the closely held company, the lender will likely require that the company's obligations to the owner or affiliated company be subordinated to the company's obligations to the lender. In riskier loan situations, the lender may prohibit the company from making any loan or lease payments to the owner or affiliated company while the lender's loan is outstanding. In most cases, the lender permits the company to make loan and lease payments to the owner or affiliated company as long as the company has not defaulted in its obligations to the lender. If the company has not already done so, the

lender typically requires that the company execute a promissory note and lease agreement, as applicable, to document the company's loan and lease obligations to the owner or affiliated company.

TRANSACTIONS BETWEEN THE COMPANY AND THE OWNERS •

Loan documents often prohibit the company from paying dividends and distributions to the owners while the loan is outstanding. Some loan documents make an exception for dividends and distributions to the owners to pay their tax obligations resulting from their ownership of company stock (or membership interests). Sometimes the company is permitted to pay dividends and distributions if the company achieves specified financial results. If the company is permitted to pay dividends and distributions, the loan documents often cap the amount of dividends and distributions that may be paid.

If the owners are employed by the company, the loan documents also may cap the amount of salary and other compensation that the company can pay to the owners for their service as employees. In addition, the loan documents usually prohibit the company from entering into "related party" transactions with the owners, family members of the owners, and entities controlled by the owners or their family members.

Payments To The Owners

Loan agreements contain financial covenants that require a company to maintain a healthy balance sheet and to meet minimum performance requirements. For example, the company may be required to maintain a given ratio of current assets to current liabilities, working capital amount, tangible net worth, ratio of senior debt to tangible net worth, cash flow margin, and/or debt service coverage ratio. The company is required to calculate specified financial ratios and other financial measurements on a periodic basis (annually, quarterly, or monthly) and to report those calculations to the lender.

A persuasive argument can be made that if the company is in compliance with its financial covenants and will be in compliance with its financial covenants after making a dividend, distribution, or salary payment to the owners, the company should be permitted to make that payment. The company's attorney can argue that the loan documents should restrict payments to the owners only if the company fails to meet its financial covenants.

Some lenders insist on restricting payments to the owners even if the company is in compliance with its financial covenants. The lender may argue that less sophisticated companies sometimes make payments to the owners without considering whether the payments will cause the company to be in breach of its financial covenants at the next measurement date. Therefore, the lender restricts the payment of dividends, distributions, and salaries to impose discipline on the company in terms that are clear to the owners.

If the lender insists on restricting payments to the owners, the owners should consider their cash flow needs and whether additional flexibility to make payments is needed. If payments are permitted but capped, the company's attorney can request that the lender increase the cap on permitted payments. If payments are prohibited, the company's attorney can request that the lender permit payments as long as the company achieves targeted financial results.

Related Party Transactions

Many loan agreements prohibit the company from entering into any related party transaction without the lender's consent. A related party transaction typically is defined as a transaction between the company and an owner, a family member of an owner, or an entity controlled by an owner or a family member of an owner. Some loan agreements, however, allow the company to enter into a related party transaction if the terms of the related party transaction are no less favorable to the

company than the terms that the company would obtain in an arms' length transaction with an unrelated party. If possible, the company's attorney should negotiate the loan documents to allow the company to enter into related party transactions on arms' length terms.

LOAN COVENANTS • Loan documents provide that the company agrees to take certain actions (affirmative covenants) and agrees not to take other actions (negative covenants). The affirmative covenants include the financial covenants. The affirmative covenants also cover a broad range of other matters, such as maintaining corporate or limited liability company existence, maintaining insurance, complying with laws, and delivering financial statements and reports to the lender.

Examples of negative covenants include the company's agreement not to create liens on its property in favor of other lenders, not to incur additional debt, not to sell assets except for inventory in the ordinary course of business, and not to engage in a merger or other change of control transaction without the lender's consent. Most of the covenants are customary but some are negotiable.

Financial Covenants

The financial covenants are significant because the lender uses the financial covenants to gauge the company's financial health. A breach by the company of a financial covenant signals to the lender that the company's financial health has deteriorated and that the company's ability to repay the loan is less certain. Consequently, lenders closely monitor a company's compliance with its financial covenants.

The company should carefully analyze and negotiate the financial covenants to ensure that the covenants are as flexible as possible. In addition, the company and the lender should review the financial covenant calculations together using the company's actual financial results for a sample period. The goal is to identify in advance any disagreement between

the lender and the company regarding the manner in which a financial statement item or transaction will be treated in the covenant calculations and to resolve that disagreement in advance of entering into the loan agreement.

Non-Financial Covenants

The remaining loan covenants are usually customary. The company's attorney, however, should review all of the loan covenants with the company and identify any planned action by the company (or failure to act) that may breach the proposed loan covenants.

