

# Those Pesky Loan Covenants

With the current economy in the tank it is very likely that your sales suffered over the past number of months. If your sales suffered, then your profits probably did also. If your profits suffered, then your net worth decreased due to losses incurred. If your net worth decreased, then either your assets decreased, your liabilities increased or some of both. Any of these scenarios are not healthy for your business.

They are also not healthy for your floor plan provider, the bank who furnishes your line of credit and or your mortgage lender. If you did not have a good year, then your lender's collateral has probably decreased. When a lender's collateral decreases, then their risk increases. When their risk increases, they become nervous. And, in these current uncertain times, they become very nervous.

Most lenders have established various loan covenants their customers (you) must maintain in order to stay compliant with the terms of the loan. Normally, your business met these loan covenants when the loan was issued. Sometime after that, your business changed enough to make you non-compliant with these terms.

If your lender requires you, as part of their loan terms, to furnish them with GAAP (Generally Accepted Accounting Principles) financial statements on a monthly basis, then you need to review your internally generated financial statements. You will need to ensure your controller is aware of the need to prepare the financial statements in the required format to satisfy the lender.

Your lender may also require you to furnish them with certified financial statements (audited, reviewed or compiled) from an approved CPA firm. If so, then you must go through the process and expense of having your CPA firm perform additional procedures while they are gathering information to complete your tax returns so they can prepare the proper disclosures and formatted financial statements to comply with your loan covenants.

There may be more than one covenant you must meet to comply with the lender's terms. There are normally good reasons why your lender has these covenants in your loan agreement. They were probably "burned" over time by different businesses that violated their loan agreements and left them with grief trying to get their loans repaid. You, as a business owner, try to put in safeguards when something happens that causes you grief also so you hopefully don't have to go through it again. If your lenders don't eventually get repaid by you, then they will not have money to loan to you or anyone else in the future. If that happens often enough, lenders tend to disappear or retract into their shells and become very conservative when reviewing the next loan application.

# Those Pesky Loan Covenants (cont'd)

Some common loan terms are furnishing the lender with monthly financial statements prepared according to GAAP, providing year end certified financial statements from your CPA, meeting debt to equity ratios, maintaining certain working capital and net worth amounts, distributions and or owner's salaries not exceeding a percentage of net income, keeping a certain amount of cash invested in an account at the bank, agreeing to pay interest and any principal required by the appropriate due date(s), meeting a required minimum EBITA (earnings before interest, taxes and depreciation), etc.

All of these covenants have a purpose. They protect the lender and establish required guidelines to protect their investor's funds they have loaned to you. Most business owners attempt to accomplish the same thing with the capital they have invested in their business and or loans they given to their company. You eventually want to get your investment and or loans returned to you along with some return on that investment or loan. Lenders want to earn money on their capital and also manage the risk they are assuming.

What happens when you violate one or more of your covenants? Your lender eventually finds out and then comes to talk to you about it. They normally want to know what caused the violation to happen and what can be done by you to correct it and reduce their risk.

What can you do about it? First, you should be monitoring any loan covenants you have on a monthly basis so you can hopefully anticipate a problem before it happens. That gives you enough time to rectify the situation and/or plan how to correct it before it becomes an issue for your lender. If you find you can't meet your covenants by correcting the problem, then you will need to plan how you are going to meet the covenants by changing your business plan, investing more funds in the business, reducing expenses, increasing sales, reducing distributions, signing personal guarantees, etc. When your lender calls to inform you that you have broken one or more of your loan covenants, then you are ready with an answer and a plan to hopefully put them at ease. They will want to know what time frame in which you will accomplish this. They may want a budget and or a projection showing them how you will get to your goal of becoming compliant with the loan terms.

If you can't meet the loan terms due to various reasons, you will then be in violation of your loan agreement. In this case, the lender normally decides if they are willing to: 1) re-write the loan covenants you are required to follow, 2) issue you a "waiver" for the specific time period or 3) in the worst case scenario, call the loan and ask for it to be repaid. They will normally give you what is called "a go away letter" directing you to find another lender to pay them off. If this happens, especially in today's economy, it could be devastating to you and your business. Some of the normal lenders you could have counted on in the past may no longer be in business or have become very conservative.

# Those Pesky Loan Covenants (cont'd)

In the worst case scenario, the lender realizes you can't rectify the problem and violations. They then come in and take over your business and or "repo" your assets they used as collateral. This is not the position you want to be in. This means in most cases you may lose a substantial portion or all of your investment in the company. You may have signed a personal guarantee which could put other unrelated assets you own at risk.

Review your loan covenants now. Don't wait until it is too late and your lender tells you that you have violated the covenants and they are "calling" the loan. You will not have enough time to find replacement financing in most cases and you could lose your business and your net worth. Normally the worst time to borrow money is when you need it the most. If you have bad credit and/or a non-performing loan, then the chances of getting a new lender to advance you money is very slim.

The answer: Review and manage your loans and their covenants. You need to know there may be a problem before anyone else does.

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