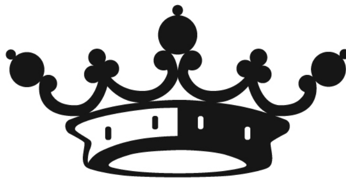
INSIDE THE MINDS

Banking and Finance Law Client Strategies

Leading Lawyers on Understanding the Client's Goals, Working with Regulators, and Developing a Transactional Strategy in a Changing Marketplace



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The New Parameters of the Commercial Lending Environment

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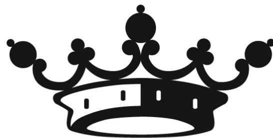

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We represent commercial borrowers and lenders almost equally in our practice. Interestingly this mix has been consistent for the last ten years. It has permitted us to render advice based upon an appreciation of the most important requirements of lenders and the needs and strengths of various types of borrowers. The perspective we have gained often permits us to recommend appropriate lending institutions to unique borrowing circumstances, and thus avoid unrealistic and time-consuming credit shopping expeditions. Moreover, it allows our clients to clear underwriting and move to the due diligence, documentation, and closing stages of the transaction much more quickly. In today's world of uncertainty and tightening credit standards, speed of execution, competently achieved, is an essential and distinguishing ingredient in legal services prized by clients.

Emerging Trends: Commercial Lending and Borrowing

The credit crisis is shifting the ground beneath the feet of the commercial lending and finance community so quickly and so dramatically that a discussion of "strategy" in commercial lending and borrowing has become extraordinarily difficult and complex. (see Katz, "Fed: Corporate Demand for Loans Plummets," 2/2/2009, www.cfo.com) (see also *Wall Street Journal*, "U.S. News: More Banks Tighten Lending Standards," 8/12/2008 (NY Ed), Office of the Comptroller of the Currency, Survey of Credit Underwriting Practices 2008 (June 2008), and Federal Reserve Board, the January 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices, 2/2/2009, www.federalreserve.gov/boarddocs/surveys.) However, in this era of tightened and possibly even contracting credit underwriting standards, we will attempt to make some general observations about the availability of credit in this seller's market to help a borrowing client achieve a strategy for originating, increasing, or renewing its loan credit facilities.

Resetting Client Expectations

It is vitally important for clients to have realistic expectations related to the closing of a credit facility. The simple fact is—and this is despite the drop in general rates charged by the Federal Reserve—the "retail" availability of credit is going down and the price of commercial term and revolving credit is going up, both in price and rigor of oversight. The bursting of the

housing bubble and consequent contraction in the value of mortgage-backed securities has deeply affected the capital adequacy levels of many if not most banking institutions and thus their willingness and ability to lend. Many borrowers, accustomed to years of comfortable if not highly favorable "5-year mini-perm" and/or "covenant lite" financing (see Lattman/*Wall Street Journal*, "'Covenant-Lite' Loans Face Heavy Hits," 3/18/09), are finding themselves shocked at the renewal terms being offered on their credit facilities, if a renewal or extension is available at all.

Banks have to some degrees always applied the golden rule (i.e., "[t]hem that's got the gold make the rules.") In their present defensive, capital-preservation mode, bankers appear to be applying this rule with renewed vigor. This is not to say that lenders are capriciously abusing their power of the purse strings over their customers. Rather, we are suggesting that lenders, in response to regulatory pressure to increase their capital reserves and spurn inordinate credit risk and their owners' and managers expectations for profitable loans (meaning higher net interest margins), are refocusing on more conservative and fundamental credit principles (character, capacity, capital, and conditions) and tightening underwriting standards. Lenders are exhibiting little hesitancy in denying credits or failing to renew loan facilities for customers who do not meet the bank's internal underwriting hurdles. (See Bauerlein/*Wall Street Journal*, "One Thing Still Working: Borrow Low, Lend Higher," 2/23/200, and Ryan, "Now What?" 10/1/2008, www.cfo.com.)

