

LOAN  
DOCUMENTATION:  
AN INTRODUCTION  
FOR  
SMALL BUSINESSES

**A Collaborative Effort**

Minnesota Department of  
Employment and  
Economic Development

Monroe Moxness Berg PA

**Loan Documentation:**

**An Introduction for Small Businesses**

is available without charge from the Minnesota Department of Employment and Economic Development, Small Business Assistance Office, 1st National Bank Building, 332 Minnesota Street, Suite E200, St. Paul, MN 55101-1351

Telephone: 651-556-8425 or 800-310-8323.

Email: [deed.mnsbao@state.mn.us](mailto:deed.mnsbao@state.mn.us)

Website: <https://mn.gov/deed/business/help/sbao/>

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**Minnesota Department of Employment and Economic Development  
and  
Monroe Moxness Berg PA**

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## **PREFACE**

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Small business borrowers are often surprised by the number and kind of documents associated with finalizing a commercial loan from a bank or other lender once a loan application has been approved. Commitment letters, promissory notes, credit agreements, mortgages, assignments, guarantees and other documents can all be part of even modest size borrowings. Often the most perplexing of these are the representations and warranties that a business must make before a loan is funded and compliance with covenants which relate to the use of funds and the borrower's conduct of its business during the term of the loan. This publication offers a brief primer on the need for and uses of many of the terms and covenants used in commercial loan transactions to aid the reader in understanding them and in framing questions for their legal counsel, bankers, accountants and other professional advisors.

The information here is not intended as, and should not be relied upon as, legal advice. Borrowers of any size should always work with their personal legal counsel in all matters relating to obtaining loans or credit from any source.

Alexandra M. Peters, Esq. Krass Monroe, P.A.

Charles A. Schaffer

Minnesota Small Business Assistance Office

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## INTRODUCTION

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Today there are many sources from which business borrowers can borrow money and obtain credit. In addition to the traditional term loan and revolving line of credit most often provided by commercial banks, other types of debt financing arrangements, such as asset-based financing from business financing companies, lease and equipment financing and sale and leaseback arrangements, have gained popularity.

Regardless of the specific type of loan or credit facility, almost every debt financing instrument will contain specific terms and conditions or “rules” relating to how the borrower uses the funds and conducts its business until the debt is repaid. These rules are contained in the credit agreement and ancillary documents, primarily in sections referring to “representations and warranties” and “covenants.” The borrower’s compliance with these covenants is the means by which the lender monitors the loan and assures itself of a return on its investment. Compliance with covenants also serves as the means by which lenders demonstrate to federal and state regulators that they are in compliance with the rules and regulations applicable to the types of loans they are permitted to make.



The purpose of this book is to provide the reader with an overview of common types of representations, warranties and covenants, what they mean, how they work and what happens if a borrower is unable to satisfy a specific covenant. Our discussion begins in Part One with a general overview of how loan documents are structured. Part Two is a discussion of common terms contained in most credit agreements. Parts Three and Four discuss representations, warranties and covenants. Part Five addresses security interests, guaranty agreements and other forms of collateral commonly required to secure a loan. This book concludes with Part Six which contains a discussion of the consequences of failure to comply with loan covenants and a lender's rights upon the borrower's default.

## **PART ONE: GENERAL STRUCTURE OF COMMERCIAL LOAN AGREEMENTS**

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Generally, commercial loan agreements can be divided into five parts: (1) credit terms, (2) representations and warranties, (3) covenants, (4) security interests and guarantees, and (5) remedies.

### **THE COMMITMENT LETTER AND FEE**

The commercial loan process starts with the borrower filling out a loan application and providing the lender with actual and projected financial information. Once the application has been received and reviewed, the lender will commence its formal review of the borrower and its financial information. Based on its review of the borrower and its financial information, the lender will submit the borrower's loan application to its credit committee, which will then decide whether and on what terms the lender will extend credit to the borrower. The lender's terms are usually communicated to the borrower in the form of a "commitment letter" detailing how much it will lend, what it requires as collateral for the loan and the amount of commitment fee to be paid.

The commitment fee is a fee charged by the lender for the cost of approving and processing the loan. Commitment fees may be a single lump sum upon execution of the loan agreement or at the time the lender otherwise becomes obligated to provide funding or may be deferred until the actual funding of the loan. Commitment fees on commercial loans typically range from one quarter of one percent (.25%) to one percent (1%) of the loaned amount.

## **CREDIT TERMS**

The loan agreement or credit agreement will describe the type of credit facility involved (e.g., term loan, revolving line of credit, etc.), the amount of funds borrowed, the interest rate and maturity date of the loan. In addition, the loan agreement will usually describe the procedures a borrower must follow to receive funds and whether the loan may be prepaid. If the lender is charging a commitment fee (also referred to as a “facility fee”), the amount of the fee and terms of payment will usually be included in this portion of the loan agreement. A detailed recitation of common provisions describing the nature of the loan is contained in Part Two.

## **REPRESENTATIONS AND WARRANTIES**

Representations and warranties are statements of fact relating to past and present situations relating to the borrower, its business and financial condition and the collateral that serves as security for the loan. Representations and warranties form the basis for establishment of the loan relationship, whereas covenants govern the on-going relationship between the lender and borrower. A detailed discussion of representations and warranties is contained in Part Three.

## **COVENANTS**

Covenants are promises by the borrower to take, or refrain from taking, certain types of actions while the loan is outstanding. Covenants generally fall into three categories: affirmative covenants, negative covenants and financial covenants. A detailed discussion of covenants is contained in Part Four.

## **SECURITY INTERESTS AND GUARANTIES**

Commercial loans are always secured by the borrower’s assets and in some cases, additional collateral. The term “secured” means that the borrower has pledged collateral to the lender, i.e., “secured” the loan. The term “security interest” refers to the lender’s right to

take (foreclose) the collateral in the event the borrower is in default under the loan and to sell it and apply the proceeds from the sale to the outstanding balance on the loan.

A guaranty is a promise by one person to repay the debt owed by the borrower to the lender in the event the borrower does not pay. A corporate guaranty is when a corporate entity (a corporation or limited liability company) promises to pay the borrower's obligations to the lender in the event the borrower defaults. A personal guaranty is when an individual person guaranties repayment of the borrower's debt owed to the lender. A detailed discussion of security interests and guaranties is contained in Part Five.

## **REMEDIES**

The term "remedies" refers to the legal rights a lender has against a borrower and its collateral in the event the borrower fails to make payment on the loan, fails to comply with any covenants, or is otherwise in breach of the terms of the loan agreement. Failure to comply with the terms of the loan agreement is referred to in loan agreements as an "event of default." A significant portion of all commercial loan agreements is dedicated to the consequences to the borrower and rights of the lender upon occurrence of an event of default. A detailed discussion of these consequences and rights is contained in Part Six.

