Business Transactions Solutions
Chapter 157 Commercial Debt Financing

§157:329 Business Counselor's Training Materials: Commercial Debt Financing

§1 Overview

Debt financing, including loans from commercial lenders, has several key advantages for the borrower. Most importantly, the lender has no direct claim on the future earnings of the company, nor does the infusion of capital dilute the equity interests of the existing shareholders. On the other hand, however, borrowing does create fixed payment obligations that must be satisfied, thereby impacting the company's cash flow planning. Also, the restrictive covenants and security requirements imposed by many lenders can have a significant impact on management discretion regarding operation of the business while the loan is outstanding.

While banks frequently provide assistance to new businesses, lending to new emerging companies creates problems for traditional banking practices. For example, the short-term financing generally offered by banks is not a good fit for companies that are not able to generate cash for repayment until completion of fairly lengthy research and development cycles. Moreover, while some banks have recruited technology managers who specialize in evaluating loan applications from risky, emerging firms, the actual level of training of these managers is minimal. Finally, the key asset of many of these firms, its intellectual property, is intangible and difficult to value and protect, thereby creating problems in crafting collateral arrangements.

§2 Types of Financing

Banks and loans are not uniform. In this section we describe the different types of commercial loans that are available. In the next section, we note that lenders differ in style and approach and emerging growth businesses should look for lenders that understand them.

- A **term loan** is a loan that is made for a fixed period of time, usually several years and most frequently from five to ten years. It provides for instalment payments of principal on a periodic basis and generally requires interest payments on a monthly basis. A term loan is commonly used for long-term capital needs, such as equipment or fixed asset purchases.
- A **revolving line of credit loan** is like a credit card. The borrower draws upon the available credit as the capital needs of the business dictate; accordingly, the loan balance will continue to fluctuate over the term of the loan. This form of loan should generally only be used to fund short-term working capital, rather than for capital improvements.
- A **revolving credit loan** combines many of the features of revolving lines of credit and term loans. Revolving credit loans begin as a revolving line of credit for a specified period of time, during which interest payments only are required. The terms of the loan specify a termination date, at which time the borrower will be obligated to repay all outstanding principal and interest owing on the promissory note evidencing the loan.
- Most commercial lenders lend money secured by the **receivables** of the borrower. The maximum amount a borrower may have outstanding at any one time is a fixed percentage, which generally ranges from 70% to 90%, of the face amount of the eligible, or acceptable, receivables of the borrower. The actual percentage will depend upon the nature, quality and terms of the pledged receivable. Promissory notes representing advances typically mature on demand or within 90 days. Terms of the credit extension, including the interest rate and the lending base, are typically reviewed annually by the lender in light of the quality of the collateral (i.e. the customer base of the borrower).

 © 2016 Thomson Reuters. No claim to original U.S. Government Works.

- Commercial finance companies will make loans based on the raw material, work-in-process, or finished goods **inventory** of a business. As with accounts receivable financing, the maximum amount a borrower may borrow is fixed as a percentage of the appraised cost or market value of its eligible inventory. However, since inventory is far more difficult to value, and less liquid, than account receivables, the maximum percentage of inventory value a lender is willing to advance is generally much lower than with accounts receivable financing.

§3 Lender Selection Factors

While the loan application and processing often seems quite sterile and mechanical, the borrower's relationship with the bank is certainly quite personal. The bank will have access to sensitive information about the borrower's business and will bargain for the leverage to force the borrower to make important decisions regarding the use of funds generated from the business. So, as the lenders evaluate the company, it is important for management to do its own investigation in the following areas:

- Management should carefully examine the overall pattern of decision-making within the bank. For example, if the principal decisions must be made other than at the office where the loan officer is located, the company may be subjected to delays that impair its ability to do business.
- While the loan agreement will be with the bank, the day-to-day relationship will be with the individual loan officer. Accordingly, it is important for the personal chemistry with the loan officer to be right and for the loan officer to have a real understanding of the company's business model, as well as experience with companies in the same industry.
- It is important to explore the lender's policies in dealing with a borrower that encounters unanticipated financial or operational difficulties during the term of the loan. The company should also seek counsel from other firms that may have some experience with the lender and the loan officer.
- Consideration should be given to the types of information that the lender will request from the company over the term of the loan. The company must be sure that the time and effort associated with preparing the information for the lender will not be excessively burdensome.
- Consideration should be given to the size of the lender. The key is to find a bank that is large enough to absorb the risks associated with borrower's business and still small enough to provide the required personal relationship. Evidence of marketing initiatives to start-up and small, but growing, businesses, can be an important indicator in this area.

§4 Loan Documents and Closing Procedures

The basic terms and conditions associated with any commercial loan are often summarized in a commitment letter that forms the basis for drafting the definitive loan documents. The commitment letter will identify the amount to be borrowed and type of purpose of the loan. The letter will also describe the interest rate and amortization schedule, collateral and guarantee requirements, and events of default. In many cases, a summary of reporting requirements and principal financial covenants will be included in the commitment letter. Finally, the letter will include a termination date for the bank's commitment and other conditions to the loan (e.g. delivery of legal opinions and no adverse changes in the lender's financial condition).

The central document in any commercial loan transaction is the actual loan or credit agreement that sets forth representations and warranties from the borrower to the lender, certain covenants to be honored by the borrower, and any events of default that may give the lender the right to accelerate payment of the loan. The basic terms of the loan agreement should include a specification of the amount borrowed or, in the case of a revolving line of credit, the maximum amount of the credit line; the payment terms; the term of the loan, including the availability of any renewals; the interest rate to be charged over the term of the loan; the fees and expenses associated with the lender's commitment; the borrower's obligations; the consequences of any prepayment of the outstanding loan amount; the need for a security interest, the terms of the security, and the lender's rights associated with the security interest; subordination agreements; representations and

 © 2016 Thomson Reuters. No claim to original U.S. Government Works.

warranties of borrower; the events of default that might permit the lender to accelerate repayment of the loan; and as is common with the case with loans to small businesses, the need for any of the owners to provide personal guarantees.

A number of additional documents may be prepared and delivered in connection with a credit transaction. Obviously, the company will deliver a promissory note that evidences the key economic terms of the loan, although many will simply cross-reference to applicable provisions in the loan or credit agreement. When the loan is secured, the documentation will also include a security or pledge agreement that identifies the specific assets used as collateral and the remedies of the lender as secured party. Also, if the company has other outstanding indebtedness, including debentures, the holders of those obligations may be required to subordinate their rights to those being granted to the new lender. Subordination will be accomplished by a subordination agreement. Guarantees may be required from the founders and other major shareholders. Finally, as with the closing of equity investments, legal opinions and closing certificates must also be prepared and delivered before the loan is funded.

 © 2016 Thomson Reuters. No claim to original U.S. Government Works.