Impact on Credit Rates

In our recent experience, lenders' pricing for new and renewal credit to profitable, highly capitalized clients has increased to a minimum of LIBOR plus 250 basis points plus a "liquidity premium" of anywhere from 50 to 150 basis points. Rates of LIBOR plus 400 basis points, capped at a floor of 6 to 7 percent for better-quality credits, are available for clients with somewhat higher leverage profiles. The 'liquidity premium' portion of the pricing represents the lender's cost of accessing 1-year funds in the overnight market (repricing monthly), and if not denominated expressly as such, borrowers will find this premium captured within the "minimum floor" rate cap. The assertion of a minimum interest rate "floor" on commercial loan rates has become almost universal because it permits

lenders with differing capital and cost structures to access funds and syndicate a loan facility that might otherwise go unfunded. In addition, the "prime rate" option that was common not so long ago has all but disappeared because it is based on a "target" Federal Funds rate set by the Federal Reserve that no longer reflects banks' actual cost of funds.

Resistance to Expanding Working Lines of Credit

Lenders, due to mark-to-market write-downs and the contraction of their capital base, will be focused tightly on managing (meaning they will re-price their loans at renewal to achieve at least a 15% return on equity) if not shrinking their current loan exposure. (See McCann, "The Key to Bankers' Hearts," 2/17/2009, www.cfo.com.) Many lenders are experiencing "adverse selection" in managing their portfolios: their high-quality, well-capitalized customers are hunkered down and sitting out this credit cycle, whereas their weaker credits are desperately craving both debt and equity capital. Borrowers should expect some resistance when renewing or attempting to expand an operating line of credit. Many banks have dramatically cut the size of the lines of credit they are willing to offer to their borrowers, regardless of the nature of the business or the scope of relationship between the borrower and the bank. (See generally, Kuehner-Hebert, "Still Lending? Yes, But…," *American Banker*, 10/10/2008; and Johnson, "Doom Seen for Multi-Year Utility Borrowing," 1/20/2009, www.cfo.com.)

Heightened Risk Management

Lenders are strengthening their risk management processes and implementing systems that require virtually constant monitoring of their assets by imposing more detailed and frequent reporting requirements. Quarterly, if not monthly, compliance certificates providing for financial covenant compliance, reaffirmations of representations and warranties, certifications of no material adverse changes, and even proffers of additional documentation on after-acquired collateral, are now the norm. Bank officers are beginning to "live and work" with their customers, and are accountable for notifying their loan committees at the first hint of a softening credit situation. Borrowers should expect increased scrutiny of their financial results, more frequent contact with the lending officer and his or her compliance team, and a commensurate degree

of vigilance in loan contract compliance, and little to no forbearance with respect to the payment of taxes (both payroll withholding taxes and estimated income taxes) or the timely submissions of required monthly, quarterly, and fiscal year-end financial statements.

Preserving Equity and Cash

Lenders are keenly interested in their borrowers retaining their net income to shore up their cash reserves and levels of retained equity. Lenders are more aggressively restricting distributions by insisting that owners not be permitted to upstream funds through caps on salary and bonuses, dividends, equity redemptions and limitations on shareholder loans. While permissive tax distributions remain commonplace for entities taxed as partnerships, some lenders are requiring that a percentage of the borrower's "excess: cash flow (earnings in excess of that needed for operations and scheduled debt service) be applied to outstanding loan principal. Lenders to small- and medium-sized closely held companies are mandating increased credit enhancement support from owner-guarantors, if not outright injections of additional equity capital. (See Staff, *The Economist*, "The Great Dilution," reprinted 1/20/2009, www.cfo.com.) Lenders demand these guarantees in order to ensure the principal owner's focus and to credit-enhance their loans, and this recourse will be enforced. In addition, lenders are increasingly prohibiting pre-payments of other company indebtedness, including amounts due by a borrower on subordinated "seller" notes and earn-outs, which the lender views as *de facto* equity capital supporting the business. (See *Wall Street Journal*, Dale and Covel, "Sellers Offer a Financial Hand to Their Buyers," 11/13/2008, www.online.wsj.com.)