## **PART TWO: COMMON CREDIT AGREEMENT PROVISIONS**

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### **GENERALLY**

As discussed above, usually the first several pages of a loan agreement consist of provisions detailing the specific terms of the loan, the collateral used to secure the loan and any fees and charges that will be assessed on the borrower as part of the loan. Common provisions describing the loan terms include:

#### **Description of the Loans**

This section is simply a statement of the agreement between the borrower and the lender. For example:

The Lender agrees, on the terms and conditions set forth herein, to make the Loans to the Borrower. The obligation of the Borrower to repay the Loans shall be evidenced by the \$500,000 Promissory Note and the \$300,000 Promissory Note, containing the terms relating to maturity, interest rate and other matters as set forth in this Agreement.

#### **Use of Proceeds**

How a lender evaluates a borrower's financial condition will in some cases depend on how the borrower intends to use the proceeds of the loan. For example, a borrower that will use the proceeds to purchase additional equipment that will enhance its ability to manufacture its products may reasonably expect to see a decrease in costs and increase in productivity. A lender may take this increased productivity as an indication of an increase in sales, and afford the borrower more flexible financial covenants; for example, a shorter period of time in which the borrower must comply with a debt to equity ratio.

## Timing of Loan Advances

If the proceeds of the loan are to be funded in multiple installments, this section of the credit agreement would detail the timing of the advances.

Most, if not all, credit agreements will contain provisions relating to closing conditions or “conditions precedent.” These provisions describe actions to be taken by the borrower or information to be delivered to the lender before the lender will fund the loan. Closing conditions are a form of representation and warranty (discussed in Part Three), and failure to meet a closing condition may result in a breach of the loan agreement. Common closing conditions include:

- Borrower’s execution of the credit agreement and ancillary documents;
- Execution of guaranty agreements and any related security agreements by the personal or corporate guarantor(s);
- Receipt of tax lien and encumbrances reports (UCC reports) confirming the lender’s ability to take a first lien position in the collateral (or such other position as the borrower and the lender have agreed upon);
- In the case of real property (real estate), receipt of (i) a title commitment for a title insurance policy, (ii) a survey confirming the legal description of the property, (iii) evidence that the property complies with all building codes and zoning ordinances;
- In the case of leased real property, a certificate (called an “estoppel certificate”) from each landlord stating that the borrower-tenant is not in default under, and is in compliance with, all terms of the lease;
- Copies of resolutions adopted by the borrower approving the loan transaction, certified by an officer of the borrower as true and correct;

- A letter from the borrower’s legal counsel (called a “legal opinion” or “opinion of counsel”) confirming the accuracy of certain matters contained in the representations and warranties section of the credit agreement;
- Copies of insurance certificates or other evidence of insurance;
- Completion of lender’s due diligence investigation of the borrower and the collateral, including environmental assessments; and
- Payment of the commitment fee or loan origination fee; most lenders will also require the borrower to pay the costs and expenses incurred by the lender in investigating the borrower, negotiating and drafting the credit agreement and ancillary documents and other out-of-pocket expenses.

## **ANCILLARY DOCUMENTS**

In addition to the loan or credit agreement itself, a borrower can expect to sign several other documents as part of the loan transaction. Common ancillary documents include the following:

### **Promissory Note**

A promissory note is a legal instrument evidencing the debt owed by the borrower to the lender. The credit agreement is the contract by which the parties agree to enter into a creditor/debtor relationship, but the actual loan is represented by the promissory note. Many of the loan terms contained in the credit agreement (loan amount, interest, defaults) will also be included in the promissory note. Borrowers utilizing different pools of collateral to secure the loan may execute more than one promissory note based upon the value of the applicable collateral.

## **Security Agreement**

Usually a lender will take a security interest in all of the borrower's assets (referred to as a "blanket lien"). Assets include real property, personal property and equipment, cash and cash equivalents, assignments of income streams (rent, insurance proceeds, investment income) and deposit accounts. The primary security agreement used in loan transactions involving real property (real estate) is a mortgage. When the real property involved includes a building or other improvements, the security agreement may take the form of a combination mortgage and fixture filing agreement to cover both the land and the improvements.

## **UCC-1 Financing Statement**

In order to secure its lien position against the collateral, the lender is required to perfect its lien on the borrower's collateral. The term "perfect" means filing a copy of the security agreement or what is called a UCC financing statement with the appropriate state and/or county offices. The filing of a financing statement makes the lender's lien a matter of public record and puts subsequent creditors (and creditors that did not file a financing statement) on notice that the borrower's assets have been pledged to the lender.

## **Personal and/or Corporate Guaranty**

Small business loans, including SBA loans, usually require the principal owners of the business to personally guaranty the borrower's debt to the lender. A borrower whose business operations are housed in subsidiary entities can expect a lender to require those subsidiaries to guaranty the parent company's debt obligations.



## **Assignment of Proceeds, Other Rights to Receive Income**

To the extent a borrower received income from rents, investment securities or insurance on assets pledged as collateral, a lender will typically require a borrower to assign the right to receive payment from these sources to the lender in the event the borrower defaults under the credit agreement. The purpose of the assignment is to get as much money into the hands of the lender as possible so as to pay down the debt upon default. Borrowers that have key man insurance on one or more individual employees can expect to assign the right to receive proceeds under those policies to the lender.

## **Officer's Certificate**

When the parties are ready to close and fund the loan, the borrower will be asked to sign a certificate confirming that all of the representations and warranties contained in the credit agreement are true and confirming that the borrower has taken all actions it was required to take prior to funding of the loan. After the initial funding of the loan, a borrower may be required to submit periodic borrowing certificates stating that the borrower is in compliance with all financial covenants contained in the credit agreement and that the financial statements accompanying the certificate are accurate.

## **PART THREE: REPRESENTATIONS AND WARRANTIES**

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### **GENERALLY**

As stated in Part One, representations and warranties are the means by which the lending relationship is established. Representations are statements of fact by the borrower intended to assure the lender that the assumptions it has made with respect to the borrower's creditworthiness, business structure, financial condition and state of its assets are true and accurate. Warranties are contractual duties created by the loan agreement itself and are almost always combined with representations in the credit agreement.

Representations and warranties are statements of facts as of the date the representation is made. Representations and warranties do not (or should not) require the borrower to state what will be true in the future, as the borrower cannot know at the time the loan is executed what facts will be true in the future. Lenders attempt to avoid the uncertainty of the future through the use of covenants. A detailed discussion of covenants is contained in Part Four.

### **TYPES OF REPRESENTATIONS AND WARRANTIES**

Almost all credit agreements will contain representations and warranties designed to provide the lender with all the material facts surrounding the borrower and its business. Common representations and warranties include:

## **Corporate Existence and Authority**

This representation verifies the borrower's legal status as a corporation or other business entity. For example:

Seller is a corporation duly incorporated, validly existing and in good standing under the laws of the State of Minnesota and has all requisite corporate power and authority to conduct its business as it is now being conducted, to own and operate its assets and to enter into this Agreement and perform its obligations hereunder.

## **Execution, Delivery and Performance**

With this representation, the borrower is assuring the lender that the credit agreement is enforceable against the borrower, such that in the event of a default, the lender will be able to exercise the remedies set forth in the agreement. Whether the loan agreement is enforceable is a determination made by the legal system, and thus the representation is essentially a statement that the loan agreement will be recognized by the applicable state judicial system. For example:

The execution, delivery and performance by borrower of its obligations under this Agreement and the Note have been duly and validly authorized by borrower's Board of Directors and do not and will not require any other action on its part. This Agreement is, and the Note when delivered to Lender will be, valid and binding obligations of borrower enforceable against borrower in accordance with their terms.

