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LOAN AGREEMENTS

A loan agreement is a valuable tool for establishing an open line of communication between the bank and borrower. By setting the submission of interim and year-end financial statements and reporting any negative trends, a business banker remains aware of the borrower's operations and moves to correct problems as they occur.

Most loan agreements are tailored to the individual lending situation and, therefore, vary in their specific terms, conditions, and complexity. The business banker, who should understand the borrower's strengths and weaknesses, protects the bank from these weaknesses and ensures that strengths are maintained. The lender's loan agreement sets minimum acceptable levels of performance. In general, comprehensive and carefully written loan agreements are especially justified when there is the following:

- A loan for a large amount or a long term
- A loan for working capital purposes and a need to control the cash flow
- An unsecured loan and a need to control purchasing or selling assets
- A loan based on projections and a need to protect against uncertain performance
- A verifiable credit weakness, such as high financial leverage, and a need to guard against that weakness

To determine the components of a good loan agreement, a business banker reviews what is known about the borrower's financial strengths and weaknesses, future prospects, managerial capabilities, legal standing, and ability to provide reliable and accurate records. With an understanding of these issues, a business banker, loan documentation specialist or outside legal counsel drafts a loan agreement that sets reasonable standards of performance and describes the options available to both the bank and the borrower if they are not met. Although the specific wording for a loan agreement varies, most agreements contain the following sections:

The loan or credit facility—This section describes the terms and conditions of the loan, including the type of loan, amount, interest rate, repayment schedule, and security. It also identifies all the parties to the loan and their roles, and may include definitions of the financial, legal, and accounting terminology used in the agreement. Reference often is made to the promissory note, security agreement (if there is one), and any other documents that may be a part of the loan package. Returning to Dry Supply, its loan agreement would reference the \$60,000 note for a term of five years with a security agreement and a fixed interest rate of 6 percent.

Borrower representations and warranties attest that certain statements the borrower made are true. For example, the owners of Dry Supply will represent or warrant that it is a corporation, that it entered into the lending agreement legally, that the financial statements it supplied to the bank are accurate, that there is no existing or pending litigation against it, and that it owns its collateral assets.

Conditions of lending stipulate what must happen before the bank is obligated to fund the loan. All documents must be in their proper form, and legal counsel for both bank and borrower must approve the credit arrangement and certify terms and conditions are in compliance with applicable laws. For example, whereas a construction loan's promissory note may allow for multiple draws, the loan agreement would specify the documents needed to evidence completed work and the payment amount due before each draw is processed.

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Affirmative covenants place certain restrictions on the borrower. Affirmative covenants state what the borrowing business proactively must do until the loan is paid in full. The following are some examples:

- Maintaining a certain dollar level of working capital or net worth
- Meeting certain ratio requirements (such as a current ratio of 1.5x or greater)
- Furnishing the bank with periodic financial statements, tax returns and other reports
- Reporting to the bank any adverse conditions or events
- Maintaining adequate levels of property and casualty insurance
- Maintaining legal, business existence in “good standing” with the appropriate state laws
- Paying all taxes and other obligations that, if unpaid, might result in a lien
- Maintaining property, plant, and equipment in good repair
- Permitting bank personnel to inspect business records to verify authenticity of financial statements and physical condition of assets
- Informing the bank of any actual or probable litigation or changes in key contracts

Negative covenants specify practices that, absent the bank’s prior written consent, the borrower cannot engage in until the loan is paid in full. The following are some examples:

- Mortgaging, selling, or pledging assets to third parties, other than those required in the ordinary course of business
- Purchasing securities (including the repurchase of its own stock) or obligations other than U. S. government securities
- Compensating owners or officers above a certain specified aggregate amount
- Paying dividends or distributions to owners above a certain specified amount
- Assuming liability of indebtedness of other entities through guarantees or other means
- Engaging in lines of business other than lines of business present at the time of the agreement
- Entering into a merger or consolidation or acquire the assets of another entity
- Incurring additional debt
- Allowing changes in management or ownership that would affect the character or operating philosophy of the business

A business banker’s objectives will impact the choice of affirmative and negative covenants to include in a loan agreement. For instance, a covenant that states the amount of working capital will be maintained at no less than \$100,000 and a current ratio at no less than 1.5x remedy concern over insufficient levels of current assets compared to current liabilities. The foundation of a loan agreement, or any other loan document, is based on what has been learned about the borrower during the Commercial Lending Decision Tree.

Events of default occur when the borrower does not comply with the loan agreement. These can include failure to make a loan payment on time or in the amount due; misrepresentation on a loan document; violation of any affirmative or negative covenant; bankruptcy, insolvency, or liquidation proceedings; or death of one of the owners or guarantors.

Remedies detail the bank’s options if the borrower defaults on the loan, including the right to demand immediate payment of all that is owed (call the note), the right to demand more security or guarantees, and the right to set-off any amount owed by the borrower on the loan against any money held by the bank, such as deposits.

Not every loan agreement needs to contain all of the sections noted above, and the detail of any one section depends on the complexity of the lending arrangement and the need for protection against credit risk. In principle, though, a loan agreement defines the loan, outlines the obligations of the bank and borrower, sets minimum acceptable performance standards, and describes what will cause a default and the bank’s remedies if default happens. The agreement is then signed by the bank, the borrower, and when applicable, the guarantor.