Residential Real Estate Financing

In more traditional real estate financing projects, the old non-recourse financing (i.e., only the mortgaged property stands good for the debt accompanied with various "bad boy" exceptions—where personal liability would attach to the principals for fraud, etc.), has at least for the foreseeable future gone away. (See Wei, "Recourse Sequel: For Developers, Loans Get Personal," 6/18/2008, C1, *Wall Street Journal* (Eastern Ed).) Today, most banks are lending no more than 80 percent of the appraised cost of a project, and requiring that at least 20 percent of the cash come in the form

of equity from the borrower. Well-capitalized developers who wish to avoid the recourse requirement must contribute at least 40 percent cash equity to a project, whether directly from the borrower or a subordinate mezzanine lender or hedge fund (which can carry double-digit rates of interest). (See Wei, "Hedge Funds Help Fill Gap in Lending for Property, *Wall Street Journal*, C1, 8.27.2008 (Eastern Ed).) Banks are very concerned with macroeconomic trends and, in certain markets, the perceived glut of inventory in regards to real estate developments. In the residential context, lenders are tending to rely almost exclusively on outside expert reports to identify the inventory of "unsold" lots and the speed at which those lots are being absorbed by builders and buyers before deciding to make a loan. Banks are not as "project-focused" as they used to be. The developer's global cash flow will be considered in the credit inquiry, even though only one of several developments is the subject of the bank's proposed loan facility.

Lender Interest in Warehouse and Industrial Facilities

In some circumstances, warehouse and industrial facilities may be more attractive to lenders than residential or office building/condominium projects. But in addition to the minimum 20 percent cash down requirement, lenders are carefully reviewing the creditworthiness of the proposed lessees. The key question for the lender is "How many empty or partially empty boxes does the developer have?" Most of these loans are based upon completion benchmarks. There is a great deal of preliminary analysis on budgets (testing for the reasonableness of the budget is performed externally by outside experts), and ultimately tracking draws based upon AIA-designed benchmarks, reliance on third-party reviews, and inspections of the construction sites.

Small Commercial Projects and Investment Real Estate

On small commercial spaces, such as strip shopping centers, most lenders are requiring pre-lease commitments of 50 percent or more before they will consider lending to the owner/landlord. Loans for office and residential condominium developments once carried terms up to three years in recognition of the time involved in leasing up the capacity. Many loans now extend for only a year. And for non-owner-occupied or managed investment real estate, the maximum loan-to-value is now ranging from 65 to 70 percent.

Audit and Going Concern Requirements

As a further safeguard against fraud and to presumably ensure some modicum of accuracy, lenders are requiring audited (as opposed to reviewed, compiled, or management-prepared) financial statements much more frequently. In certain working capital loan situations, a bank may be convinced to limit its audit requirement to a "field exam" of accounts receivable and inventory. Nevertheless, the requirement of an audit serves to place additional pressure on a borrower to improve its accounting systems (and thus avoid the auditor's "management letter") and earn "going concern" marks.

Changes in Financial Ratios

Banks scrutinize funded debt-to-EBITDA and other cash flow ratios as a proxy for a borrower's ability to service its repayment obligations. In the current business climate, most commercial lenders will not approve a loan with a funded debt-to-EBITDA ratio greater than 3.0 to 1. Occasionally a lender will approve a 'special situation' loan at 3.5 to 1, but almost never at levels beyond 4:0: to 1. The ratios do bear some industry correlation. Highly capital-intensive industries with long-lived assets such as trucking, printing, and facility-based health care (hospital, nursing homes, etc.), if accompanied by strong cash flow and adequate collateral values, will support higher levels of debt, but no longer do they reach the old pre-2008 standards of 5.0+ to 1. Documentation of debt service coverage ratios (EBITDA/R to debt service) used to hover on 1.1 or 1.15 to 1, but in today's economy those ratios may no longer leave borrowers enough room to accommodate the economic bumps they are experiencing. Many banks have raised these covenants to 1.25 to 1.4 to 1, and some are installing minimum EBITDA and EBITDAR thresholds (i.e., thou shall earn $XX in each fiscal quarter beginning in Q2-2009) as an early warning system against deterioration of a borrower's financial performance.

Margin Calls on Stock Portfolios

Borrowers and/or their equity principals should expect their stock and bond portfolios, if pledged to collateralize a loan, to be monitored much more closely than in the past. While some banks will still make a 75 percent

loan-to-value ratio loan against securities, borrowers should understand that loan managers are more apt to sell those securities quickly, with or without notice to the customer, if the portfolio declines in value below a pre-set "call" or comfort margin.