## **Noncontravention**

This representation confirms the results of the lender's due diligence investigation of the borrower and shifts to the borrower the burden of disclosure of other agreements, documents, facts and existing circumstances which could impact or impair the borrower's ability to repay the loan or the lender's ability to successfully exercise its remedies upon a default by the borrower. This representation is often combined with the "execution, delivery and performance" representation described above. For example:

The execution, delivery and performance by borrower of its obligations under this Agreement and the Note do not, and will not, conflict with, result in, or constitute a breach of or default under or violation of, any provision of borrower's articles of incorporation or bylaws or any other agreement, instrument or contractual restriction binding upon or affecting the borrower or any of its assets or any law, statute, rule or regulation or order, judgment or decree applicable to borrower or its assets.

## **Consents**

Borrowers are required to represent that they have obtained all required consents and approvals by third parties. Third party approvals may include governmental agencies, preexisting secured parties, landlords and other lessees. Contracts such as stock purchase agreements with equity investors may limit the borrower's ability to incur debt absent the investors' consent. The purpose of this representation is to assure the lender that there are not any impediments to the borrower's ability to incur and repay the debt or the lender's ability to take possession of the collateral upon default. For example:

No consent, approval, authorization of any person or governmental authority is required for the execution, delivery and performance by borrower of, or compliance by borrower with, this agreement or the consummation of

the transactions contemplated hereby, other than those consents which have been obtained by borrower as of the date of this Agreement.

### **Accuracy of Financial Statements**

Borrowers are usually required to provide a lender with financial statements as part of the loan process. Information in the financial statements will be used to assess whether the borrower is a good credit risk and will also determine the breadth of financial covenants that will be imposed on the borrower. Financial statements are prepared on a monthly, quarterly and annual basis. The purpose of this representation is to give the lender assurance that the information contained in the financial reports accurately reflects the borrower's financial condition even though a month may have passed since the reports were prepared. For example:

All financial data, including the statement of the cash flow and income and operating expense, that have been delivered to lender in respect of the borrower and the property (a) are true, complete and correct in all material respects, (b) accurately represent the financial condition of the borrower as of the date of such reports, (c) have been prepared in accordance with generally accepted accounting principles (GAAP) throughout the periods covered. Borrower does not have any contingent liabilities, liabilities for taxes, unusual forward or long-term commitment or unrealized or anticipated losses from any unfavorable commitment that are known to borrower and reasonably likely to have a materially adverse effect on the borrower or operation of borrower's business, except as referred to or reflected in said financial statements. Since the date of the financial statements, there has been no material adverse change in the financial condition, operations or business of borrower from that set forth in said financial statements.

## **Litigation**

This representation requires the borrower to affirm that it is not involved in any litigation or to disclose any litigation to the lender. The purpose of this representation is to assure the lender that cash flow generated by the borrower's business will be available to make payments on the loan and to fund the borrower's business operations and not be diverted to pay legal costs and expenses. For example:

Except as set forth in the Disclosure Schedule, there are no actions, suits, proceedings, orders or investigations pending or, to the best knowledge of Borrower, threatened against Borrower, at law or in equity, or before or by any federal, state, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, and there is no reasonable basis known to Borrower for any of the foregoing.

## **Title to Collateral**

This representation requires the borrower to confirm its ownership of the property pledged as security for the loan and to identify any liens existing on the property. Ownership of the collateral is significant to the lender because it directly affects the lender's ability to foreclose upon and take possession of the property in the event of a default by the borrower. The presence of liens on the property ahead of the lender's security interest in the collateral may impair the lender's ability to exercise its remedies. For instance, liens imposed by the government for unpaid taxes take priority over all other liens. Consequently, a lender desiring to foreclose upon the property must pay those taxes and get the liens released before it can proceed with foreclosure on the property. Similarly, a borrower may have already pledged the property as collateral to a prior lender. Unless the loan proceeds are going to be used to pay off the debt owed to that prior lender, the second lender's ability to exercise its rights against the collateral will be subject to satisfaction of the debts owed to the prior lender with the priority lien. For example:

Borrower has good and marketable title to the Property, free and clear of all liens and encumbrances of any nature whatsoever except for those encumbrances identified on Schedule A attached hereto (“Permitted Liens”). The Mortgage, when properly recorded in the appropriate records, together with any Uniform Commercial Code financing statement required to be filed in connection therewith, will create a valid, first priority, perfected lien on the Property, subject only to the Permitted Liens. There are no mechanics’, materialman’s or other similar liens or claims which have been filed for work, labor or materials affecting the Property which are or may be liens prior to, or equal or subordinate with, the lien of the Mortgage. None of the Permitted Liens, individually or in the aggregate, materially interfere with the benefits of the security interest intended to be provided by the Mortgage and this Agreement, materially adversely affect the value of the Property, impair the use or operations of the Property or impair Borrower’s ability to pay its obligations in a timely manner.

### **Licenses and Permits**

Because many businesses are subject to some type of state or local permit requirements, lenders want to be sure that the borrower has all of the required permits, certificates and other approvals applicable to its business. The purpose of this type of representation is to ensure the lender that the borrower’s business will not be shut down, fined or otherwise impaired on account of failure to have the appropriate license or permit. Compliance with this representation requires the borrower to be familiar with any changes in the applicable permitting/licensing requirements. Borrowers often times can request a knowledge qualifier be added to the representations, as in the second example set forth below to avoid being inadvertently in default in the event the applicable law changes or if the borrower inadvertently omitted to obtain or maintain a particular permit that was not material to the operation of its business. For example:

Borrower possesses all of the licenses, permits, franchises or certificates required to conduct its business in the manner it is presently conducted.

To the best of its knowledge, the borrower owns or possesses in its own name (either directly or by assignment), all licenses, permits, authorizations or other rights necessary to conduct its business.

## **Taxes**

Liens for unpaid taxes take priority over all other liens, and the existence of a tax lien would impair the lender's ability to exercise its rights with respect to the collateral. Therefore, a lender wants to be sure that the borrower has paid all of its tax obligations. For example:

The Borrower has timely filed all tax returns required to be filed or sent by it in respect of any taxes required to be filed by it and has timely paid all such taxes shown thereon to be due, including interest and penalties, which are not being contested in good faith by Borrower, and has provided adequate reserves for the payment of any taxes not yet due and payable or for taxes which the Borrower is contesting as provided herein. The Borrower has complied with all laws relating to the withholding of taxes and has timely and properly withheld from individual employee wages and paid over to the proper Governmental Entity all amounts required to be so withheld and paid over under applicable law.

Credit facilities secured by real estate (also referred to as "real property") will contain a significant number of additional representations and warranties relating to the borrower's ownership or right to use the property, easements and other encumbrances, utilities, environmental matters, taxes, insurance and zoning, to name a few.