For example, the company usually is prohibited from selling assets except for inventory in the ordinary course of business. The company may plan to sell certain equipment. The owners usually are prohibited from transferring the company's equity. An owner may plan to transfer equity to another owner or to a trust or family member for estate planning purposes.

If the company plans to take action that will breach a proposed loan covenant, the company's attorney should explain the business reason for the planned action to the lender. Provided that the business reason for the proposed action is sound and that the planned action does not change the lender's assessment of the loan risk, in most situations, the lender either will change its standard covenant language to accommodate the proposed action or will provide its consent to the planned action.

REPRESENTATIONS AND WARRANTIES •

Loan documents include customary representations and warranties by the company. The lender has the right to declare a default if the company breaches (or, in some loan agreements, breaches in any material respect) the representations and warranties.

In merger and acquisition transactions and other commercial transactions, the transaction documents often require that the company indemnify the other party for liability resulting from the com-

pany's breach of its representations and warranties. In those transactions, the company's breach of its representations and warranties can result in financial harm to the other party for which the company is liable. As a result, the company's attorney attempts to add flexibility to the representations and warranties. The parties often spend considerable time negotiating whether materiality qualifiers ("in all material respects") and knowledge qualifiers ("to the company's knowledge") should be added to the company's representations and warranties.

In loan transactions, the company is responsible for rectifying matters that constitute a breach of its representations and warranties as part of the ordinary course of its operations. If the company satisfies its payment obligations and complies with the loan covenants, it is unusual for the lender to suffer financial harm if the company breaches its representations and warranties. It is also unusual for a lender to declare a default based solely on a breach by the company of its representations and warranties (although it has the right to do so) when the company is satisfying its payment obligations under the loan.

The company needs to review the proposed representations and warranties to confirm that they are accurate. In addition, it is appropriate for the company's counsel to propose materiality qualifiers to very strict representations requested by the lender. However, the company generally is best served by focusing the negotiations on other loan terms.

CROSS-DEFAULT • Cross-default provisions in loan documents can be very broad. The company's default with respect to any debt obligation may trigger a default under the loan documents. In addition, if an owner defaults under a personal obligation to the lender, even if the obligation is unrelated to the company's loan, the owner's default may trigger a default under the loan documents.

Company Obligations

The company may inadvertently fail to make a payment to a third party or may have a dispute with a third party regarding a payment obligation. If the payment obligation is not material, the failure to make the payment obligation should not constitute a default under the loan documents.

If the company's failure to fulfill any debt obligation, regardless of the amount of the debt obligation, constitutes a default under the proposed loan documents, the company can request that only a default with respect to material debt obligation trigger a default under the loan documents. The loan documents can specify a dollar amount that will be deemed material. Alternatively, the company can request that only a default that "materially affects the company's ability to repay the loan" (or "materially affects the company's ability to perform its obligation under the loan documents") trigger a default under the loan documents.

Personal Obligations Of The Owners

An owner may have a personal loan, line of credit, or other banking relationship with the lender. Most owners do not intend for personal obligations that are unrelated to the company's loan to be cross-defaulted to the company's loan.

If an owner has personal obligations to the lender that are unrelated to the company's loan, the company's attorney should determine whether the owner's default under those personal obligations will trigger a default under the company's proposed loan documents. If the owner's default under personal obligations to the lender will trigger a default under the proposed loan documents, the company can request that the cross-default provisions be modified. Most owners are not concerned with cross-default provisions because they do not anticipate defaulting under their personal obligations. It is in the company's best interest, however, to modify those cross-default provisions, particularly when the company has multiple owners, so that personal cir-

cumstances affecting one owner do not cause a default under the company's loan.

If an owner has personal obligations to the lender, the owner should review the owner's personal loan documents. The cross-default provisions in the owner's personal loan documents may be broad, and the company's default under the company's loan documents may trigger a default under the owner's personal loan documents. In that situation, the owner should consider requesting that the cross-default provisions in the owner's personal loan documents be modified. If the lender refuses to modify those cross-default provisions, the owner can consider moving the owner's personal banking relationship to another lender to avoid the risk of a cross-default.

EVENTS OF DEFAULT AND REMEDIES •

In addition to cross-defaults, the loan documents typically include the following standard events of default:

- Failure to pay principal or interest when due;
- Breach of the representations and warranties in the loan documents by the company or by any guarantor;
- Breach of the covenants in the loan documents by the company or by any guarantor;
- Submission of false or misleading information to the lender;
- Failure to pay or discharge a final judgment against the company within a certain time period;
- Termination of the lender's liens or loss of lien priority; and
- Events relating to receivership, insolvency, or bankruptcy of the company or any guarantor.