Minimization of Exposure

To protect their net interest margins and dissuade borrowers from early conversions in a falling interest rate environment, lenders are more frequently imposing pre-payment penalties on substantial term loans. Due in part to a relatively flat yield curve (i.e., low rates on the long end of the spectrum) and difficulties in raising or preserving precious capital, lenders are also unwilling to commit large chunks of capital to a loan on a long-term basis. Thus, they are shortening the maturities of both term and revolving facilities. This gives lenders more frequent opportunities to re-underwrite their exposure, require updated appraisals of assets, search lien records to ensure clean collateral, and assess more renewal and origination fees. Many bullet term loans that would formerly have been written on a five-year term are now being offered on only two- or three-year maturities, and revolving lines of credit call for maturities of only one year or less against a shallow and a tightly defined borrowing base. Finally, lenders are vigorously enforcing "no additional indebtedness" covenants and insisting on having unilateral and discretionary consent rights to various strategic actions of their borrowers.

To further limit exposure, lenders are more eager than ever to share substantial loan exposures by co-lending with, or selling participations in loans to, other institutions. Historically, lenders tended to care more about their regulatory loan limits than their exposure to a particular customer or industry. But as their balance sheets have contracted and as banks have become more wary about loan concentrations to any one industry or borrower, lenders have likewise shrunk their internal hold limits that require them to spread around the principal of desirable larger credits.

Developing a Borrower Strategy

While in a commercial context it has never been easy to borrow money (although perhaps in retrospect it seems so now), the simple reality is that

for the foreseeable future it is going to be more difficult for client borrowers to access capital. Equity providers are seeing their returns sink in tandem with the availability of leverage, so one can expect equity providers to be extremely choosy with their investments and very likely less willing to accept inordinate risk. The debt capital that is accessed is likely to be less than requested, more expensive, and come with more and largely unwelcome tethers. This reality presents all manner of challenges and temptations. There are certain key principles that counsel can use to help clients develop a borrowing strategy.

Obtaining Key Background Information

Prior to a first meeting with a client, counsel should attempt to interview the borrower's chief financial officer to get his or her perspective on the target financing, determine the type and amount of financing the client is seeking, and request copies of the company's last three years of financial statements, the company's recent "road show" or trade show/industry presentations, any offering or private placement memoranda, and prior loan applications regarding the business. Counsel should determine whether an independent auditor compiles, reviews or audits the client's financial statements. Counsel should search online databases to pick up press releases, stories, and other public information (e.g., Google©, Westlaw© or Lexis/Nexis© searches, and Standard & Poors© and Dun & Bradstreet© credit reports) about the entity and its principal owners and officers. This information will help counsel sift through what the client considers public versus proprietary or confidential information, what issues may be sensitive to the client, and how the client is viewed publicly. Additionally, counsel should probe the following:

- Whether the client is facing "reputational" headwinds when approaching a lender
- Whether the client's auditors have issued any management letters regarding internal controls or procedures, or if there are systemic financial reporting problems that still need to be addressed
- Depending on counsel's history with a particular client, counsel should run a background check on the client's principals to ferret out the "unworthy" client and possibly decline the representation.

(Lenders are admonished by regulation to "know your customer." Counsel should too.)

- After reviewing the financial statements, counsel needs to determine whether to seek a retainer, bill in regular increments, or take the representation on a success basis (i.e., payment upon closing of the financing).

The scope of counsel's engagement and the terms of the engagement letter with the client are more important than ever. Borrower's counsel is customarily called in to help the client "get the money." But rarely is a debt transaction closed in a vacuum. The company's entire capital structure is usually viewed and analyzed, and thus conflicts with and among the client's equity sponsors—who as founders, later equity-round investors, etc., may be called upon to put up additional equity capital contributions and/or personal guarantees—are not only possible but likely.

As noted above, lenders are increasingly demanding equity owner guarantees (which will not be forthcoming from institutional venture capitalists and other investors), outright injections of additional equity capital (to lower the loan-to-value ratio of a debt financing) or subordinated loans (the payments on which may or may not be blocked), prohibitions on distributions to owners, and so on. Depending on the number of shareholders or members involved and the relative depth of their pockets and bargaining power and the consequent potential for conflicts, counsel should consider carefully whether it can effectively and ethically represent the "collective."