## **PART FOUR: COVENANTS**

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### **WHAT IS A COVENANT?**

As stated in Part One, covenants govern the on-going relationship between the borrower and lender for the life of the loan. A covenant is a promise by the borrower to take or not to take certain actions. There are two categories of covenants: “affirmative” covenants, which are promises to take certain actions in the future, and “negative” covenants, which are promises not to take certain actions in the future. While most covenants can be stated in either the affirmative or the negative, as a general rule affirmative covenants focus on actions a borrower should take in the normal course of its business. Negative covenants function to prevent the borrower from changing the structure or nature of its business or the fundamental assumptions about its business upon which the lender based its decision to make the loan.

### **PURPOSE OF COVENANTS**

The purpose of covenants is to provide the lender the ability to manage its investment in the borrower and ensure a return on its investment in the borrower’s business. Affirmative covenants are lender-imposed guidelines the borrower must follow in the operation of its business. Negative covenants are prohibitions on the borrower’s ability to change the nature of its business without the lender’s consent. Financial covenants establish set guidelines for operation of the borrower’s business and carry forward the borrower’s representations and warranties as to its financial condition. A borrower’s failure to comply with a covenant triggers a default and the lender’s right to terminate the loan, accelerate the loan (declare the entire loan immediately due and payable) and foreclose on the assets that serve as collateral for the loan.

## TYPES OF COVENANTS

Loan covenants generally fall into three categories: (1) affirmative covenants, (2) negative covenants and (3) financial covenants. Compliance with covenants serves to protect the lender's investment in the borrower by establishing guidelines for operation of the borrower's business and gives assurance that assumptions as to the borrower's creditworthiness at the time the loan was made remain true over the life of the loan. Failure to comply with a covenant serves as the basis for the lender to terminate the loan and exercise its remedies against the borrower and its collateral.

### Affirmative Covenants

Affirmative covenants require the borrower to take certain actions. Financial covenants are generally considered affirmative covenants. Typical affirmative covenants include:

- **Payment and Performance of Obligations.** In addition to making payments on the loan itself, lenders want to be sure the borrower is paying on its other obligations. A default by the borrower on obligations owed to other creditors could result in the filing of a lien against the borrower's assets that have been pledged as collateral to the lender, thereby posing an impediment to a lender seeking to foreclose upon and take possession of collateral upon default. This is of particular concern with respect to taxes, as liens for unpaid taxes take precedence over all other liens. Consequently, almost every credit agreement will contain a covenant similar to the following:

Borrower shall pay and discharge as the same shall become due and payable (a) all taxes, assessments and governmental charges of any kind payable by it, except that it shall contest in good faith and by appropriate proceedings providing such reserves as are required by generally accepted accounting principles, and (b) all lawful claims which, if unpaid, would by law become a lien upon any of the Borrower's assets.

- **Maintenance of Corporate Existence.** This covenant requires the borrower to maintain its legal status as a corporation or other business entity in good standing in its state of incorporation and any other state in which it does business. The purpose of this covenant is to prevent the borrower changing its corporate structure or dissolving its existence to avoid repaying the loan. For example:

For so long as any Obligations shall remain outstanding, Borrower shall preserve and maintain, and cause each subsidiary to preserve and maintain, its corporate existence in good standing in its state of incorporation and qualify and remain qualified, and cause each subsidiary to qualify and remain qualified, as a foreign corporation in each jurisdiction in which such qualification is necessary.

- **Maintenance of Collateral.** Generally, collateral will be defined in the loan documents as all of the borrower's existing property (assets) and any property (assets) acquired in the future. A maintenance of collateral covenant requires the borrower to retain properties necessary for the operation of its business and maintain them properly. This covenant serves two purposes. First, it assures the lender that the borrower has the assets it needs to operate its business competitively, which increases the likelihood that the borrower will continue to be creditworthy through the life of the loan. Second, the obligation to keep that property in good condition will result in the lender being able to get a higher price for those assets after foreclosure in the event of a default. For example:

Borrower shall maintain keep, and preserve, and cause each of its subsidiaries to maintain, keep and preserve, all of its properties, tangible and intangible, real and personal, necessary or useful for the conduct of its business in good and working order and condition, ordinary wear and tear excepted.

- **Conduct of Business.** Related to the maintenance of collateral are the conduct of business and compliance with laws covenants. The purpose of these types of covenants is to ensure the lender that the borrower will continue to operate its business over the life of the loan and generate sufficient income to service the loan. Borrower's compliance with applicable laws ensures that the borrower's creditworthiness is not adversely affected by having to pay fines or penalties or suffer liens against its assets which could impair the lender's ability to exercise its remedies in the event of a default on account of failure to comply with the law. For example:

Borrower shall continue, and shall cause each subsidiary to continue, to own its properties and conduct its business in the same manner as the same are owned and conducted as of the date of this Agreement.

Borrower shall conduct its business in compliance with all applicable federal, state and local laws, rules, regulations, ordinances and orders, whether judicial or administrative, and whether arising under common law, statute or otherwise.

- **Insurance.** Loan agreements will often contain a provision requiring the borrower to maintain the same insurance in the same amounts as that maintained by similar businesses in borrower's industry. It is not uncommon for lenders to require specific types and specific amounts of coverage to ensure that the borrower can repay the loan in the event the borrower's assets are destroyed or is obligated to pay substantial claims to third parties and cannot recover the full amounts from its insurance carrier. In many cases, the lender will also require that borrower list the lenders as a loss-payee on the policy. For example:

Borrower shall maintain such policies of insurance with reputable insurance carriers as is normally carried by companies engaged in similar businesses and owning similar property, and name the Lender as loss payee on all policies insuring real or personal property in which Lender has a security interest and provide Lender with certificates of insurance evidencing its status as a loss payee. The loss payee endorsement shall provide for payment to the Lender (subject to the rights of any prior lien holders) notwithstanding any acts or omission of the Borrower and shall require notice to the Lender thirty (30) days prior to the expiration or cancellation of any policies of insurance.

- **Financial Reporting.** Lenders typically require the borrower to provide copies of its financial statements and other finance-related documentation to the lender on a regular basis, usually within a specified number of days after the end of each financial quarter and end of fiscal year. Having a borrower's financial information allows the lender to monitor compliance with financial tests and covenants contained in the credit agreement. Lenders will also ask the borrower to certify the accuracy of the financial information and that it is in compliance with all financial covenants.

Typical financial reporting requirements include the delivery of quarterly and annual financial statements, management letters and budgets. For example:

Borrower shall at all times maintain accurate and complete books and records and copies of all material agreements to which it or the Collateral is a party or is bound. Lender may inspect and make copies of those books and records and any other data relating to Borrower or the Collateral at reasonable times. Borrower shall deliver or cause to be delivered to Lender the following:

- (i) Management prepared certified quarterly financial statements for Borrower, including unit level profit and loss statements relating to the Business, within thirty (30) days after the end of the first three (3) quarters of each fiscal year of Borrower;
- (ii) Annual financial statements for Borrower, including unit level profit and loss statements relating to the Business, prepared by an independent certified public accountant within ninety (90) days after the end of each fiscal year of Borrower, which financial statements shall be audited, reviewed or compiled as Lender shall direct;
- (iii) As soon as available, but in any event not less than thirty (30) days prior to commencement of each new fiscal year, a business plan and projected financial statement for such fiscal year; and
- (iv) Within ten (10) days after notice thereof delivered by Lender to Borrower, such other information and data with respect to the Business as Lender may from time to time reasonably request.

