How Small And Medium-Sized Businesses Can Deal With Banks

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You can't anticipate every possible debt financing issue or contingency, but you can help the client by knowing the basics.

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ALTHOUGH THE MAJOR SOURCES of tension between equity investors and founders involve thorny issues of overall structure, philosophy, and relationship of the parties, sources of tension between the small and medium-sized business ("SMB") and its lenders, however, do not tend to be so philosophical. These issues are economic, pure and simple. This article is intended to serve as a guide to major debt financing issues that SMBs are likely to encounter in relationships with lenders.

SENIOR LENDERS • The issues can be divided into two categories—payment and economic terms and restrictions on operational freedom.

Payment And Economic Terms

The senior lender and SMB will discuss whether the interest rate is fixed or floating:

- If a floating rate is used, the flexibility to use particular base rates will be discussed. Will the base rate be a certificate of deposit-based rate? London Interbank Offered Rate ("LIBOR")? The bank's prime rate? In more heavily leveraged transactions, if a floating rate is permitted, the bank will insist that a certain portion of the loan be hedged by entering into interest rate swap transactions;
- If the interest rate is fixed, the bank will want to ensure the loan is not prepaid, so the bank will not lose money if rates decline. In addition, upon a prepayment, the bank will lose the opportunity to re-lend the money if interest rates have increased. So the parties will negotiate an appropriate prepayment penalty. The next economic issues that arise are:
- Fees for closing the loan and for any portion of the credit facility which remains unused. This issue has taken on increased importance in recent years since banks have increased their financial dependence on one-time fees as compensation for being more competitive in interest rates;
- The timing and manner of payment of interest and amortization of principal is a key economic topic. In addition to the fixed repayment schedule, will the SMB be required to make prepayments of principal based on the availability of free cash flow? If so, sometimes the parties agree that a certain portion of the free cash flow must prepay the debt and a certain portion may be distributed to the owners. Sometimes, the distribution to owners cannot occur unless certain financial targets have been met or exceeded;
- Most loans are accelerated upon the sale of the business. However, upon the sale of a division or subsidiary, the bank still desires that principal be prepaid by the sale price or some percentage thereof. The parties may negotiate a partial paydown and a partial distribution. The bank may also agree to re-loan the amount prepaid in the event the SMB replaces the sold business with another business meeting certain defined parameters;
- Senior lenders virtually always demand a senior security interest in all of the business assets. If a senior lender has made a loan to a subsidiary of an SMB and the new lender desires to make a senior loan at the parent level, appropriate subordination or priority agreements need to be worked out between the two lenders. Exceptions to the bank's requirement that it have the senior lien on all items are sometimes made for purchase-money security interests in financed equipment and inventory, subject to limitations on the dollar amount of that equipment. Once the SMB has evolved from the start-up stage, with just the founders as owners, to the stage where the investors have entered the scene, personal guarantees are sometimes removed or not required depending on the collateral level.

Operational Flexibility

Financial and operational covenants are a frequent source of debate between the SMB and senior lender. Banks impose financial covenants and ratios on borrowers to monitor their financial health and to serve as "early warning" signals of potential erosion in the borrower's financial health. Borrowers will argue that these financial covenants are onerous and misrepresent the full story of the borrower's condition. Besides, if the bank is fully collateralized, the existence of the covenants merely permits the bank to panic at the first sign of trouble. Borrowers also promise to provide significant volumes of information regarding their businesses to the senior lenders, and agree to open their books and premises to periodic inspections.

Financial covenants include:

- Debt to cash flow;
- Fixed charges to cash flow;
- Interest obligations to cash flow;
- Debt to equity;
- Minimum cash level;
- Maximum capital spending level; and
- Maximum distributions to owners.

Non-financial covenants include:

- Restrictions on salaries;
- Redemptions;
- Acquisitions (and whether proceeds from divestitures be used for acquisitions);
- Mergers; and
- (Sometimes) payments on junior debt.

JUNIOR LENDERS • Negotiations with junior creditors raise the same issues as with senior lenders. Additional issues are also presented.

Interest And Equity Kickers

Interest on junior debt is frequently accrued and accreted, instead of being paid regularly. The parties will discuss how often the accrued interest is compounded. If it is not to be paid currently, will it be paid at all, or will it simply be added to the principal amount of the debt and "paid-in-kind" at a later date?