Understanding the Lender's Perspective

Counsel's most important role may be to shape realistic expectations for a financing. The first question any loan officer asks him or herself is "Assuming I want to make this loan, how and when will I get paid back?" The borrower's counsel must thoroughly understand the client's objectives in seeking the financing, and assess quickly whether a requested loan or a facility package is realistic. This is not to say that counsel should not undertake representation of a client in a futile effort to borrow money. However, if the attempt is to be made, counsel should at least advise its

client to structure its affairs in a way that at least has a chance of attracting capital.

If the client is in precarious financial shape (e.g., with a shrinking or insolvent customer base or highly concentrated revenue exposure, minimal or nonexistent operating margins and profits, or disproportionate overhead and high debt relative to shareholder equity), perhaps the client would be better served by urging it to consider other sources of financing. Some of those sources include diluting ownership and taking in partners, adding a mezzanine or preferred layer of capital, talking with a commercial finance, leasing, or factoring company, or even discussing a workout of some sort (e.g., sale to or merger with a strategic competitor, or a pre-packaged Chapter 11 bankruptcy filing). (See Covel, "Keeping Borrowers Afloat," 2/23/2009, *Wall Street Journal*, www.online.wsj.) In any event, counsel should focus quickly on the purpose of the funding being sought, and seek answers to the following questions:

- Are the funds simply refinancing an existing loan with the existing lender?
- Is the loan a form of semi-permanent capital supporting the operations and assets of the company?
- Are the funds to be used for expansion of an existing plant or business line?
- Will it fund a "bolt-on" acquisition of a competitor, or an acquisition of a completely new, diversifying line of business?
- Wills the loan be used to cash out one or more owners and lever up the balance sheet?
- Is this loan simply a working capital line to be used to finance work in process, inventory, and accounts receivable pending the collection cycle?
- Is the loan to be used to fund operating or net losses?
- Is the client moving the loan facility at the behest of the incumbent lender (i.e., is the client intending to flip its "story," meaning "troubled," credit to a new lender)?

In today's market, some lenders are releasing excellent credit risk borrowers simply because of a mandate of the bank's managers to conserve its internal

capital or to limit the bank's industry or geographic exposure. This, of course, can make a sale to a new lender relatively easy. As a result, the following questions that help the lender feel that the exposure will be minimized are also germane:

- Is the client confident that it is consistently profitable enough and has enough capital to be treated principally as a "cash flow" type of loan with relatively minimal covenants and collateral requirements (such as a publicly traded company might expect)? Or will it be a principally asset-based loan arrangement where the lender and borrower rely heavily on the value of the underlying assets of the business (all of which will be pledged to the lender as collateral under a dragnet clause)?
- Does the enterprise have enough cash? Will the client be able to demonstrate that with (or even without) the loan, it has sufficient liquidity to survive and prosper?
- Who are the directors, partners, owners, and equity sponsors of the client? How committed are they to the business and its capital structure? Are they willing to increase their equity commitment to the enterprise if an "equity cure" is needed to either close a loan or cure a covenant default? While of course some loan requests will not be funded under any circumstances, the old rule still applies: "The more you put down, the greater your chance of being approved."
- Are the requested terms and amortization and repayment schedule sensible? Will the loan fully amortize, or will it need to be refinanced at maturity? Can the borrower really afford to amortize a "short"-term financing to buy "long"-term equipment?
- Does the client have the ability to sell excess or underutilized assets or underperforming business lines to raise cash quickly?
- Under certain circumstances, and provided the lender can do so, would it make sense for the client to adopt a strategy of potentially trading off a higher rate of interest on the loan in exchange for more flexibility and leniency on covenants?
- Is it possible for the client to be classified as a "middle market" loan customer? This may give the client access to a more experienced loan officer, and avoid the perceived complications of

> very large and very small credits. Large loans, if they go bad, cause disproportionate increases to a lender's loan loss reserves, and small companies are viewed as having insufficient resources to sustain the lumps the declining economy is delivering.