Financial reporting requirements are often imposed upon the person or entity that has guaranteed the borrower's obligations to the lender. For example:

During the term of the Loan, Guarantor shall deliver to the Lender, annually, (a) the personal financial statement of the Guarantor on the Lender's form, together with a copy of the Guarantor's federal tax return including all schedules, within 120 days of each calendar year end; and (b) from time to time, such further information regarding the personal financial condition and net worth of the Guarantors, as the Lender may request.

- **Compliance Certificate; Notice of Certain Events.** Lenders do not necessarily monitor a borrower’s compliance with the loan agreement on a daily basis. Lender’s typically put the burden of disclosing non-compliance on the borrower through the use of a compliance certificate and “notice of certain events” covenant. A compliance certificate usually sets forth the borrower’s calculations of all financial tests and ratios and certifies to the lender that the borrower is in compliance with all covenants and obligations contained in the loan documents. For example:

Within thirty (30) days after the end of each fiscal year, Borrower shall provide to Lender a Certificate of Borrower in the form attached hereto as Exhibit D signed by the Chief Financial Officer of the Borrower. In the event such certificate shows that an Event of Default has occurred under this Agreement or any of the Ancillary Agreements, or any event that would constitute an Event of Default under the same with the passage of time or the giving of notice or both, the Certificate shall state in reasonable detail the circumstances surrounding such event and action proposed by the Borrower to cure such event.

Borrower shall promptly notify Lender of any of the following, but in no event later than three (3) business days after any Responsible Officer of Borrower obtains actual knowledge thereof:

- (i) the occurrence or existence of any Event of Default or any event or circumstance that foreseeably will become an Event of Default;
- (ii) any breach or nonperformance of, or any default under, any contractual obligation of Borrower;
- (iii) any dispute, litigation, investigation, proceeding or suspension which may exist at any time between the Borrower and any governmental authority if the amount in controversy exceeds \$20,000;

- (iv) the commencement of, or any material adverse development in, any litigation or proceeding affecting the Borrower in which the amount of damages claimed is in excess of \$20,000 in excess of applicable insurance coverage (or exceeds \$20,000 and the insurer has denied coverage), or in which injunctive or similar relief is sought, or in which the relief sought is an injunction or other stay of Borrower's performance under this Agreement or any of the Ancillary Agreements;
  - (v) any material adverse change in the assets, liabilities and net worth of Borrower subsequent to the date of the most recent financial statements of the Borrower delivered to Lender pursuant to this Agreement;
  - (vi) any material change in accounting policies or financial reporting practices of Borrower; and
  - (vii) any material labor controversy resulting in or threatening to result in any strike, work stoppage, boycott, shutdown or other material labor disruption against or involving Borrower.
- **Further Assurances.** As additional protection for the lender, most loan agreements contain a catch-all "further assurances" covenant designed to cover any circumstances not specifically included in other covenants. For example:

Borrower shall ensure that all of its submissions to the lender, including written information, exhibits and reports, do not and will not contain any untrue statement of a material fact and do not and will not omit to state any material fact or any fact necessary to make the statements contained therein not misleading in any material respect in light of the circumstances in which made, and Borrower will promptly disclose to Lender and correct any material defect or error that may be discovered therein or in any other document executed in connection with the Loan.



## Negative Covenants

Negative covenants obligate the borrower to refrain from taking certain actions it might otherwise take if the credit facility was not in place. Like affirmative covenants, negative covenants are an attempt by the lender to establish guidelines for operation of the borrower's business over the life of the loan so as to ensure the lender that its assumptions as to the borrower's business remain true over the life of the loan. The primary difference between negative and affirmative covenants is their emphasis. Affirmative covenants generally focus on the borrower's business practices and compliance with prescribed standards. Negative covenants, on the other hand, focus more specifically on preservation of the collateral supporting the loan and limit the borrower's ability to further encumber those assets or create situations that may result in third party claims against the collateral. Typical negative covenants include restrictions like the following:

- **Negative Pledge.** Almost all credit facilities will contain a provision prohibiting the borrower from creating additional liens on the assets serving as collateral for the loan. In the event of a default, a lender with a security interest in the collateral (lien on the assets of the borrower) has the right to seize and liquidate the collateral and apply the proceeds to repayment of the loan. The lender may do this without regard to the existence of other creditors that do not have a security interest (lien) in the assets. If, however, the borrower's assets have been pledged as collateral to more than one creditor, the lender may not have the unfettered right to seize and liquidate the collateral; if the competing lien was in existence prior to lender's extension of credit to the borrower, the lender would have to get the prior secured creditor's permission to seize and liquidate the assets, and/or apply the proceeds from any such liquidation to repay the debt owed to that prior creditor before applying the proceeds to the loan. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower will not, without the prior written consent of Lender, create, incur, or suffer to exist, any mortgage, deed of trust, pledge, lien, security interest, hypothecation or other charge or encumbrances of any nature, upon or with respect to any of Borrower's properties, now owned or in the future acquired.

- **Additional Indebtedness.** A covenant restricting the borrower's ability to incur additional debt does two things. First, it provides the lender with assurance that the borrower has sufficient cash for operations to service the loan. Secondly it protects the lender's lien position by limiting the claims that can be made against the collateral to junior lien holders and unsecured creditors. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not create or suffer to exist any Indebtedness other than the Note and Indebtedness secured by Permitted Liens.

"Indebtedness" or "Debt" as used in credit agreements is typically defined as (i) indebtedness for borrowed monies or for the deferred purchase price of property or services, (ii) obligations as a lessee under leases that have been or should be recorded as capital leases, (iii) obligations under direct or indirect guaranties in respect of any obligations (contingent or otherwise) to purchase or otherwise acquire, or otherwise to assure a creditor against loss in respect of, indebtedness or obligations of others of the kinds referred to in clauses (i) and (ii) above, or (iv) liabilities in respect of unfunded vested benefits under plans covered by ERISA.

- **Payment of Dividends or Distributions.** Corporate borrowers often strive to provide shareholders with a return on their investment through the payment of cash dividends or distribution of assets to its shareholders. Once cash or assets have been transferred to shareholders, those assets are no

longer available to the borrower to operate its business, pay debt service or to support the credit facility. The purpose of this covenant is to assure the lender that all obligations owed to it will be satisfied before any of the borrower's shareholders or other equity holders receive any assets. This covenant also assures the lender that the borrower will have sufficient assets available to absorb any losses. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not purchase or redeem any of its equity interests, declare or pay any distributions thereon, make any cash or property distributions to equity holders, or set aside any such funds for such purpose.

