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How to deal with bank loan covenants

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For business owners, negotiating the best loan terms, rates and cost conditions with the bank are done with the sharpest of skills.

However, the same care is not always taken when determining the loan covenants or restrictions. Before signing a loan agreement, you must understand the various types of covenants banks may require.

Loan covenants determine conditions the borrower must adhere to during the term of the loan agreement. They establish when the bank has the right to call the loan, renegotiate the terms and rates, impose additional restrictions or controls, send in an auditor or assess extra charges and fees.

Reporting covenants cover the type of financial statements and other schedules that must be provided to the bank, their frequency and possibly the right to veto the choice of the independent auditor.

Financial condition covenants state minimum net worth, working capital and maximum equipment spending for the borrower.

Distribution covenants restrict salaries and other compensation payments to shareholders/employees and dividend payments to owners.

Ratio covenants require certain financial relationships to be maintained and include working capital, debt service and debt to equity ratios.

Action covenants entail certain steps that must be taken, such as using a lock box for customer payments, adding a board member or establishing a board of advisors.

Restriction covenants can affect additional borrowings, unfinanced equipment purchases or mergers and acquisitions.

Care should be taken to set covenants in reasonable amounts that are likely to be achieved, or in the case of equipment spending, amounts that are not too restrictive of the business' growth plans.

Net worth covenants are usually set at current amounts with the only violations being business losses that will reduce net worth.

If you are going to have expected write downs of assets such as inventory or equipment, tell the bank *before* the covenant is determined and include those write downs in considering that covenant.

Furthermore, if the business is expected to be reacquiring stock from a shareholder or the estate, make sure the bank is aware of this likelihood.

If a company is a pass-through entity such as an LLC or S corporation, exemptions should be provided for distributions to cover personal income taxes on the business' profits that are taxed to the owners.

When a covenant is not met and the bank wishes to maintain the relationship, the banker would grant a limited waiver of the covenant — usually not for more than one year. The best friend you can have when you don't think the covenants will be met is the banker, provided he or she is kept informed about any adverse situations.

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