The loan documents may specify additional events of default. The loan documents always provide that the lender has extensive remedies upon an event of default.

Approach To The Events Of Default

Most of the events of default are customary and are not negotiable. Some lenders, however, will agree to a short grace period for payment defaults. The grace period is usually five or 10 days. In addition, some lenders will agree to provide notice to the company and a grace period to cure breaches of covenants that are capable of being cured. The grace period is usually 15 or 30 days.

Some loan documents provide that an event of default occurs if the lender “deems itself unsecured” or “believes in good faith that the prospect of payment or performance by the company is impaired.” The company should request that these general insecurity clauses be removed because they give the lender broad discretion to declare an event of default. It is common, however, for the lender to insist on these provisions.

Some loan documents provide that the death of an owner constitutes an event of default. If personal guaranties by the owners are significant to the lender’s decision to extend credit, the death of an owner may be an appropriate event of default. Some lenders will agree, however, to give the company a grace period after the death of an owner and before declaring a default to identify a substitute guarantor who is willing to guaranty the loan. The loan documents usually provide that the substitute guarantor must be reasonably acceptable to the lender.

Approach To The Lender’s Remedies

The lender wants the ability to pursue all available remedies to collect on a loan after an event of

default. As a result, the lender usually is unwilling to negotiate the remedies provisions in the loan documents.

In most cases, the company is better served by negotiating the covenants and events of default in the loan documents than by negotiating the lender’s remedies. An event of default is less likely to occur if the company obtains more flexible covenants and narrows the circumstances in which the lender has the ability to declare an event of default. With limited negotiating leverage, the company should focus more effort on reducing the likelihood that an event of default will occur and less effort on limiting the lender’s available remedies after an event of default occurs. Consequently, except in circumstances in which the lender’s remedies include a particularly egregious provision, it is probably reasonable for the company to accept the lender’s proposed remedies provisions.

CONCLUSION • Lenders vary significantly in their underwriting standards and the amount of authority that they grant to individual loan officers to negotiate loan terms. The lender’s willingness to negotiate loan terms also largely depends on the strength of the company and the guarantors and the available collateral. The company’s attorney can provide significant value to the company by helping the company to exercise good judgment when determining which loan terms to negotiate. In a tight lending environment, companies have fewer chances to secure changes to the lender’s proposed loan terms. Companies should use those chances wisely.

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PRACTICE CHECKLIST FOR Negotiating Loan Terms For Closely Held Companies

- Basic loan terms:
 - Are the financial terms accurately reflected in the loan documents?
 - Do the loan documents state that the company may prepay the loan?
 - Do the loan documents specify whether or not there is a prepayment penalty?
 - Is the company permitted to use the loan proceeds for the company's intended purpose?
 - Are the lender's collateral requirements acceptable?
 - Do the lender's proposed liens and mortgages conflict with any existing liens or mortgages?

- Personal obligations of the owners:
 - Should the company request limitations on personal guaranties by its owners?
 - Should the owners enter into a contribution agreement?
 - Are the lender's requirements, if any, for the owners to pledge personal property acceptable?
 - Does the lender require guaranties by affiliated companies? Are those requirements acceptable?
 - Does the lender require that the owners and/or affiliated companies subordinate loans made by them to the company? Are those requirements acceptable?

- Transactions between the company and the owners:
 - Are the lender's proposed restrictions on dividends, distributions, and salary payments acceptable?
 - Is the company permitted to enter into related party transactions on arms' length terms?

- Loan covenants:
 - Is the company comfortable with the lender's proposed financial covenants?
 - Should the company request changes to the proposed covenants or lender consent to permit the company to take action that the company plans to take after the loan is in place?

- Representations and warranties:
 - Are the representations and warranties true and accurate?

- Cross-default:
 - Does a default by the company under a debt obligation cause a loan default, regardless of materiality?
 - Does a default by an owner under the owner's personal obligations to the lender cause a loan default?
 - Should the company request modifications to the cross-default provisions in the company's loan documents?
 - Should the owners request modifications to the cross-default provisions in the owners' personal loan documents?

- Events of default and remedies:
 - Does the company have a grace period for payment defaults?
 - Is the lender required to give the company notice and a grace period to cure a covenant default?

- ___ Does the lender have broad discretion to declare an event of default if it “deems itself insecure” or “believes payment or performance by the company is impaired”?
- ___ Does the company have a grace period after the death of a guarantor to offer a substitute guarantor before the lender can declare an event of default?
- ___ Should the company request modifications to any of the events of defaults?
- ___ Are any of the lender’s remedies objectionable?

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Getting Your Hands On The Evidence

By Ronald S. Beitman



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