- Some junior debt does not have any stated interest rate but is a zero-coupon note, effectively paying principal and interest in one lump sum at maturity. In this event, and when interest is deferred, an accrual basis lender will have an income tax obligation on the accruing yet unpaid interest, yet not have any cash to pay the income tax;
- Due to the inherently risky nature of a junior loan, the junior lender may seek compensation in addition to fees and interest. The junior lender may seek warrants or a contractual right to receive a certain percentage of the borrower's common stock. Whether payment is required for the stock, the length of time to exercise the warrant, and whether the exercise price is at today's value or a premium, are hotly negotiated.

Operational Flexibility

Junior lenders also try to protect their loans by imposing the same types of operational covenants as senior lenders. However, many junior lenders can be persuaded to forgo these covenants since the senior lender already has imposed them on the borrower:

- Some junior lenders will agree to more relaxed covenants than those required by the senior lender. This middle ground enables the junior creditor to have some early warning protection by virtue of covenants, but not as much protection as the bank. Finally, some junior debt is structured so that the covenants are suspended until certain events occur, such as a ratings agency downgrade or missing certain financial targets;
- Although covenants in subordinated loans are typically less restrictive than those in senior loans, some junior lenders attempt to limit the amount and type of senior debt to which it is subordinated. Once the existing senior debt is repaid or refinanced, the junior lenders may seek to totally block any borrowing of new senior debt or have some say in its incurrence. Conversely, the senior lender tries to clarify that all re-debt financings of its loan will enjoy its first level of priority. Absent this provision, re-debt financing lenders may lose interest.

Subordination To Senior Debt

Senior lenders often abhor the grant of a security interest to a junior creditor, notwithstanding the subordination of the junior creditor's position. The junior security interest is considered cumbersome, the senior lender could accidentally fail to perfect or continue its perfected lien and thus lose priority,

or the senior lender may be forced to foreclose on its position to defend it against the foreclosure by the junior creditor on its second position.

Some things that the senior lender will want include the following:

- The senior lender will thus try to assure the subordination of the junior lender. The senior loan's negative covenants will prohibit junior debt. If the senior lender is called upon to waive this prohibition, the senior lender then has a forum to negotiate subordination terms it feels appropriate. The subordination of payments takes these basic forms along the continuum from most to least restrictive: a total block on payments period, a total block on principal and interest until maturity, a total block on principal until maturity but periodical interest payments, and regularly scheduled payments unless a default on the senior debt occurs. Another approach by senior lenders is to allow payments of junior debt only in situations when a certain level of excess cash flow has been generated. Sometimes, a mandatory prepayment of the senior loan is also required simultaneously with the payment on the junior loan;
- The senior lender will also assure that a default under the junior debt will trigger a default under the senior loan. If the default involves a non-monetary issue, it is difficult to conceive of how this default would not also have occurred under the senior loan since it is typically more restrictive than the junior loan. If the default under the junior loan is a monetary one, some question why the senior lender cares, as long as the junior lender cannot or does not exercise its collection remedies. Even if the junior lender does seek to collect its debt, as long as this does not trigger a default under the senior loan documents, one wonders why senior lenders care. Senior lenders respond that the default under the junior loan documents is another early warning sign of trouble;
- Senior lenders also require that, upon a default under the senior loan, all payments under the junior debt be suspended and the exercise of all remedies to seek collection of the junior loan stop. This cessation of activities by the junior lender gives the senior lender the chance to order its priorities and exercise its rights without fear of being interfered with by the junior lender. The length of the standstill period is frequently contested and typically ranges from 90 days to one year. The events triggering the standstill obligation is also challenged. Senior lenders like the standstill to occur at any time a default under its debt occurs. Junior lenders feel that only certain major defaults (such as a bankruptcy or payment default) should initiate its obligation to standstill. Senior lenders reply that this view puts them in a worse position than a junior creditor and almost forces the senior creditor to accelerate the loan to protect its position, instead of painstakingly working with the borrower to avoid an acceleration and attempt to salvage the loan;
- Finally, if a subordinated lender receives payments to which it was not entitled, the senior lender will want those unapproved payments returned. Therefore, if a payment was made to a junior lender during a standstill period, or in violation of a contractual provision, or which would be considered a preference in bankruptcy, the senior lender desires a means to recover those payments.

CONCLUSION • The exact nature of the debt financing needed can be as varied as the businesses themselves. But there are fundamentals encountered in most cases as they relate to the senior and junior lenders. Knowing these in advance can help you structure the client's new business for success.