The borrower must be prepared to offer the lending institution many, if not all, of the borrower's various accounts and pseudo-banking needs (i.e., management of retirement accounts, escrow accounts, and personal owner accounts).

Determining Borrower Intent and Commitment

Experienced counsel understands the importance of forcing their client's senior management team to think about their situation objectively. Counsel's natural conservatism should be applied to offset the natural optimism and tendency of the client's executive officers to sugarcoat less-than-optimum facts. Counsel should resist the tendency to focus solely on the documents and exceptions disclosures and "let the chief financial officer worry about the financial covenants." Before seeking new, expanded, or extended credit, borrowers should engage in critical, uncensored self-reflection.

Stability and Growth Prospects

Clients should think about the stability and growth prospects for their operating or gross margins. A company's capacity to borrow (or sell itself later in a strategic transaction) is largely driven by its ability to generate EBITDA, so it is imperative that companies stress-test their historical and projected operating leverage models under a range of sales and expense levels. Minimal earnings volatility is key, and thus many lenders are backstopping their credits by imposing minimum thresholds of EBITDA and EBITDAR, which in turn stand as numerators in the classic debt service coverage ratio and minimum fixed charge coverage ratios that are similarly imposed by most lenders.

Negotiating Leverage Covenants

In days past, lenders were often able to wink at certain covenant violations. Unfortunately, lenders are now taking covenant violations very seriously for most borrowers, especially those tied to cash flow, leverage and collateral

coverage. It is imperative for the client's chief financial officer and other advisors to negotiate thoroughly with the lender to establish financial covenants that management understands and to which the business can adhere. Counsel must appreciate that the temptation of a chief financial officer to just close a loan within the bank's underwriting parameters is often overwhelming. Clients who agree to covenants that are too restrictive almost inevitably wind up bumping up against their financial covenant limits later, and this is a perilous and costly way to do business. If the borrower is expanding its asset base and can credibly demonstrate *pro forma* compliance with covenants, it may be possible to convince a motivated lender to delay the actual testing of certain financial covenants for a number of calendar quarters in order to give the borrower time to grow into compliance. Lenders however, assuming they choose not to accelerate the credit and demand repayment, will normally view these defaulting borrowers as an exploitable income opportunity and impose very painful waiver or forbearance fees in order to entice them to look temporarily the other way. Ultimately, these borrowers will often find themselves to be *persona non grata* sitting in front of a "special assets" officer of the bank having a discussion about refinancing (almost always somewhere else), raising equity, putting up additional collateral/guaranties, winding down or selling the business, etc., that they would rather not be having.

Treat Lenders as Buyers

Counsel should encourage their borrowing clients to treat their existing or prospective lender as a "buyer" of the business. In addition to working through the due diligence checklist, an often useful exercise is for counsel and the client to work hypothetically through a detailed stock or asset purchase agreement, with particular emphasis on the representations and warranties. This exercise should include creating the exception or disclosure schedules to address those areas that need some housekeeping, whether payment of taxes, termination of old liens, or litigation. Counsel should also insist that the client dig mercilessly into their business and its component parts, and pay close attention to who its customers are, whether they fast-pay, and what the trend is on receivables days outstanding.

The examination must extend outside of the company as well. For example, counsel should understand the micro and macro trends in the general

economy that affect the business, the regulatory environment in which the company operates, the company's level of compliance and whether there are latent liabilities (penalties, fines, enforcement actions), whether there is increasing or decreasing occurrence of insurance claims, the stability of the client's workforce relative to the industry sector, and the frequency of complaints under federal and state employment and safety laws.

When conducting this type of in-depth review, counsel should never underestimate the potential benefits of reaching out and talking to the borrower's operating officers, controllers, and other lower-level employees. Often their perspective on the "state of the union" can provide meaningful information regarding the borrower and the state of its affairs and finances.