Many lenders will allow limited payments of dividends and distributions to equity holders in such amounts as are necessary to enable those persons to pay any income tax liability they have incurred on account of their equity interest in the borrower. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not purchase or redeem any of its equity interests, declare or pay any distributions thereon, make any cash or property distributions to equity holders, or set aside any such funds for such purpose; provided, however, that in the absence of an Event of Default, Borrower may make distributions to its equity holders on a periodic basis in such amounts as are necessary to permit them to timely pay that portion of their income tax liability attributable to their ownership of an equity interest in the Borrower.

- **Extraordinary Transactions.** The lender's decision to make a loan is based on its analysis of the borrower's capital structure, business operations and assets. A covenant prohibiting extraordinary transactions seeks to maintain the integrity of the lender's initial decision to make the loan by prohibiting

fundamental changes in the borrower's capital structure, business operations and assets. More simply stated, this covenant assures the lender the composition and business of the borrower remains the same over the life of the loan.

"Extraordinary transactions," also sometimes referred to as "fundamental changes" typically include a merger or consolidation of the borrower with another company, the purchase or sale of any division or line of products or service offering or the sale of all or substantially all of the borrower's assets and the dissolution of the borrower's legal status as an entity. A merger is the acquisition of one company by another company, with the acquiring company being the sole remaining entity upon completion of the transaction. A consolidation refers to a transaction in which two companies come together to form a new company, and terminate their individual existence. A reorganization can take several forms, but generally refers to a transaction where a company exchanges all of its outstanding securities for the securities of another corporation, resulting in the first company becoming a subsidiary of the other company. The occurrence of any of these transactions could result in a different mix of assets and liabilities, the loss of collateral, new management or even termination of the borrower's existence. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not wind up, liquidate or dissolve itself, reorganize, merge or consolidate with or into, or convey, sell, assign, transfer, lease or otherwise dispose of, (whether in a single transaction or series of transactions), all or substantially all of its assets (whether now owed or in the future acquired) to any other Person, or acquire all or substantially all of the assets or business of any Person.

- **Compensation.** Covenants prohibiting an increase in salaries and bonuses paid to employees serve the same purpose as covenants limiting or prohibiting dividends and distributions to shareholders, which is to ensure that the borrower has sufficient cash available to service the loan and repay the loan at maturity. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not pay any salary, employee benefits or other compensation (including, without limitation, bonuses and perquisites, insurance premiums, employer contributions to a 401(k) plan, loans, rent overrides, payments under automobile leases or any other allowance for housing or the use of automobiles) to or for the benefit of any employee, director or shareholder of Borrower, excluding, in each case (i) the payment of life insurance premiums relating to one or more buy-sell agreements by and among Borrower and any such person(s) consistent with past business practice, and (ii) compensation paid to employees in the ordinary course of business consistent with past business practice.

- **Transactions with Affiliates.** This covenant prevents a borrower from entering into transaction with persons or entities that are affiliated with the borrower. An “affiliate” is generally defined as any person that is an officer or director of the borrower, a shareholder that owns more than 5% or 10% of the borrower’s outstanding voting stock or a person or corporation that is controlled by, or under common control with, the borrower. An easy example of an affiliate is a subsidiary, which is an affiliate of its parent company. Regardless of the specific language, almost all credit agreements will contain a prohibition on the borrower doing business with any person or entity that has the ability to influence or direct the borrower’s business decisions.

The purpose of this type of restriction is to make sure that all of a borrower's business agreements are as favorable as possible and consistent with existing market rates and trends. Transactions with affiliates are less likely to be at market rates, and therefore less profitable for the borrower. Obviously this is an issue for a lender seeking assurance that there is enough cash in the business to service the debt and repay the loan. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not engage in any transaction (including, without limitation, loans or financial accommodations of any kind) with any Affiliate, provided, that such transactions are permitted if they are on terms no less favorable to the Borrower than would be obtainable in an arm's-length transaction with a person not an Affiliate.

- **Investments.** Another covenant intended to prevent diversion of funds away from operations, debt service and repayment of the loan is a restriction on the borrower's ability to make investments that are not readily convertible into cash. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not make any loan or advance to any Person, or purchase or otherwise acquire the capital stock, assets, or obligations of, or any interest in, any other Person other than readily marketable direct obligations of the United States of America and deposits in commercial banks of recognized good standing in the United States of America.

- **Adverse Action.** Similar to the catch-all "further assurance" affirmative covenant is the adverse action negative covenant. For example:

For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not (i) take any action that would (A) be in violation of any provision of the Loan Documents, (B) materially impair the ability of the Borrower to perform its obligations under the Loan Documents, or (C) materially amend the terms and conditions of any agreement to which the Borrower is a party.

## **Financial Covenants**

Financial statements are one of the primary pieces lenders look at in their determining whether to extend credit and the terms of a specific loan. Financial covenants focus exclusively on information contained in the borrower's financial statements and serve as guidelines for operation of a borrower's business. The primary differences between financial covenants and affirmative and negative covenants are twofold. First is the level of borrower's control over compliance. Typically, the borrower has control over whether it complies with an affirmative or negative covenant, i.e., the borrower can control whether it is in good standing as a legal entity or incurs additional indebtedness. In contrast, a borrower may be in compliance with all affirmative and negative covenants yet still suffer a loss in any given year due to matters beyond its control, such as the state of the industry, market trends, etc., and fail to comply with the financial covenants.

Generally, financial covenants are a set of minimum financial tests with which a borrower must comply, although they also function to carry forward the borrower's representations and warranties as to its financial condition that were made on the date the credit facility was entered into. Because they focus exclusively on a borrower's financial statements, financial covenants have nothing to do with the collateral aspects of the loan. They are simply the numerical or mathematical limits generated by the lender intended to control how the borrower operates its business. Compliance with financial covenants ensures the lender that the borrower's financial

condition will not deteriorate during the life of the loan. In some cases, financial covenants are used as an indication of improved financial condition.

Unlike representations and warranties, which apply to circumstances at a specific point in time, i.e. at the time of making the loan (or at the time of each draw on a revolving loan), covenants apply throughout the life of the loan. Borrowers should consider negotiating financial covenants that apply to specific points in time, for example, at the end of each fiscal quarter to tie in with completion of the borrower's quarterly financial reports. Unless a borrower prepares financial statements on a daily basis, it cannot know with any certainty whether it is in compliance with applicable financial covenants on the days in between the date of the financial statements.

Financial covenants are generally stated as either a dollar amount or as a ratio. Compliance with covenants stated as a dollar amount will be determined by reference to a specific line item in the financial statements or by adding and subtracting various items in the financial statements. Common dollar amount financial covenants include:

- **Minimum Working Capital.** Working capital measures the amount of cash and other readily available assets that may be converted into cash available to the borrower. Working capital is an indication of a borrower's ability to pay its debts and ability to absorb losses. Lenders impose minimum working capital requirements on their borrowers to ensure themselves that the borrower will have sufficient resources to operate its business properly, and thereby make payments on the loan. A decrease in working capital often sends a signal to the lender that the borrower is having financial difficulties. Working capital restrictions limit a borrower's ability to use cash from operations for new product development, marketing or to fund distributions or dividends to shareholders.



