Negotiating Commitment Letters
For
Traditional Bank Financing

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Most businesses cannot finance their fixed asset needs or complete an acquisition of an additional business enterprise solely on the basis of the cash flow generated by business. Consequently, when a business needs financing for fixed assets (i.e., real estate, equipment, business unit, etc.), it usually turns to the equity markets or the commercial lending markets. In most instances, banks are preferable as the equity markets can be quite expensive and complicated.

By way of background, there are three phases to a bank loan transaction. First, there is the application phase where the bank or lending institution makes a determination as to the viability of the loan applicant's request. Second, there is the commitment letter phase where the Lender issues a term sheet or commitment letter to the Borrower indicating the terms and conditions under which the loan will be made. Lastly, is the loan closing and funding phase where the loan is actually closed and the Borrower is funded.

While each phase is important, the commitment letter phase is often overlooked because the potential Borrower desires to move quickly to the third phase and close the loan. What is overlooked is that the commitment letter is a contract that can be negotiated between the Borrower and the Lender, which, if negotiated properly, results in the loan documents incorporating the Borrower's business and financial objectives. In addition, it can save money.

Borrowers should also remember that the commitment letter or term sheet is issued after the Lender obtains a level of comfort in the Borrower's ability to repay the loan. The Lender is essentially trying to "close the deal." In other words, the Lender has already reviewed and concluded that the Borrower has passed the five "C's" of lending prior to the commitment letter stage, which are:

1. <u>Capacity</u>. The Borrower's ability to repay the loan out of monies generated by the business.
2. <u>Capital</u>. The amount of money or equity the business or principals of the businesses have available to invest in the particular transaction.
3. <u>Collateral</u>. The assets that are pledged by the business to secure the repayment of the loan and to give the Lender comfort in the event cash flow falls short of expectations, there are assets the Lender can reduce to cash for the repayment of the loan.
4. <u>Character</u>. The Lender is comfortable with the integrity and track record of the principals running the particular enterprise and has concluded it can conduct business with such individuals.
5. <u>Conditions</u>. The economic conditions that exist at the time of the loan; conditions are both particular to an industry and to the overall economy.

Therefore, the Borrower is in position to negotiate the basic terms of a commitment letter with the Lender. The remainder of this article addresses such negotiation.

Amount of the Loan

The amount of the loan is generally a percentage of the overall transaction costs that a Lender is comfortable lending. Generally, banks lend between approximately 60% and 80% of the costs of the assets being financed. This provides the bank with some cushion with respect to its collateral. Banks generally will not lend for the "soft costs" of the transaction (i.e., legal fees and title work). Consequently, in the event that a building is being financed for $1,000,000.00, the Lender will typically require a down payment of approximately $250,000.00 to have some cushion with respect to the transaction.

The amount of the down payment (or conversely, percentage of the loan) is a function of the Borrower and the Borrower's financial statements. Obviously, certain Borrowers can demand a greater loan percentage for a project based upon the track record and net worth of the business. Further, most Lenders will address a particular transaction by indicating that they will finance a percentage based on the "lower of cost or fair market value (pursuant to an appraisal)." This is done so the Lender has some assurance that it will be in the best position with regard to the transaction. When construction or renovations are involved with respect to real estate, the Lender will normally advance monies based upon either value-in-place or an as-completed appraisal to assure itself that it keeps the loan-to-value ratio in an appropriate amount with respect to the loan.

In addition to real estate, banks will also finance equipment, leasehold improvements and the acquisition of a business enterprise. The same rules generally apply to these transactions. That is to say, the Lender will look to maintain a particular loan-to-value ratio with respect to assets that it finances. Further, the Lender will require that the loan repayments are tailored to reflect the useful life of such assets. Generally, equipment has a useful life of between 7 and 10 years and the Lender will want the loan repaid in some fashion so that the loan (in its entirety and on a pro-rata basis) is reduced based upon the remaining useful life of the assets.

Borrowers can obtain funding for greater percentages by offering "side collateral" or guaranties in a transaction. If the Borrower can provide the Lender assurance by demonstrating that it has or can provide other collateral or other cash flow available besides the assets being financed, the Borrower may be able to obtain more monies from the Lender.

Lastly, offering a Lender other business opportunities (i.e., banking relationship/deposits and other financings) will also help in increasing the loan amount and may lower the interest rate, as discussed later.

Collateral for Transaction

With respect to financing relating to real estate, banks typically request a mortgage (*lien on the real estate*), an assignment of leases (*a pledge of lease payments*) and a security interest in the fixtures being financed. With respect to equipment and asset financings, banks generally require a security agreement and UCC financing statement filing indicating their security interest (i.e., *lien*) in such assets.

