THE ANATOMY OF NEGOTIATING BETTER BANK LOANS

POZZUOLO RODDEN, P.C.

COUNSELORS AT LAW

2033 WALNUT STREET, PHILADELPHIA, PA 19103

215-977-8200/FAX 215-977-9663

JANUARY 2010 NEWSLETTER

REPORT FROM COUNSEL

HOW TO MAXIMIZE YOUR COMPANY'S BARGAINING POWER

The negotiation of a better bank loan is generally done in two parts. The first part is for the borrower to determine the type and terms of loan desired. The second part is to take the necessary steps to maximize the borrower's bargaining power and credibility in the negotiations. This can range from having a more professional business plan to equity injection to shopping the loan to different target banks.

First: Types of Loans and Negotiable Terms.

A: Types of Loans:

To negotiate a better bank loan, the first step, as with anything else, is education. In

preparation it is necessary to understand the different loan agreement options available. Once these are understood a business must determine which terms it can flexibly negotiate, which terms it cannot, and which terms are unacceptable to the borrower. A bank is not going to give a borrower the ideal terms when the business is uncertain of its own requirements.

There are many different types of loans: interest only debt, installment loans and balloon payment debt are the most common. An interest only loan is the bank lending a principal amount and the business simply pays "x" % interest a year without any reduction in principal. At the end of the interest only loan, the full principal amount borrowed is still outstanding requiring full repayment. This is normal with a revolving credit loan where at each maturity date another interest only loan assumes the principal to extend the loan.

An installment loan on the other hand requires equal payments monthly where each payment is partially interest and partially a reduction of principal. Compared to interest only loans, the advantage is that the principal is completely paid off at the end of the loan, but it requires higher monthly payments throughout the life of the loan.

Balloon debt is generally an installment type loan that requires repayment before the principal would be completely paid off.

Convertible debt financing is an attractive sweetener for startup businesses to raise money whereby an investor's loan can be converted to equity at a future date.

Each loan, including convertible debt financing, has its own place depending on the relative bargaining power, credit history and expected debt needs. More importantly, each loan has its own appropriate targets. Look for a bank that is familiar with your loan type, industry, geographic locale and has done business with companies like yours. Do not be afraid to ask competitors and other local businesses for referrals.

B: Interest Rates:

Interest rates can be either fixed or adjustable. Fixed rates are usually longer term (5-10 year terms). Adjustable interest rates are generally the one year LIBOR rate plus "x" points and readjusts as the LIBOR rate changes. Fixed is usually a higher rate than adjustable rates when interest rates are low, but lower when interest rates are high. Fixed interest rates are desirable when a business wants certainty in its interest payments, whereas adjustable rates are used if a company wants to take advantage of low interest rates at the risk of higher future rates if interest rates increase. Adjustable rates may also be capped if rates increase too much to limit interest rate risk.

Borrowers should not automatically accept the offered interest rate. Rates are negotiable, so ask for a lower adjustable rate or a lower fixed rate or better schedules on an adjustable rate or a longer period of time of fixed rates. In essence, always request the lowest possible rates for the longest period of time.

C: Loan Fees:

Usually there is a loan fee assessed at 1 to 10% of the principal. This is meant to cover the cost of the loan transaction and adds to the overall cost of borrowing. With larger principal amounts, this fee can be substantial. For instance a 5% fee on a $5 million loan is $250,000. Negotiate and attempt to cap your fee.

Loan fees are the other source of income for banks when making loans, except that the bank realizes this income up front. Loan fees include various charges such as application fees, document preparation, appraisal and even legal fees. If the lender feels secure with a loan at the outset, in many instances they will waive or cap one or more of these charges. Many times a higher loan fee will lead to slightly lower interest rates, thus it is necessary to calculate the tradeoff between paying the indirect interest in an upfront fee over the interest payment savings. However, always negotiate for lower fees.

D: Guarantee:

Loans may require a personal guarantee. In essence, a personal guarantee is your promise to the bank that if your business fails and cannot pay the money back, the bank can satisfy the loan with the guarantor's personal assets. For instance, if an owner guarantees the loan, even if the business enters bankruptcy and is judgment proof, the bank can recover the debt from the owner's personal assets such as his house, bank accounts, and other liquid assets. Because a business owner's personal assets are at risk if they personally guarantee the debt, they should negotiate limitations on the dollar amount of those guarantees and avoid automatically giving unlimited guarantees. These negotiations also provide a bargaining chip to get better term at a cost.

Your argument for a guarantee release is greatest if (1) sales are growing steadily; (2) your debt-to-equity ratio continues to trend down; (3) you are selling to customers who pay on time; (4) you have three years of sustained profitability; and (5) your bank believes you will jump to another bank.

At a minimum, we recommend negotiating a restricted number of years for the guarantee if your company has been punctual in its payment schedule and financial covenants. It is always best to avoid unlimited guarantees.

