Understanding Bank Loan Covenants: What You Need to Know Before You Sign

This white paper, produced in collaboration with the Small Business Finance Institute, is the first in a series of educational articles about financing options for small and mid-sized businesses.
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A special report by The Receivables Exchange in association with the Small Business Finance Institute

Bank loans are the most common source of business and commercial financing, with rates that are generally affordable compared to other sources of capital. Following a sharp drop in bank lending after the financial crisis that disproportionately affected small and mid-sized businesses, demand is once again increasing among this group, with about 30% of small businesses applying for a loan in the first quarter of 2011, according to a recent Greenwich Associates survey. That’s up from 15% in the last quarter of 2010 and 5% the quarter before that.

There is no doubt, however, that the financial crisis decreased access to bank financing and made it harder for businesses to get the money they need. Lending standards have become stricter, and the declining value of real estate has made it harder for business owners to secure loans against their homes or other properties.

Access isn’t the only thing that’s changed. Tighter oversight of banks has brought a renewed emphasis on bank loan covenants, which can put constraints on a business’s growth, increase the overall cost of a loan, and raise business risks.

This paper outlines the various types of covenants associated with many bank loans and briefly examines the constraints they may place on a business. The paper also introduces a “covenant-free” financing option that is flexible enough to work alongside bank financing or as a primary source of liquidity.

Taking a Closer Look at Covenants

A business financing report from the Risk Management Association (RMA) Journal defines covenants as “set minimum

Bank Financing by the Numbers

- Percent of SMB companies that were turned down for bank loans in the past 12 months: 50%
- Average number of banks approached by companies that secured financing: 2
- Average number of days spent by SMBs during the process to successfully obtain financing (e.g. submitting proposals, meeting with providers, furnishing documents): 6 days
- Average length of time needed for bank to process loan application: 64 days

Source: Pepperdine Private Capital Markets Project
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standards for a borrower’s future conduct and performance typically accelerate the maturity of the loan in the event of a violation.” Covenants establish benchmark metrics that are intended to ensure that your company stays financially healthy and, more importantly, that the bank’s investment is protected. They are generally classified in two broad categories, restrictive or financial, and within these categories can either be affirmative or negative.

“As important as covenants are in managing lending risks, little is known about these contracting devices.”

The RMA Journal

Affirmative covenants require your company to meet certain standards defined by the bank, such as maintaining a minimum level of liquidity, revenues or profitability. Negative covenants are intended to restrain you from taking specific actions, such as adding more debt, making investments or replacing top management, without the bank’s approval.

The RMA Journal analyzed a series of loans made to U.S. companies between 1991 and 2001 and identified 92 different covenants, grouped into nine categories. Some covenants occur more frequently in loan documents than others, and some are more constricting and potentially more challenging for a company. Here are the main types of covenants you may encounter in a typical bank loan agreement:

1. **Financial covenants** are restrictions based on specific balance sheet, income statement or cash flow items. They may be the largest, most commonly used category of covenants. These covenants are directly measurable and verifiable based on accepted metrics from your financial statement, and while typically associated with more high-risk borrowers, often are applied indiscriminately in one-size-fits-all loan security agreements. Common financial covenants require a company to maintain a minimum level of liquidity (indicated by a minimum “current ratio”) or equity (measured as a percent of assets). Other covenants may cap leverage or a company’s debt by asserting a maximum debt to equity ratio, or minimum debt to cash flow coverage ratio.

2. **Operating activity covenants** dictate how you operate your business. Most common operating activity covenants require that you continue to operate the business, pay business taxes, and comply with laws and regulations. The more restrictive covenants in this category will prevent you from using business proceeds (your capital and profits) for certain purposes without bank approval.
3. **Reporting and disclosure covenants** set a minimum standard of communication with your bank. You will be required to furnish periodic financial statements for your company (and possibly on business owners), keep “proper” records, and prove compliance with your loan agreement upon demand. More restrictive covenants in this category may permit the bank to demand to see your records at any time without advance notice.

4. **Preservation of collateral/seniority covenants** require you to maintain the collateral you’ve provided for a loan and ensure the bank’s senior lien position remains intact. You may be required to purchase casualty insurance and maintain property and equipment to the bank’s standard. You also have to avoid liens being placed on your business assets, which may trigger a bank loan default. While no one plans to get liens, more than one taxpayer has disputed their liability with the IRS, which can place a lien on your assets while you sort it out.

5. **Investment expenditure covenants** tell you how you can invest the profits your business earns. They can prevent you from making certain capital expenditures, strategic acquisitions and other cash investments that could be beneficial or competitively necessary for your company’s growth.

6. **Asset sale covenants** may prevent your company from selling off assets during the course of business, restricting transfers and voluntary liquidation as well. You may be forced to hold onto underperforming assets to satisfy these covenants and lower the returns on your capital.

7. **Cash payout covenants** restrict transfers of wealth among the owners of your firm. Common covenants of this type restrict dividends, prepayment of subordinated...
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debt – even prepayment of the bank loan itself. These kinds of provisions could inhibit the ability to buy out a partner or shareholder, even in the event of their death.

