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Client Alert

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Strategies For Dealing With Your Lender In the Credit Crunch

Commercial banks have long provided working capital to established businesses in the form of revolving lines of credit, letters of credit and term loans. In recent months, however, banks have severely tightened credit by reducing credit limits and in some cases terminating the credit facilities, even for long-time established customers.

These actions are understandable with respect to banks that are undercapitalized or under a cease and desist order from the banking agencies. What is less clear is why other banks are taking similar actions.

Why Good Loans Are Not Renewed

The simple reason is the need to preserve capital and/or increase capital ratios. Under applicable banking regulations, banks with "risk-based" capital in excess of 10% are considered "well capitalized," and those with risk-based capital in excess of 8% are considered "adequately capitalized." However, for years, the *de facto* minimum standard has been 10%, with most banks maintaining in excess of 12%. A bank whose risk-based capital falls to less than 10% is generally subject to a regulatory order to increase capital, may not accept brokered deposits, and is subject to increased regulatory scrutiny.

Bank capital levels and capital ratios have been adversely affected by increasing non-performing assets that are not expected to slow down in the near future. As banks approach the 10% capital level, they generally look to increase their capital ratios. They can do this in two ways—sell securities (stock or qualifying subordinated debt) or *decrease their total assets.*

Given the state of the stock market, and depressed stock prices (often below book value for banks), issuing equity securities is generally the last resort for banks. They prefer to decrease their total assets, which may even require shedding of otherwise good loans.

What You Can Do

What can you, as a business borrower, do to mitigate the risks of the current credit markets? We recommend that you consider the following:

- Carefully review your loan documents, including the affirmative and negative covenants, and make certain that you are and continue to be in compliance with each and all of those covenants. Being out of covenant compliance ("busting a covenant") will seriously harm your loan renewal chances. In today's business and regulatory environment, defaults historically labeled "technical," because they did not increase the lender's risk, may now trigger non-renewal of the loan, or worse.

- Take a careful look at your bank's financial condition. Bank financial statements are publicly available. Check the capital ratios—if the bank's risk-based capital is less than 12%, the bank may be downsizing (do not rely on the fact that your bank may be "well capitalized").

- Do not assume your credit facility will be renewed. Commence negotiations to extend the facility many months before the maturity date and pursue a back-up facility in parallel with those negotiations.

- Negotiate a longer term on your credit facility. Some banks will provide an 18–24 month commitment. You may have to pay greater up-front fees or a marginally higher interest rate, but these additional costs may well be worth the assurance that you have a credit facility. An 18–24 month commitment may get you past the current credit crunch.

- Lastly, when you have the opportunity, negotiate changes in your loan documents to mitigate the risk of technical defaults. We all know banks generally offer relatively one-sided loan agreements with covenants that are substantially broader than they need to be. In other words, the bank will include covenants that everyone believes, at least at the outset, are unlikely to be enforced stringently. As mentioned above, this may no longer be the case. Instead of relying on the failure to enforce, try to negotiate better covenants.

  For example, we have reviewed loan documents providing that any change in management is a default. This is far too broad. What if a new executive officer is added? Arguably, this would be a “change,” permitting the bank to declare a default. In addition, which officers are in fact “management” for purposes of the covenant? If you have five or six officers, should the termination of employment of one vice president be the basis to call the loan?

Your ability to complete some or all of these actions will, of course, depend in part on the financial condition of your business. However, regardless of your financial condition, you should be looking as far ahead as possible to mitigate risks of termination of your credit facility.