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10 Key Provisions

How to translate a loan agreement into (almost) plain English

By Dennis L. Monroe

As a business owner, you either have existing debt financing, are currently working on debt financing and/or at some point in the future will be seeking debt financing.

It is simply the nature of the business, whether you are refinancing an existing loan, funding capital improvements to your business, seeking to fund an acquisition or for a host of other reasons. While you certainly understand the needs of your business and have an understanding of the economics of your financing arrangements, what about all of that other verbiage in the loan agreement and the pile of related documents that you receive from your lender and their attorneys?

Our best advice is to consult with professional advisors whom you trust and who have franchise finance experience, and to focus on a few key issues that are central to your relationship with the lender. Your ability to successfully operate and continue to grow your business may depend on it. Here are 10 of the most important issues that you need to focus on:

1. Borrower and related party issues. It is important to understand not only which of your entities is the "borrower," but also whether any of your other related entities are obligated on the loan either directly as a "co-borrower" or indirectly as a "guarantor." In some cases, the lender will want to tie up a number of related entities to provide additional credit support for the loan and to control the cash flow of the overall business. This may limit your ability to obtain additional third-party financing through one or more of the related entities and therefore negatively impact your ability to fund future growth.

2. Guarantor Issues. Likewise, it is important to understand any personal guarantee requirements for the loan. In many cases, the lender will require a personal guaranty from all "principal" owners of the business, which frequently includes anyone with a 10 percent or greater ownership interest. While the requirement for one or more personal guarantees is generally not negotiable, it may be possible to negotiate with the lender the maximum amount guaranteed, the length of the guaranty, the requirement for any collateral security for the guaranty and the conditions for full or partial release of the guaranty.

3. Cross-default provisions. Franchise lenders typically "cross-default" their loans to various other obligations of the borrower and related parties, including existing or future loans with the same lender, loans with other third-party lenders, lease obligations and franchise agreements and related obligations with your franchisor, meaning that a default on one of these other obligations will constitute a default under the current loan. It is critical to understand the scope of these cross-default provisions, as the result can be a domino effect creating multiple defaults with lenders, landlords and the franchisor. Your goal should be to narrow these provisions as much as possible, and to provide for appropriate notice and cure rights so that you have an opportunity to prevent multiple defaults.

4. Cross-collateral provisions. A franchise lender will also frequently "cross-collateralize" all loans which that lender has with the borrower, and in many cases with other entities "related" to the borrower. This means that the lender's security interest or other lien on the assets of a borrower secure not only the loan made to that specific borrower, but also secure other loans made by the lender to "related" borrowers. It has the effect of limiting your ability to refinance individual loans or to use the assets of related entities to secure funding, since the lender essentially has all of the assets of the overall business tied up.

5. Prepayment restrictions. It is common for franchise loans to have one or more restrictions on prepayment, ranging from a defined "lockout" period, which means you are not allowed to prepay the loan, to a "make whole" or "yield maintenance" provision designed to compensate the lender for the lost return over the remaining life of the loan, to a premium based on a percentage of the outstanding principal balance of the loan. It is important to understand these restrictions before entering into the loan transaction, as they may limit your ability to sell or refinance your business without incurring a

significant cost.

6. Representations and warranties. The loan agreement will contain numerous representations and warranties concerning the borrower and related parties. These representations and warranties will be made to the lender by the borrower, and in some cases by the principal owners and the guarantors as well. Again, it is critical that you fully understand and confirm what is being represented to the lender, as any misrepresentation or breach of one of these representations or warranties will constitute a default under the loan, triggering the lender's remedies. This is an area where you need to consult closely with your professional advisors to make sure that they understand all of the facts in connection with your business so they can help you make sure that all representations and warranties are true and correct. It is also important to remember that the truth of these representations and warranties will likely be reaffirmed by you each time you submit a compliance certificate to the lender, which is typically on a monthly or quarterly basis.

7. Financial Covenants. Franchise lenders customarily employ a number of financial covenants as a way to monitor the health and performance of your business. These typically include a cash flow covenant called a fixed charge coverage ratio and a leverage covenant called effective debt to EBITDAR, or earnings before interest, taxes, depreciation, amortization, and restructuring (or rent costs). You must fully understand how these covenants are calculated, what revenue and expense items are included and for which entities, how and when the covenants will be measured, and how much cushion is built into the covenants at closing. It is important to make sure that there is sufficient cushion so an unexpected downturn in business will not result in a failure to meet one of these financial covenants and therefore trigger a default under your loan. You should also keep in mind that these covenants are typically measured on a trailing 12-month basis, so a problem in one period can continue to cause covenant issues well into the future. This is an area where professional advisors with experience in franchise finance can be very helpful.

Randy Evans

8. Operating Covenants. The lender will likely also impose a variety of operating covenants on the business, including limitations on your ability to incur additional indebtedness, grant additional liens, enter into leases or other material contracts, make distributions to owners and other matters. You need to think about issues that may arise as you operate your business over the life of the loan, including any required remodel or other capital expenditures, planned acquisitions or expansions, potential buyouts of owners and other issues, and work with the lender to address these issues appropriately in the loan documents.

9. Lender consent and veto rights. In some cases, depending on the purpose and structure of the loan, the lender may want certain governance rights with respect to your business. For example, you may be required to obtain the lender's consent before opening additional locations, taking on additional owners, entering into material contracts such as leases and franchise agreements or taking a host of other actions. It is important to understand before entering into the loan transaction how involved the lender expects to be in connection with the operation of your business.

10. Closing conditions. It is not uncommon for a franchise borrower to view the laundry list of closing conditions in the loan agreement as simply a checklist for the lawyers closing the transaction. Unfortunately, you really need to pay close attention to these requirements to avoid any last minute surprises or delays in closing your loan. There are frequently items on this list which involve third parties, including landlord estoppel certificates, landlord consents to lease assignments or leasehold mortgages, franchisor consents to assignments of franchise agreements or related documents, business licenses or permits from state, county or local government agencies, and other third party items. More often than not, a delay in closing is not caused by an issue between borrower and lender, but rather by a required third party consent or other item. Your best chance for a timely closing is to identify and address these third party issues as early as possible in the transaction.

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This is obviously not an exhaustive list, but you will be well-served to focus on these key provisions early and often throughout the negotiation and closing of your loan transaction. FT

Thanks to Randy Evans, my partner and senior attorney at Monroe Moxness Berg for his input on this article.

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