Working capital is calculated as the excess of a borrower's current assets over current liabilities. Current assets generally refers to assets that are readily convertible into cash (usually within one year), such as cash, accounts receivable, inventories and prepaid expenses. Current liabilities generally refers to obligations that must be satisfied within one year. For example:

Borrower shall maintain an excess of current assets over current liabilities of not less than 1.5 to 1.

- **Tangible Net Worth.** Tangible net worth (sometimes referred to as "shareholders' equity") represents the assets that would remain in the borrower after all of its liabilities were satisfied. This is significant because as a creditor, the lender would be paid first in a liquidation of the borrower, and thus tangible net worth represents the assets available to the lender to satisfy the loan before any payments may be made to the borrower's shareholders. The purpose of a tangible net worth requirement is to assure the lender that the borrower will maintain sufficient assets to support the loan (i.e., sufficient assets which, if sold by the lender, would generate proceeds equal to the loan amount). Like working capital covenants, tangible net worth covenants restrict the amount of assets available to the borrower to fund distributions or dividends to shareholders.

Tangible net worth is calculated as the difference between all of a borrower's assets (current and long-term) and all of the borrower's liabilities (current and long term). Loan documents containing a tangible net worth covenant will usually specify which assets and liabilities are to be included in the calculation. For example:

Borrower shall maintain at each fiscal year end a tangible net worth of not less than \$1,500,000.

Borrower shall maintain Tangible Net Worth of not less than \$900,000 until December 31, 2005, and not less than \$2,000,000 thereafter.

- **Capital Expenditures.** A capital expenditure is the purchase of a capital asset. Capital assets are assets used in the borrower’s business that have a useful life of more than one year at the time they are acquired by the borrower. Capital assets typically include owned real property, building and equipment, i.e., assets necessary to operate the business but which are not sold by the borrower as a part of its business. Non-real estate capital assets are sometimes referred to as “FF&E,” meaning, “furniture, fixtures and equipment.” Capital assets generally cannot be disposed of (sold) by a borrower absent liquidation of the business. Consequently, capital assets are not assets the borrower can use to pay down the loan. Capital expenditure covenants restrict the amount of money or other assets the borrower may use to acquire capital assets. By limiting capital expenditures, the lender is assuring itself that the borrower will maintain sufficient current assets to pay down the loan. Capital expenditure covenants restrict a borrower’s ability to expand its operations. For example:

Borrower shall not make any expenditures for fixed or capital assets if, after giving effect thereto, the aggregate of all such expenditures made by the Borrower would exceed 2% of net profit during any fiscal year of the Borrower.

Common financial covenants expressed as a ratio include:

- **Debt-to-EBITDA Ratio.** The term “EBITDA” stands for Earnings Before Interest, Taxes, Depreciation and Amortization and is a common method used by lenders to calculate cash flow. The calculation of EBITDA indicates how much cash is generated by a borrower’s business that can be used to pay creditors, investors and other capital costs. A debt-to-EBITDA ratio calculates the amount of debt a borrower has in relation to its cash flow. Lenders use this calculation to determine how much money the borrower has to pay its debts or whether it has the ability to take on additional debt. A change in debt to EBITDA could indicate a downturn in business making it more difficult for the borrower to pay the debt. For example:

Borrower shall maintain a ratio of Funded Debt to EBITDA of not less than 4 to 1.

“Funded Debt” refers to indebtedness of the borrower to a bank or other financial institution, as opposed to loans from officers, directors, etc.

A concept similar to EBITDA is EBITDAR. EBITDAR is an EBITDA calculation that includes rent. EBITDAR is useful when comparing the financial condition of two or more borrowers when one of the borrowers owns its property free and clear and the other leases its property.

- **Debt-to-Equity Ratio.** Sometimes referred to as the “leverage test,” this calculation measures the amount of debt a borrower has in relation to the amount of equity invested in the business and income generated by the borrower’s business. Lenders use this calculation to determine how much debt (leverage) the borrower can support (afford to pay). Borrowers generally prefer a high debt to equity ratio so that they can use the borrowed funds to generate additional profits and increase the return on shareholders’ investment. Lenders want to be sure there is enough equity in the business to absorb losses, including losses resulting from a failure to generate profits using borrowed funds, and thus prefer a lower leverage ratio. For example:

Borrower shall maintain a ratio of total liabilities to tangible net worth of not greater than 3 to 1 and a ratio of consolidated total liabilities to consolidated tangible net worth of not greater than 4 to 1.

Often times the debt to equity ratio test is included as an exception to a prohibition on a borrower’s ability to incur additional debt. For example, the borrower may not incur additional indebtedness “except that debt may be incurred if, immediately after giving effect to the receipt and application

of proceeds thereof, the ratio of total debt of Borrower to the tangible net worth of Borrower would not be greater than 4 to 1.”

A related concept is “debt to tangible net worth.” This ratio modifies the pure debt-to-equity ratio by excluding assets that are of minimal value, i.e., assets that are not essential to support the loan because they have little value or would not be saleable by the lender. For example:

During the term of the Loan, Borrower shall maintain a Debt to Tangible Net Worth Ratio not to exceed 4.75 to 1.0 until December 2005, and not more than 2.75 to 1.0 for all times thereafter.

- **Debt Service Coverage Ratio.** A debt service coverage ratio is the ratio of available cash flow (normally EBITDA) to the borrower’s annual debt service payment or amount of senior debt. This ratio calculates the ability of the borrower to repay the loan and is useful to the lender in assessing the credit risk of the loan. For example:

For each fiscal year beginning with the fiscal year ending on December 31, 2004, DSCR for Borrower shall not be less than 1.1:1.

- **Fixed Charge Coverage Ratio.** A fixed charge coverage ratio is the ratio of cash flow (EBITDA) to debt service. This ratio calculates the amount of cash flow available to pay the borrower’s fixed charges. “Fixed charges” are obligations recurring on a regular basis, such as loan payments and lease obligations. Lenders use this calculation to determine how easy or difficult it will be for a borrower to service its existing financial obligations and take on new debt. The difference between FCCR and a debt to equity ratio is that FCCR includes all fixed obligations. For example:

For each fiscal year beginning with the fiscal year ending on December 31, 2004, FCCR for Borrower shall not be less than 1.1:1.

- **Current Ratio.** The current ratio is a close cousin of the minimum working capital covenant. A current ratio covenant measures a borrower's liquidity. Current ratio is calculated as the ratio of current assets to current liabilities. Unlike a working capital covenant that is tied to a specific amount, the current ratio will grow proportionately as the borrower's current assets and liabilities grow which allows a lender to ensure the appropriate balance between assets and liabilities is maintained over the life of the loan. For example, a working capital covenant of \$1,000,000 may be appropriate for a borrower that has \$10 million in liabilities, but not appropriate when that borrower's business grows and its liabilities increase to \$50 million. The current ratio would take into account the changes in assets and liabilities over time. For example:

Borrower shall maintain a ratio of current assets to current liabilities of not less than 1.5 to 1.