In the event that collateral is offered and accepted, a potential Borrower can negotiate the "release" of certain collateral based upon either cash flow achievements, the Borrower obtaining better loan-to-value ratios or based upon meeting certain objective standards.

Interest Rate

Aside from the amount of money that a Lender is willing to provide for a particular project, an important element of the loan transaction is the interest rate charged by the Lender. Most banks determine the interest rate based upon their costs of funds. That is to say, a bank will charge a certain amount above an index that is used to determine the bank's costs of funds. This "spread" is the bank's gross profit with respect to the loan. As a general rule, the longer the interest rate is fixed, a higher interest rate is charged because of increased uncertainties in the financial markets.

One method of adjusting the interest rate on a loan is to negotiate reset provisions and/or a balloon payment. A reset provision allows the loan to be fixed for predetermined intervals of time and then be readjusted based on a formula. A balloon payment allows for a longer amortization of the loan with the pricing of the loan based upon a shorter term.

There are two ways that a Borrower can stabilize a variable rate of interest on a loan.

One is to request that the bank "swap" the interest rate charge. In this instance, the bank and/or a swap provider fixes an interest rate for a certain period of time. In this situation, both the Lender and the Borrower are contractually bound to the interest charged irrespective of market conditions. In the event that a Borrower wishes to prepay a loan that is the subject of a "swap", the Borrower is required to make a yield maintenance payment which reflects the monies that the Lender is asked to give up as a result of the prepayment of the loan. Conversely, in the event that interest rates decline, the Borrower is "in the money" and a swap provider may pay the Borrower in order to be released from the loan transaction.

Another way is for the Borrower to request a ceiling (or limitation) on the interest rate. That is to say, a Borrower can request a variable rate loan with an interest rate cap. Sometimes the negotiation between a Borrower and Lender results in a "collar" on the interest rate where there is both a maximum and a minimum interest rate in effect and each party must stay within the confines of the transaction.

As discussed earlier, another factor in reducing interest costs for a loan is the amount of other business (deposits, etc.) that a Borrower can offer the Lender. Borrowers should offer other business to the Lender in the negotiation of the terms of the Loan since the Lender will review the overall profit of the Borrower's relationship in pricing the Loan.

Prepayment Penalty

A natural follow-up to the interest charges in a transaction is the prepayment penalty imposed. Most Lenders insist upon the prepayment penalty in making a loan so that the Borrower will not abandon the Lender after it has spent the time and effort in evaluating the transaction and putting it in place. There are numerous potential prepayment formulas available with respect to a loan.

One formula is a simple declining percentage penalty based upon the duration of the loan. For example, 3% of outstanding principal during the first year, 2% of outstanding principal during the second year, etc. Another formula is a yield maintenance calculation when the Lender is compensated for receiving payments earlier than anticipated.

A Borrower can negotiate certain provisions that help with respect to prepayment penalties. One is to request that a Lender allow a percentage prepayment each year without penalty. For example, a Borrower could request that it be allowed to pay 10% or 20% of the loan balance (or up to a specified dollar amount) each year under the theory that if the business has excess cash flow, it should be allowed to prepay the loan in some fashion. Another frequent request is that the Borrower be allow to prepay the loan without penalty out of funds it did not receive from another Lender. For example, if a Borrower has new shareholders or has an infusion of equity, such monies could be used to pay off the debt since the prepayment was clearly not designed to abandon the Lender. Such concepts satisfy the Lender's fear that it has created a transaction and that the Borrower will "shop the deal" after the initial loan is in place.

Guaranties

Lenders typically require that the principals of a business personally guaranty the loan transaction. Most lending institutions believe that the principals should be willing to demonstrate their confidence in the success of their loan request. There are several ways that a Borrower and its principals can deal with these provisions in the negotiation of a commitment letter.

First, a guaranty can be limited to a "partial" guaranty. For example, each of the principals of a business has a guaranty limited to a specific dollar amount. Guaranties can be several (each Guarantor responsible for a portion of the debt) rather than joint and several. Guaranties can also contain burn-off provisions. Over time (and depending on the loan), guaranties are either partially or fully released as the loan-to-value of the collateral decreases or the loan is repaid. The guaranties can also be released based upon the achievement of particular financial covenants which demonstrate to the Lender that the Borrower has the capacity to repay the loan.

With respect to real estate loans, it is somewhat common that such loans are on a non-recourse basis given the stability of the collateral provided to the Lender. Basically this means that the Lender will look solely to reducing the real estate to cash to recoup the loan in the event of a default of the loan.

