Read before you sign

Take the time to understand loan terms and how they might affect you

INTERVIEWED BY MARK SCOTT

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Businesses that borrow money tend to put a priority on interest rate terms and the amount of money that a bank is willing to lend them. Often that means they either overlook or pay less attention to the other terms of the loan, says Marc B. Merklin, managing partner at Brouse McDowell.

"It's usually those other terms that can come back to haunt you and your business," Merklin says. "When you're negotiating a loan agreement and reviewing the documents, it's critical that you understand what creates default so that you don't find yourself in a position where your bank can put you in default."

Borrowers are often surprised to learn they are in default, especially when they've made all their payments on time. But there are other factors that can trigger such an action, factors that can be missed when you don't thoroughly review all loan documents before signing.

"Whether you get a lawyer or you do it yourself, it's important that you read the loan documents and understand what they say," Merklin says.

Smart Business spoke with Merklin about how to approach the discussion with your lender to renegotiate or extend the terms of your loan.

What are some things that can trigger a default?

In most loan agreements, you'll see financial covenants such as fixed-charge coverage ratios and net worth requirements. It's not that difficult to run into a fixed-charge coverage ratio violation if you're a seasonal business or a business that has routine cash flow variances. Be aware of these variables as you negotiate loan terms so that any covenants account for the normal fluctuation of your business.

There are also discretionary defaults that can give the bank the power to declare default based on adverse material changes in your financial position. But what is material? What is adverse? This may vary, depending on your point of view. It's best to avoid things that you can't measure. If you have a default provision in your loan agreement, you should know by looking at numbers or performance what will trigger the default.

Another common issue for smaller businesses is change of control. Your loan agreement may include a default if there is a change in control of your business. It might not just be sale, but it could happen after the death of a principal owner.

If you have a husband and wife and they are both involved in the business and are both guarantors, and the wife dies, the husband may not want that to be an event of default for his business. Understand how change of control in the ownership of your business could affect your financial status.

What is a cure provision?

If you do have a default, you can negotiate a cure provision that gives you an opportunity to fix the problem. You might be able to put more money into the company as equity or subordinated debt or cut your expenses to bring you back into compliance. If you can get a cure provision in your loan agreement, it can be a valuable tool when you get in trouble.

What can you do to avoid problems with your loan agreement?

Keep the future in mind as you negotiate the loan documents and always think about the worst-case scenario.

The bank may give you a break on your interest rate if you have a demand feature on your line of credit that allows it to make your loan immediately due in full. If you include that demand provision, know that the bank could actually make a demand.

Talk to more than one bank about your loan. If you can have two banks competing for your business, that helps you. Try to negotiate loan agreements when things are going well. If you wait until you're in trouble and then try to negotiate terms, it's much more difficult.

Finally, if you know you have a problem, don't hide it from your lender and hope they won't find it. Be communicative and if you have a difficult situation, be honest about what you're doing to fix it. ●