E: Default Terms:

Default terms are the most important terms second to interest payments. These determine what events are considered a default, how the bank receives a judgment, and what property the bank can use to repay a defaulted loan. The less credit worthy the business is, generally the stricter the default terms will be.

Loans can be unsecured or secured with collateral. In secured loans, the lender normally has first lien on certain assets in the event of default. Upon default the bank is entitled to seize this property in payment of its loan. For unsecured loans, the bank would need a judgment from the court to access these assets. Thus secured loans may lower interest rates, but allows the bank easier access to assets to satisfy a judgment.

A business can negotiate on what events constitute default. For example, many loans will state that a debt to equity ratio above a certain amount constitutes an event of default. Limiting the events of default will limit the bank's ability to obtain a judgment in the event of default. Further, if it is not provided in the loan documents, a business should negotiate for a required notice of default and a right to cure or fix non-monetary defaults before seeking redress, typically thirty (30) days. This would allow the business a chance to correct certain defaults such as maintaining insurance, providing financial statements, maintaining certain collateral and avoid a loan default proceeding.

A loan agreement may have what is known as the “nuclear bomb” of remedies - a confession of judgment clause. Usually, a bank would have to bring a lawsuit in court and prove it is owed money and the loan is in default. With a confession of judgment clause, the borrower waives significant rights to trial and a hearing to contest any default; the bank need only file an instrument with the court for an automatic court judgment (barring extraneous circumstance) without your being present or even notified. Banks do not have the right to confess judgment without the consent of the borrower expressly set forth in the loan documents, and businesses should request that these powerful legal provisions be deleted. If you can accomplish this, your legal rights will be better protected.

F: Prepayment Penalties:

A penalty for early payment is to discourage a refinancing at lower rates because it reduces the income the bank will realize on the loan. If the loan provides for prepayment premium or penalty, the business should request that such provision be deleted from the loan documents or at a minimum decreased over a 2 to 5 year period to keep its options flexible.

Second: Improve Your Business’ Borrowing Leverage:

After knowing the desired terms, there are a number of steps a business can take to improve its leverage. To have leverage, the business must give a clear signal that it will repay the loan and bring value to the bank in exchange for the use of its funds. This can be done through a number of methods ranging from having an effective business plan, collateral, or simply shopping the loan to different banks.

A: Business Plan:

It is important that the business plan be professional, comprehensive, and contains a concise and effective executive summary that details what you will use the money for and how you plan to pay it back. A business plan should be professionally formatted, done in a professional manner and be relatively comprehensive. It should address if there are any major business risks for the loan and provide pro-forma statements with realistic assumptions. If some major issue is generalized and glossed over, the bank will likely pick up on it and deny the loan. The bank wants to know that its money will be returned. A more comprehensive plan will be able to yield a more favorable loan agreement in terms of points, interest rates, and default provisions. Broad, unsubstantiated

statements should be avoided.

B: Bargaining with Non-financial Terms:

A second way to leverage for a better interest rate is to negotiate and bargain with the terms mentioned above. It is necessary to map out the bottom line ranges of these terms as well as which terms are flexible as the flexible terms could be used as bargaining chips for other more rigid terms. Some more common areas where concession can be sought are in adjustable interest rate caps, guarantee caps, loan fees, attorney fees, the default terms, financial covenants and allowing for bank participation.

For example, an owner or parent company making a partial limited "short fall" guarantee may reduce interest payments by a few percentage points. Additional loan fees, equity investment or collateral, such as any outside real estate, inventory, accounts receivable, equipment or other types of assets, may also be used to negotiate better default terms or better interest rates. Although a pledge of collateral is generally unavoidable, a borrower can negotiate to retain some flexibility with pledged collateral, such as limiting the amount pledged, reserving the right to substitute collateral or the right to sell in the ordinary course of business or restricting the bank's security interest to property already owned and not after acquired property.

One thing to note while using default terms or guarantees as bargaining chips, borrowers should realistically evaluate these as there is a tendency to undervalue them as a distant impossibility.

C: Improve the Debt to Equity Ratio and Other Financial Ratios:

Before seeking a loan a business could restructure and clean house making its operations leaner and more efficient. Loan officers look at key ratios such as the debt to equity ratio, the debt service coverage ratio, current assets over current liabilities, and other ratios before granting a loan. This will show a stronger company and signal that the company is in control of its finances. Many times, even personal debt conversion to equity or an equity or cash injection will improve the debt to equity ratio to allow a business to achieve more favorable terms.

D: Negotiate Multiple Loans in One Package:

If a business is negotiating three or four separate loans at once, it may be best to negotiate them together to have greater leverage. When a loan officer is faced with one $500,000 equipment loan, this will not have as much influence with the bank as if it was negotiated together with the company's $10 million line of credit. Assuming a 7% interest rate, an opportunity of $35,000 a year in income is much less significant for the bank than one of $735,000 a year plus fees on a total $10.5 million combined loan. Further, it allows you to address the loan with a more senior lending officer with more moving parts to use as bargaining chips.

