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Borrower Beware – Eight Areas to Focus on when Negotiating a Loan

Experienced counsel should focus on key provisions in "standard" loan documents

With interest rates remaining at historically low levels, debt continues to be an attractive option for many businesses. While money may be (relatively-speaking) cheap in today's market, many first time borrowers fail to appreciate that there are additional costs to taking on a loan; namely significant operational limitations. Loan agreements can be several hundred pages long, containing a laundry list of representations and warranties, affirmative and negative covenants ("thou shall" and "thou shall not" provisions) and events of default designed to ensure that the business remains able to repay the loan. The initial drafts of the loan documents will be very pro-lender and generally will not reflect significant consideration of the operational needs of the borrower. It is the borrower's and its counsel's job to thoroughly review the loan documents and negotiate changes to allow the business to function without the necessity of having to continually seek lender consent, or worse, finding itself in default of its loan. As in all transactions, negotiations

are largely a function of leverage, but it is a certainty that a borrower will not get any changes it does not request (or even know to request). While the needs of each business vary (and so do loan documents), here are eight general areas borrowers should focus on when negotiating their loan documents.

Negative Covenants

For the lender, one of the most important elements of any loan transaction is to make sure that the borrower is prevented from doing things that might jeopardize its ability to timely repay the loan or which might compromise the lender's collateral. A key tool employed by lenders is negative covenants (promises that the borrower will refrain from taking certain actions). These can cover almost any aspect of a business and frequently include, among others, prohibitions on additional debt, liens in favor of third parties, mergers and acquisitions, transactions with affiliates and sales of assets. One of the most important jobs for the borrower and its counsel in negotiating loan documents is to try to get as much flexibility negotiated into these covenants as possible. While certain items will almost undoubt-

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edly be off-limits (for example, it would be unreasonable to expect the lender to allow a borrower to sell all of its assets without repaying the loan) there are many ways in which lenders will accommodate some operational flexibility. Some relaxation of the covenants can be achieved through materiality qualifications or more objective measures of materiality such as baskets and caps (e.g., borrower cannot grant a lien on any asset having a value in excess of some dollar amount). The other typical way to deal with these prohibitions is to seek carve-outs for specific actions, events or circumstances. Many of such carve-outs are widely accepted and customary and experienced finance counsel will raise those for the benefit of their client (e.g., there is a fairly standard list of immaterial liens that should be permitted) but some are less obvious and can be very significant. For example, most loan documentation will prohibit a borrower from distributing cash or other property to its owners. This is particularly problematic for a borrower that is a pass-through entity for tax purposes such as a limited partnership or LLC. Most lenders will accommodate a limited exception for distributions to cover the pass-through tax liability of the owners. The most challenging area is identifying needs that are specific to a given business. Experienced outside counsel will have a good sense of the areas in which carve-outs are often needed and the types of things a lender will concede but will likely not know enough about the future direction of a particular business to identify all necessary changes. It is, therefore, imperative for the borrower's key executives and other advisors to read the covenants thoroughly with an eye toward the future and to engage in a dialogue with outside counsel to make sure there is a clear understanding of what the covenants prohibit and where relaxation is needed.

Financial Covenants

These are covenants designed to measure financial performance against the projections relied upon by the lender in its underwriting process in order to monitor the financial health of the business. The types of financial covenants utilized by a lender will depend upon the nature of the business, the structure of the loan and the metrics that are important to the lender. Some of the more commonly utilized financial covenants include leverage ratios, current ratios, fixed charge coverage ratios, minimum EBITDA requirements and limits on capital expenditures. As these financial covenants are built upon the borrower's projections, it is critical for the borrower to make sure the projections are realistic and that the benchmarks the lender is establishing leave a sufficient margin for error. While it may be tempting to utilize optimistic projections as a way to attract a lender, this will come back to haunt the borrower when the lender crafts financial covenants holding the borrower to such projections and putting the borrower in default if they are not met. The negotiation of the ratios or numerical values is generally settled by the time the loan documents are provided to the borrower, but the action in negotiating the loan documents is usually in confirming that the definitions that serve as the component parts of the financial covenants track the way the financial covenants were modeled. For example, if the projections included any non-GAAP add-back to EBITDA, that should be reflected in the definition of adjusted EBITDA in the loan agreement. Again, this will require a collaboration among the outside counsel, the borrower's CFO and the borrower's outside accounting firm, who should review all of the financial covenants and associated definitions.