- **Quick Ratio.** A quick ratio is used to measure a borrower's liquidity and is expressed as the ratio of the sum of a borrower's liquid assets to the sum of its current liabilities. The quick ratio is different from the current ratio in that the borrower's inventory and receivables are excluded from the calculation. Inventory is excluded because it may decline in value upon liquidation, and receivables are excluded because they may not be readily collectable (i.e., readily convertible into cash). Consequently, the quick ratio is a more stringent test of liquidity than the current ratio. This ratio is often used to assure the lender that the borrower has enough liquidity (available cash and cash equivalents) to satisfy the borrower's ongoing needs. For example:

Borrower shall maintain a ratio of (1) the sum of (a) cash on hand or on deposit in banks, (b) readily marketable securities, (c) readily marketable commercial paper rated "A-1" by Standard & Poor's Corporation (or similar rating by any similar organization which rates commercial paper) and (d) certificates of deposit, to (2) current liabilities of not less than 2 to 1.

The type of financial covenants a lender will include in a particular credit facility depend on several factors, including the borrower's creditworthiness, type of business, amount and type of collateral available to secure the loan as well as the current state of the market the borrower serves or industry in which it operates.

Prior to signing the loan agreement, every borrower should prepare a pro forma analysis of its business operations over the life of the loans to assess whether it will be able to comply with the financial covenants on a going-forward basis.

## **PART FIVE: SECURITY INTERESTS AND GUARANTIES**

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### **SECURITY INTERESTS AND SECURITY AGREEMENTS**

As discussed in Part One, commercial loans are always secured by the borrower's assets. Assets include real property, personal property and equipment, cash and cash equivalents, assignments of income streams (rent, insurance proceeds, investment income) and deposit accounts. A borrower that carries key-man life insurance on one or more of its employees can expect to assign the policy to the lender such that the lender, not the borrower, will collect the proceeds in the event the covered individual dies. A borrower holding such policies for the purpose of funding shareholder buy-sell agreements will need to address how the company (or the shareholders, if the shareholders own the policies) will pay for acquisition of a deceased shareholder's shares of stock if the proceeds from the policy have been pledged to the lender.

A borrower can expect to sign a security agreement pledging all of the business's assets to the lender and granting the lender the right to foreclose upon the assets upon an event of default under both the credit agreement or under any other agreement comprising the credit facility (the promissory note, guaranty, etc.). An event of default under any one loan document will generally constitute an event of default under all of the loan documents, a concept referred to as a "cross default."

Security agreements generally contain their own set of representations and warranties and covenants that are in addition to those contained in the credit agreement. While there is generally some overlap between the representations, warranties

and covenants contained in the two documents, it is not usual for covenants in the security agreement to focus specifically on the borrower's use, maintenance, encumbrance and disposal of the collateral rather than the borrower's global financial performance. In real estate transactions, the mortgage is the security agreement, although a separate, stand-alone security agreement may be required for any personal property not associated with the real estate.

In order to protect its rights in the borrower's collateral from the claims of other creditors of the borrower, the lender will "perfect" its lien by filing a financing statement with the Secretary of State's office or the county recorder's office, depending on the nature of the underlying collateral. These financing statements are referred to as "UCC-1" financing statements, as the form is prescribed by the Uniform Commercial Code (UCC). At such time as the debt is repaid or otherwise satisfied, the lender will file a UCC-3 statement with the appropriate office releasing its security interest and putting the world on notice that it no longer has an interest in the collateral.

## **PERSONAL AND CORPORATE GUARANTY AGREEMENTS**

A guaranty is a promise by one person to repay the debt owed by the borrower to the lender in the event the borrower does not pay. Almost all small commercial loans (and some larger loans, depending on the borrower's industry) require the principal owners of the borrower to personally guaranty the borrower's obligations to the lender.

A corporate guaranty is when a corporate entity (a corporation or limited liability company) promises to pay the borrower's obligations to the lender in the event the borrower defaults. A personal guaranty is when an individual person guaranties repayment of the borrower's debt owed to the lender.



Most personal and corporate guaranty agreements cover both the specific debt described in the credit agreement as well as any other, future obligations the borrower may have to the lender, such as additional loans or refinancing of an existing loan. This is called a “continuing guarantee.” Whether a lender is willing to limit the scope of the guarantor’s obligations under a guaranty agreement to one specific loan transaction will depend on the amount of the loan, the nature and amount of collateral as well as the lender’s internal policies.

It is customary for lenders to require personal and corporate guarantors to pledge collateral to the lender to secure their obligation to repay the borrower’s debt in much the same fashion as the borrower. A common arrangement is for the lender to take a security interest in a personal guarantor’s home or in shares of stock or other marketable securities. Lenders generally take a blanket security interest in all of a corporate guarantor’s assets, particularly when the guarantor is a subsidiary of the borrower.

Whether personal or corporate in nature, commercial loan guaranty agreements will provide that the lender has the option to enforce the guaranty regardless of whether the lender is taking any legal action against the borrower or the borrower’s assets. Depending on the nature of the loan and the borrower’s collateral, a lender may be willing to limit a guarantor’s liability under the guaranty agreement to a specified amount, for example, limit the guarantor’s liability on a \$75,000 loan to \$50,000. Limitations on guarantor liability are, however, the exception rather than the rule.

## **PART SIX: REMEDIES**

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As discussed in Part Five, the purpose of the lender taking a security interest in the borrower's assets and other collateral is to provide the lender with ready access to that collateral in the event the borrower fails to make a payment on the loan or otherwise is in violation of the terms of the credit agreement. Circumstances under which the lender is entitled to foreclose on the collateral and/or exercise its other rights against the borrower are referred to as "events of default."

Events of default fall into two categories: payment defaults and covenant defaults. A payment default is when the borrower fails to make a scheduled payment on the loan when due, and any applicable grace period has expired. A covenant default is when the borrower is in violation of one or more of the affirmative, negative or financial covenants contained in the credit agreement.

Some credit agreements do not differentiate between payment defaults and covenant defaults. Some credit agreements will provide for different remedies for payment defaults and covenant defaults. The difference is usually one of timing: payment defaults typically trigger the lender's right to exercise its remedies against the borrower, whereas covenant defaults may not trigger some or all of the lender's remedies until they have happened a number of times or the variance from the covenant is deemed to have a material adverse effect on the borrower's business or financial condition.

A lender's remedies against the borrower include acceleration and foreclosure. "Acceleration" means that all amounts owed by the borrower to the lender are immediately due and payable in full regardless of the repayment schedule. "Foreclosure" refers to the process by which the lender takes possession and control of collateral pledged as security for the loan. The lender will typically sell the collateral and apply the proceeds from the sale to the outstanding balance on the loan. To the extent the proceeds from the sale of collateral are not sufficient to pay off the entire balance of the loan and any accrued but unpaid interest, the lender will usually seek to obtain a deficiency judgment against the borrower for the balance.

If a third party has signed a personal or corporate guaranty, the lender may look to the guarantor for payment of the borrower's obligation in addition to exercising its remedies against the borrower and the collateral.

Lenders are often willing to waive events of default and work with a borrower to get its payments or financial situation back on track. It is common for a borrower who has regularly defaulted under the terms of the credit agreement to be put into the lender's loan workout group. The workout group reviews the borrower's financial condition and considers changes to the terms of the credit facility that the borrower will be better able to meet, thereby increasing the likelihood that the lender will receive the expected return on the loan.

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