Establishing Trust between Borrower and Lender

Establishing and maintaining trust between the borrower and the lender is paramount, because ultimately the loan will close (or not close) based on the relationship established between the loan officers and the senior management team. Consequently, it is far better to confront uncomfortable issues up front and implement corrective actions ahead of time. Lenders hate surprises. Clients should develop plans and present workable, in-process solutions to negative items and get them cured by the time the loan closes or commit to do so shortly thereafter pursuant to a post-closing agreement. If embarrassing issues show up for the first time on disclosure schedules to the loan agreement, the borrower can be assured that the lender will feel misled, and the relationship may be irrevocably damaged. Moreover, we have never seen a borrower benefit in the long term from conveniently forgetting matters that should have been disclosed on a disclosure schedule (regardless of whether it was deemed immaterial at the time), or in misstating or concealing the occurrence of defaults (matured or unmatured).

Best Practices for Working with Borrower Clients

Clients must sometimes be reminded to stay engaged with counsel in getting a financing closed. Many a chief executive officer "closes" a deal in his or her mind once the term sheet for a transaction has been negotiated and issued, and thus moves on to other matters under the assumption that

the professionals will handle the details of the documents and closing of the loan transaction. Obviously much will depend on the sophistication of the particular client (especially the chief financial officer), but counsel must keep the client's senior officers closely involved in the transaction, if for no other reason than to help draft and affirm those annoying disclosure schedules and ensure that the client understands the loan agreement's post-closing affirmative and negative covenants (including those actions that will require the lender's consent, which may or may not be unreasonably withheld).

Because of the complexity of the financing process, it is always prudent to help the client develop a backup plan. Ask the client, "What will you do if the lender turns you down or the loan doesn't close because of ______?" and "What options do you have if the loan officer says your company's financial performance is too tepid or your balance sheet is insufficiently capitalized to justify the requested loan amount?" As mentioned previously, counsel must be prepared to counsel their clients into and through alternative financing sources and possibly that "zone of insolvency" if their lender balks at new or renewed financing.

Focus on Important Negotiation Points

Clients must demonstrate tight management of their core business. Lenders will scour financial and management numbers to detect underlying deterioration in business fundamentals and use that as a basis to deny requests for credit. The increased scrutiny makes securing competent counsel an absolute must for any commercial client. Inexperienced counsel may fail to appreciate the risks and burdens presented by many loan and security document provisions. They may also waste valuable time and money inserting "materiality" qualifiers into loan documents in a vain attempt to weaken standard representations, warranties, and covenants. In today's hard market, borrowers will not find lenders and their counsel to be overly accommodating on terms. And while the legal boilerplate is important, the practical reality is that lenders and borrowers are most concerned about the financial matters that can propel or founder a business (i.e., the generation and submission of financial statements, compliance with financial and leverage covenants, the placement and effect of material adverse change provisions, the payment (and possible escrow) of property,

payroll and income taxes, the securing and payment (and possible escrow) of adequate insurance coverage, and limitations on additional or other permitted indebtedness). Clients should be advised to focus their negotiating energy on these big items.

Counsel should also consult with the client regarding the identity of the proposed lender. Does the client's current lender have sufficient expertise in lending to participants in the client's industry, and does the lender have an historical appetite for exposure to that industry? Would it be worthwhile to consider splitting the client's credit business between two or more lending institutions to mitigate the risk of a lender refusing a loan request? Most borrowers are sufficiently sophisticated to know where they stand with their proposed lender (which is likely to be their depositary relationship as well) and whether that lender is receptive to a renewal or expansion of the relationship, or whether they are an undesirable credit that has worn out its welcome and should move its relationship to another institution. Loan officers often change seats, and sometimes it is in a client's best interest to move with that officer. Borrowers must sometimes be reminded that their loan officer is not usually their enemy. Rather, their loan officer is, in a very real sense, an independent contractor who serves as the client's advocate before the true gatekeepers: the lender's credit committee. While no loan officer can state your client's business case as well as the senior management team, your client should invest significant time and resources in "educating" the loan officer so he or she presents your client's case in the best light during the approval process.

The Importance of Non-Credit Business

In the present environment, lenders are "suggesting" quite forcefully (because they cannot demand it without running possibly afoul of anti-trust laws) that borrowers award their non-credit business, i.e., deposit/treasury, credit card processing, lockbox, interest rate swap, employment benefits plan/401k trustee, with the lender. Banks covet this fee-based business, so borrowers should be sure to highlight this base of business to their best advantage; conversely, borrowers should not expect to close a credit-based relationship with an institution without bringing a substantial portion of their non-credit businsess to the lender.