8. **Financing covenants** impose limits on debt, debt-like contracts such as leases, or on changes in capital structure. They restrict loans to subsidiaries, sale-leasebacks, and other financing arrangements. *Routine equipment leases and inter-company financing transactions may be subject to bank approval under these types of covenants.*

9. **Management, control and ownership covenants** restrict the governance structure of your company, keeping you from merging with other firms, consolidating your business, transferring ownership or changing your management or board without explicit bank approval.

**Implications for Your Business**

A covenant represents a contract with your bank, and in many larger loans, banks require your CPA to provide a letter certifying that your company is in full compliance with all the loan covenants each quarter. If you breach, or “trip” a covenant, the bank has the legal right to take a number of actions, generally described in the agreement, including demanding that you pay your loan off immediately.

While the bank’s response usually depends on the severity of the lapse, it can range from the relatively mild to very severe.

Among the range of choices open to your bank are:

1. A caution letter alerting you to the violation and giving you a short time frame to correct it;

2. Enacting default provisions in your agreement that could increase the interest rate your company pays for the remainder of the loan, or imposing a one-time monetary penalty;

3. An acceleration of the maturity of your loan and demanding full payment immediately.

“Poorly considered restrictive covenants can limit an organization’s ability to respond to market conditions or take advantage of opportunities that arise.”

Source: Negotiating Fair Financial Covenants, CFO Edge, 2011
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More ominous is to recognize that in the post-economic crisis period, following the closure of more than 415 banks and the present designation of at least 815 “problem” banks, your bank may not have the final say in how to respond to your covenant violations—it may be left to the FDIC. If your bank is a “problem” bank, it may be operating under a consent order or cease-and-desist agreement (which it cannot publicly disclose or acknowledge). As such, it may be subject to tight scrutiny by the FDIC, which could decide how your account is managed by the bank.

How to Negotiate Better Terms

The good news is that covenants can be negotiated with your bank before you sign a loan agreement. But once you sign, you are responsible for adhering to the letter of the agreement, which can have broad interpretations and implications for your company. Tripping a covenant, however small, can mean losing your funding entirely. That’s why it’s vitally important to know what each covenant in your loan agreement means, to negotiate the most favorable covenant terms available to your company, to notify your bank as soon as possible if you are headed for a breach, and make sure to have an alternate source of financing available.

The Journal of Accountancy encourages businesses to request a waiver or reduction in the penalty when a covenant is tripped, and to be prepared to negotiate, with the help of a CPA or financial advisor, if the penalty is unreasonably severe. To support your position, cite other examples of companies who satisfied reasonable penalty terms after breaching a covenant, and explain how a severe penalty could impair your business, increasing the overall risk to the bank. The bank does not want your company to fail. If the breach is small, you may be able to work out a solution without losing your funding or having to pay a higher rate.

While many covenants are reasonable and/or unavoidable, it’s important to do your research, consult a CPA or financial advisor, and read your loan agreement carefully in its entirety before signing. Agreeing to covenants that force you to maintain a minimum level of liquidity—or prevent you from raising additional capital or paying your employees what they’re worth—can hurt your business in the long run. If you don’t agree with or can’t comply with the covenants, try to negotiate them out of the transaction. If that doesn’t work, you should search for alternative funding.
The Importance of Financing Alternatives

Whether or not you are in good standing with your bank, you should always have a relationship with a second lender for a few key reasons: Conditions at banks change frequently, due to acquisitions, regulatory issues or internal needs, so having a second source of capital lined up gives you somewhere to go if you lose your funding. A second lender can also provide additional liquidity when you have reached your credit limit with your bank. You can augment your liquidity with more flexible financing options that are less likely to complicate your relationship with a primary lender. Smart business owners and executives should consider financing options such as online receivables financing, which does not require any covenants, all-asset liens, personal guarantees or long-term contracts. Online receivables financing enables you to sell your receivables, either to supplement existing financing, or as a primary source of liquidity.

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The Receivables Exchange – A Covenant-Free Financing Option That Works With Your Bank

The Receivables Exchange is a game-changing alternative to traditional financing that won’t place burdensome restrictions on your company. The Exchange enables you to convert your outstanding invoices into working capital without covenants, personal guarantees, all-asset liens, monthly minimums, long-term contracts, or notification to your customers. You can access financing through the Exchange even when your bank is in the first position, making it an easy-to-use tool to supplement existing business financing.

The Receivables Exchange connects businesses with a community of banks, financing companies and factors looking to purchase your outstanding invoices. Dynamic bidding drives down your cost of capital, and you have complete control over the terms of the sale. For more information about The Receivables Exchange visit http://tre2.receivablesxchange.com/meeting or call 877-845-5445.

The Small Business Finance Institute’s mission is to foster and develop organizations which create jobs, improve communities, and change lives through successful entrepreneurship and better financial management. It was founded by veteran Atlanta banker and small business financing expert Charles H. Green, and who wrote the bestselling SBA Loan Book and the forthcoming book Get Financing Now. For more information, visit www.sbfi.org