Events of Default

The section of the credit agreement that tends to grab the attention of most borrowers is the one titled "Events of Default." However, with the exception of certain specific events of default that are sometimes encountered and which will be discussed separately below, there is often little action to be had here in the negotiation of the loan agreement. That is because the broadest event of default (the borrower's breach of the covenants contained elsewhere in the documents) is largely negotiated by focusing on the relaxation of those covenants themselves as previously discussed. That said, a borrower should make sure there are appropriate grace, notice and cure periods so that breaches can be remedied before a lender can start exercising remedies. Typically a lender will allow a short grace period for payment defaults (other than failure to pay at maturity) and some cure period (generally 15-45 days) for breaches of certain covenants (generally a lender will not afford any cure period for financial covenant or negative covenant defaults on the grounds that they are non-curable). Borrowers should also pay attention to cross-defaults to other agreements (either with the lender or third parties) and the thresholds for defaults based on other external events (e.g. judgments against the Borrower) so that defaults are only triggered by occurrences that would be material to the business.

Representations and Warranties

Every set of loan documents requires the borrower to make various representations and warranties about its business. Commonly, these will cover such topics as the authority of the company to enter into the loan, the accuracy and completeness of diligence items provided to the lender, compliance with laws and contracts, environmental compliance, tax issues, absence of litigation and so on. As a breach of a representation or warranty will be an event of default under the loan, it is critical that the borrower thoroughly review all representations and warranties and make any necessary disclosures. It is useful to negotiate in materiality qualifiers wherever possible so that minor inaccuracies or omissions do not give rise to a default. It is also important to keep in mind that representations and warranties may be restated or "brought down" at certain times (for example, if the loan has a revolving credit feature or some other multi-draw component, the representations are generally re-made upon each advance). Any such bring-down clause should contain a materiality qualifier as the facts that existed at closing will change over time. Borrowers should also be on the look-out for representation and warranty clauses that double as covenants. Sometimes these begin with a phrase such as "the Borrower represents and warrants *at all times* that." Again, as facts change over time, this requirement is unfair to a borrower; the lender's protection is better handled through the negative covenants.

MAC or General Insecurity Clauses

Some loan agreements (more commonly in the lower middle market and smaller deals) contain a catchall event of default for material adverse changes (MAC) or in the event the lender feels insecure about the prospects of repayment of the loan. Borrowers do not like these subjective events of default, particularly when there are page upon page of other covenants and conditions dealing with almost every imaginable circumstance. Lenders think of these clauses as gap fillers to cover circumstances their documents do not otherwise contemplate. Borrowers should always put this on their list of items to try to negotiate out of their loan documents but should not be surprised to get pushback from the lender (often accompanied by the statement that the borrower should not worry about the clause because it is almost never invoked). Some experienced counsel believe these are less appropriate in detailed loan documents with extensive covenants, but in deals where there are very few covenants and restrictions, the rationale for their inclusion is more supportable. If a borrower is unable to get the lender to remove this type of clause, consider angling for a material adverse change clause over a general insecurity clause to lessen the degree of subjectivity. There may also be room to negotiate a material adverse change clause to exclude certain events that are beyond the control of the borrower such as non-borrower specific, industry-wide economic downturns, impacts resulting from acts of war or terrorism and the like.