E: Use an Experienced Negotiator/Someone with a Good Relationship with the Bank:

Using an experienced negotiator or someone with a good relationship with the loan officer may help the negotiation terms. The experienced negotiator will know tactics to get extra benefits without ruining the negotiation. The experienced negotiator will know how and when to push hard, but not too aggressively. Further, a representative with a good relationship with the bank helps signal credibility. The loan officer may realize that this representative would not risk his/her reputation by bringing a bad debtor to the bank and that the representative has implicitly done a pre-screening that this would be a good loan. This brings added credibility and more favorable terms.

F: Shopping Around:

It is always important to shop around. Three different banks will likely give three different sets of terms. Banks sell money like automobile dealerships sell cars. Unless the first bank was offering the best terms, it is highly likely that another bank will offer the same loan at a lower interest rate with better non-monetary loan terms. Also, when a business owner can mention they received better terms from bank X, this will help bring some leverage to the table. As with purchasing an automobile, a person seeking a loan should educate him/herself about other deals in the market before committing.

Conclusion:

To gain better loan terms it should be remembered that loan officers want to lend money, but they want to avoid a default. As a result, the three keys to achieve better loan terms are to: 1) know what terms are desired and acceptable to your business; 2) position the business as a professional and credible party worthy of a loan; and 3) find the right bank that recognizes that the business would be a good debtor. In conclusion, a little footwork, close attention to detail and a working knowledge of the legal issues in a loan will help you make your business stronger and build a positive working relationship with the lending officer.

If anyone has any questions or inquiries concerning this subject matter, do not hesitate to contact us. Feel free to email us your questions or comments concerning this newsletter.

Please visit our website: www.pozzuolo.com

UPCOMING SEMINARS

JOSEPH R. POZZUOLO, ESQUIRE AND LISA A. LEGGIERI, ESQUIRE WILL BE PRESENTING: ***"A GRAYING POPULATION: ESTATE PLANNING FOR THE AGING MIDDLE CLASS SUBURBAN CLIENT"*** A CONTINUING LEGAL EDUCATION/CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS ***ON FRIDAY, MAY 7, 2010 AT NEUMANN UNIVERSITY.***

JUDITH P. RODDEN, ESQUIRE AND LESLEY M. IBANEZ, ESQUIRE WILL BE PRESENTING:

"CURRENT TRENDS IN EMPLOYMENT LAW: DISCRIMINATION THROUGH THE FAMILY MEDICAL LEAVE ACT" *A CONTINUING LEGAL EDUCATION/CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS* ***ON FRIDAY, MAY 13, 2010 AT NEUMANN UNIVERSITY.***

JOSEPH R. POZZUOLO, ESQUIRE AND JEFFREY H. SMITH, ESQUIRE WILL BE PRESENTING: ***"HOW TO INTEGRATE AN ESTATE PLAN FOR SUCCESSION PLANNING FOR A SUBURBAN CLOSELY HELD BUSINESS INCLUDING ETHICS"*** A CONTINUING LEGAL EDUCATION/ CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS ***ON FRIDAY, MAY 21, 2010 AT NEUMANN UNIVERSITY.***

Publications

All of the following professional articles and past newsletters published by attorneys of this office are available by clicking here: http://pozzuolo.com/Pubs_Articles.shtml

Corporate/Tax

Design Buy-Sell Agreements For Maximum Utility

Deferred Compensation Rewards And Retains Key Employees

How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool

Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

Money Purchase Pension Plan Falls Out Of Favor

Why An Employment Contract Is Mandatory

What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs

Structuring Loans From Qualified Plans – How To Handle The Strict Tax Rules

How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend

Bankruptcy – How To Prevent It And How To Cope With It Should It Happen To Your Business

How To Look, Act And Sound Like A Professional Corporation

How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations

How to Structure a Suitable Buy-Sell Agreement

Estate Planning

The Limited Liability Company – A Sophisticated Tool For Estate Planning

Diversify Strategies For An Effective Estate Plan

Use Wills To Maximize Family Protection And Minimize Tax

Six Proven Estate Planning Techniques

Divorce Raises The Need For Performing An Estate Planning Review

Divorce and Estate Planning

Remarriage Situations Can Raise Special Estate Planning Considerations

College Funding Tool Offers Estate Planning Advantage

Drafting The Durable Power Of Attorney For Wealth Protection Purposes

Why Living Wills – Advance Directives Are An Essential Part Of Estate Planning

Special Needs Trust – An Estate Planning Tool For The Disabled

Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects. It is to provide insight into legal developments and issues. You should always consult with legal counsel before taking any action on matters covered in our updates

To unsubscribe to this enewsletter email: info@pozzuolo.com