Another alternative is a deficiency guaranty. In this situation, the Lender must look to the collateral of the Borrower first before seeking any deficiency payments from the guarantor of the loan.

Financial Covenants

Other frequent provisions in a commitment letter deal with financial covenants. Such covenants often deal with the "capacity" of the Borrower to repay the loan. For example, a debt service coverage requirement would provide that there has to be a certain minimum cash flow available to the Borrower to service the loan. Another financial covenant could be a net worth covenant which would require the Borrower to maintain a certain net worth (assets in excess of liabilities) throughout the life of the loan. Such covenants are important and should be reviewed carefully because failure to maintain such requirements would typically constitute an event of default under the loan.

Casualty and Condemnation Proceeds

This overlooked provision in the commitment letter concerns itself with the use of insurance or condemnation proceeds which are received for these unforeseen events. A Lender's general position is that it can utilize such proceeds as it deems appropriate; meaning, either repayment of the outstanding principal of the loan or requiring the Borrower to restore the facility utilizing such proceeds. The common response from a Borrower to such a provision should be that so long as no event of default exists and that the Borrower can provide comfort to the Lender of its ability to remain in business and restore the project without additional debt, the Borrower should be allowed to do so since the Lender's collateral has not been impaired. In the event that prepayment is required, the Borrower should be allowed to pay the credit facility without penalty since it was not a voluntary prepayment.

Default Provisions

A complete commitment letter will also contain provisions specifying the rights and remedies of the Borrower and Lender upon the default of loan provisions. Common defaults include monetary default for nonpayment of the loan or breach of financial covenants. Nonmonetary defaults usually include the breach of the affirmative and negative covenants, which are discussed later.

With respect to nonmonetary defaults, the Borrower should request that an appropriate period of time be provided so that the Borrower can cure a nonmonetary default and, further, allow additional time to cure a nonmonetary default in the event that the Borrower is diligently attempting to cure the default.

There should be negotiated provisions for dealing with default rates of interest and late charges in which the Lender is allowed to charge during a default period. Borrowers should clearly focus on and address grace periods for monthly payments with the Lender.

It is not uncommon in a banking relationship for Lenders to require all credit facilities be cross-defaulted and cross-collateralized so that a default under one credit facility would trigger a default under all credit facilities and allow the Lender to pursue all the collateral available to it with respect to the entire relationship. Particular care should be given by the Borrower with respect to such a provision.

Affirmative and Negative Covenants

One very important but overlooked component in negotiating a commitment letter is the affirmative and negative covenants. These covenants restrict the Borrower's ability to perform certain acts which include but not limited to the sale of the business or certain assets, conveyance of interests in the Borrower, the ability to take on additional debt or incur liens, merge and/or the ability to form a subsidiary and/or management change.

In the event that the Borrower contemplates soliciting additional investors for the enterprise or contemplates conveying interest in ownership to others, this should be negotiated in the commitment letter. Frequently, a Borrower is a closely held entity and the existing shareholders may wish to build in provisions which would allow them to convey ownership interests for estate planning or buyout situations. In the event that either the merger or sale of the Borrower is contemplated, certain requests should be made allowing for assumption of the loan by a new borrower satisfying particular criteria or allowing for the loan to be assumed so long as the original guarantors remain in place. After all, the loan was based on certain assumptions concerning collateral and guaranties and so long as the same

remain in place, a bank should be willing to allow for the assumption of the loan. Alternatively, in the event that the Lender requires repayment of the loan, this may be a reason to request that prepayment penalties be waived.

Miscellaneous Provisions

In addition to all of the foregoing which are the basic terms of a commitment letter, there are still other terms that need to be reviewed and negotiated. For example, the expiration date of when the commitment letter expires for the loan closing date has to be negotiated. Contingencies regarding the Lender's obligation to fund the loan, which may include an appraisal or environmental review, need to be reviewed. Fees, including commitment fees, appraisal fees and environmental review fees, can be negotiated. Ongoing financial reporting to the Lender needs to be discussed with the financial officer or accountant for the Borrower. If any shareholder loans are going to be subordinated to the bank debt, the parties must negotiate what payments (i.e., interest only, principal and interest, etc.) will be allowed on the shareholder loans during the term of the bank loan.

Conclusion

Obviously, each financing and each party in a transaction is unique. However, negotiating the commitment letter that provides the roadmap for the ultimate financing should be reviewed carefully. The Borrower should use creativity and good business sense in reviewing the provisions of the document that will ultimately be put in place in the loan documents, which are the terms that will exist for the life of the loan.