Beware the Risks of Syndications

In addition, to the extent possible, borrowers should encourage their lender to commit to loan the entire principal amount rather than sell participations; if talking to more than one lender, the borrower should place great weight on whether the lender will be participating the proposed loan out or not. Co-lending arrangements expose borrowers to multiple-party closing risks, multiple-lender underwriting standards and reactions to covenant defaults, and productions of due diligence, and co-reporting obligations.

The Importance of Tangible Asset Valuations

One particularly nettlesome issue now confronting both borrowers and lenders are "impairment of capital" charges caused by reductions in booked asset values. (See Taub, "The Impairment Hits Keep Coming," 2/23/2009, www.cfo.com.) In the former era of easy credit, many a company allegedly overpaid for highly-leveraged acquisitions, and this is now manifesting itself in GAAP-mandated write-downs of goodwill. (See Johnson, "Revolver Saved by 'Goodwill' of Lenders," 2/19/2009, www.cfo.com.) (This trend is the corollary to lenders' mark-to-market write-downs of the value of their mortgage loans or mortgage-backed securities, if any, carried on their balance sheet.) If the corporate and sub-prime meltdown debacles have reminded us of anything, it is that value of assets matter just as much as the full vetting and disclosure of liabilities on the balance sheet. Borrowers must be prepared to adapt their financial covenant compliance to the potential for balance sheet compression. Moreover, borrowers must factor into their credit-shopping budgets the cost of rock-solid tangible asset valuations/appraisals, property condition reports, and Phase I environmental assessments, all of which must be "fresh" (six months or less old).

Negotiating Term Sheets

Borrowers should be reminded that adequate time for planning and negotiation are critical to a successful loan funding in today's environment. We advise clients to "talk often and talk early" and work their term sheets very hard and critically with their lender. Long lead times are necessary to

get those difficult pricing, collateral, and equity support details and issues introduced and negotiated *before* the loan request is submitted for approval to the credit committee. This may involve a specific enumeration of certain covenants, restrictions on dividends (permission for tax distributions), and limitations on equity-sponsor guarantees. Delaying a confrontation on difficult financial issues in the documentation stage will severely jeopardize a closing in today's hardened credit environment. Borrowers should not expect to lure a lender into committing to make a comfortable loan (informally via term sheet or formally via a commitment letter) and then think they can have financial terms adjusted unilaterally by the loan officer later at the documentation and closing stages of the transaction. Loan officers have very limited 'last minute' authority and are finding it virtually impossible to have previously-approved terms revised to accommodate a borrower or a principal guarantor.

Similarly, when possible, borrowers and their guarantors should take steps at the term sheet stage of negotiations to monetize and/or limit their personal exposure. Various options to pursue include the use of springing guarantees (i.e., a guaranty of collection) and the limiting of their personal exposure on the credit. There are certain situations, especially in start-up or young company situations, during which a guarantor's signature is more important than the collateral value of the enterprise. It is crucial that counsel identify those situations and make it clear in no uncertain terms to the parties involved (who may or may not be clients) that the lender may not really be looking to the borrowing entity on the promissory note for repayment on the loan.

Closing Thoughts

The ground rules for bank lending and borrowing have changed dramatically in recent months. To a great extent it has evolved into a "take it or leave it" world in which a commercial borrower is lucky to get financing at all. Some might say that today's market conditions, at least on the retail pricing side, are in some measure reflective of conditions that existed twenty years or so ago when borrowers had fewer market options. While lending institutions have always sought profitable loan opportunities based upon fundamental principles of repayment capability, the axiom that "[l]enders only lend to borrowers who don't really need to borrow" is being

severely tested in today's environment. On the one hand, the lending "survivors" henceforth will be raising the bar to access debt financing by requiring additional collateral and performing intense due diligence on their borrower's operations and financial performance. On the other hand, wise borrowers who persevere will establish reliable access to multiple sources of capital and create contingency mechanisms to enable them to survive in a challenging economy.

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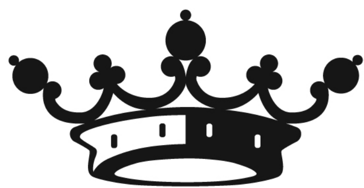

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