Change of Control and Key Man Provisions

Some loan agreements also contain events of default based on changes of ownership or loss of involvement of certain key executives. Change of control provisions are generally found in deals where the loan is being made, at least in part, on the strength of certain ownership factions and a desire to keep ownership economically aligned with the lender (i.e., "skin in the game"). Key man clauses generally appear where certain key management are deemed indispensable to the business. These are often important components of the lender's underwriting of the loan and generally will not be removable in their entirety but the borrower may be able to negotiate certain aspects. For example, the amount of equity transfer that would constitute a change of control might be negotiable so as to afford ownership the possibility of some liquidity. With key men clauses, the borrower needs to consider the unintended leverage this gives to the named executive whose departure would now create a default under the loan facility. If a lender insists on a key man provision, the borrower should make sure that it only applies to the truly "key" person or persons and that it has an adequate cure period to find a suitable replacement, remembering that replacing a person of such significance can take substantial time. Also, lenders often require key man life insurance on certain individuals and an assignment of the proceeds of such insurance to the lender. If such insurance is part of the deal, it is reasonable to request that the key man default provision not be invoked if loss of the key person is on account of death as the lender's loan will be de-risked by the amount of insurance proceeds.

Prepayment

Many loans require the payment of a premium if a loan is repaid in whole or in part prior to its scheduled maturity date. The amounts of these premiums are generally negotiated along with the pricing terms very early in the deal. The finer points that need to be looked at in the loan documents are under what circumstances must a loan be prepaid and do the prepayment premiums apply to these mandatory prepayments (as opposed to voluntary prepayment). Prepayments are generally required when there is some loss of collateral (casualty or condemnation). A lender often will also require that any extraordinary receipts be paid over to the lender in reduction of the loan (such as amounts received from a litigation claim or a tax refund). In some deals (particularly in circumstances where there is no regular amortization of the loan but the lender does want the loan paid down if the business is doing better than expected), the loan will have an excess cash flow prepayment requirement (e.g., 50% of the cash generated by the business beyond what is needed for ordinary operations). Some elements of these required prepayments are negotiable. For example, the borrower should be able to secure some period of time to redeploy the proceeds of insurance or a condemnation award to replacement of condemned or destroyed assets, rather than in repayment of the loan. The definition of excess cash flow warrants the company's and its accountants' scrutiny and should be negotiated to make sure it properly accounts for all of the borrower's operational needs and truly reflects the borrower's cash flows. A borrower should also examine whether the loan documents require a prepayment premium be paid with respect to mandatory prepayments. A borrower should argue that an excess cash flow recapture is akin to amortization and should have been factored into the pricing; hence no prepayment fee should be charged on such payments. Borrowers can also argue that they should not have to pay premium on proceeds of a casualty loss or condemnation as these are events outside of their control.

Assignment by the Lender

An often overlooked section of a loan agreement is the assignment provision. Many borrowers simply assume that they cannot modify these "boilerplate" provisions or are tired of reading the agreement by the time they reach this provision on page 117, but the assignability of the loan by a lender should be given some consideration by the borrower. Some borrowers only care about the clause if the loan is a revolving facility or they expect to draw down future advances because they worry about an assignee's wherewithal to meet future funding obligations. However, given the amount of control a lender has in a loan transaction, who is sitting across the table from the borrower can also be important in terms of navigating issues as they arise. Many times a borrower will say, "I'm not concerned about that covenant because my banker says he will work with me and I trust him" to which a savvy lawyer will reply, "But what happens if he is no longer your banker?" While lenders will resist any incursion into their ability to transfer a loan, some lenders will agree to give the borrower an approval right (not to be unreasonably withheld) over an assignment, but usually only if the loan is not in default. It is also a good idea to ask for a prohibition on assignments to direct and indirect competitors, which if circumspect enough, is a difficult request for a lender to reject. Borrowers should also insist on lenders securing confidentiality agreements for the benefit of the borrower from prospective assignees before sharing the borrower's confidential information.

Read the Fine Print

Loan products and loan documents come in many flavors and, invariably, there are many other elements of any loan transaction worthy of thoughtful review and negotiation. The above is intended to give a prospective borrower an idea of some of the common areas to consider, but any significant loan transaction should be considered carefully with the assistance of the company's legal and financial advisors.