Credit SCORE

Compliance with credit agreements can be a major challenge

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After months of negotiations, your company closed and funded its new credit facility today. Now it is finally time to start thinking about compliance, right? Wrong. Companies need to think about compliance from the earliest stages of any financing—ideally when they are negotiating term sheets for proposed transactions.

KEY TAKEAWAYS:

- It is critical that a borrower focus attention on key operational issues or transactions reflected in its business plan when negotiating a term sheet. Those restrictions are likely going to be in place for years.
- Don't agree to covenants if you know at the outset the company likely cannot or will not comply with them.
- Once the credit agreement has been signed, make sure senior management has been alerted as to likely compliance issues. It is important that everyone in charge of making decisions that may be constrained by the credit facility is aware of the relevant restrictions.

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Why term sheets matter

Term sheets typically list in summary fashion the representations, financial covenants, negative covenants and events of default that a company can expect to see included in its credit agreement. Therefore, it is critical that a borrower focus attention on key operational issues or transactions reflected in its business plan when negotiating a term sheet, especially when those restrictions are likely going to be in place for the next four or five years. Typical examples of such considerations include expressly permitting any contemplated acquisitions or dispositions, and negotiating additional flexibility to restrictions contained in the company's existing credit facility that are potentially problematic.

In the term sheet, you should clearly define key terms to be used in the calculation of the financial covenants to make sure the definitions used in the credit agreement are consistent with the company's financial modeling (with comfortable cushions). If the company wants larger lien, debt or investments baskets, or wants the ability to pay dividends, you should talk with the lenders early in the process about carve-outs to those negative covenants.

By discussing material business issues up front when negotiating the term sheet instead of after a draft credit agreement has arrived in your inbox, you'll be able to provide lenders a clearer understanding of the company's key business drivers affecting the transaction terms and, thereby, make the processes of marketing the transaction and agreeing to the definitive documents much smoother. Because participating lenders in multi-lender facilities may not even see the full credit agreement until a few days before closing, it is critical to ensure linchpin business issues are vetted at the initial phase of negotiations to avoid credit approval issues popping up at the 11th hour.

Other considerations

Don't agree to covenants if you know at the outset the company likely cannot or will not comply with them. Although companies do it all the time, many underestimate the risks associated with defaults or overestimate the ease with which they will be able to obtain a waiver.

If your company has a complex capital structure, you may want to align the financial covenants, negative covenants and events of default across your multiple debt agreements. At the very least, you should identify the controlling covenants by flagging the agreement with the strictest covenants.

Often, a lender's first draft of a term sheet or credit agreement contains provisions that are inapplicable to or just do not make sense for your industry or business. While negotiating away these types of provisions takes additional time and may require incurring higher legal fees, removing irrelevant or overly broad provisions can help avoid inadvertent breaches of these provisions during the term of the credit agreement.

Many credit agreements contain Loan Syndications & Trading Association (LSTA) model provisions and other boilerplate terms. Banks are reticent to move away from the comfort of those "market" terms but they are by no means off limits.

At the risk of being accused of being foxes guarding the henhouse, it is important that the lawyers you hire to assist with documenting the credit facility know your business and routinely see deals in the credit markets. Experienced attorneys can help advise on the company's relative positions of strength and have a good sense of the current state of market terms.

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Once the credit agreement has been signed, make sure senior management has been alerted as to likely compliance issues. It is important that everyone in charge of making decisions that may be constrained by the credit facility is aware of the relevant restrictions. Summarize in layman's terms what the company can and cannot do to remain in compliance with the credit agreement. For example, if there's an acquisition basket, your corporate development team needs to know the limits (although ideally, they had a voice in the term sheet negotiations when those limits were established).

On a final note, do not underestimate the value of building and maintaining strong relationships with your bankers. If you forecast a potential compliance issue under the credit facility, consider alerting your primary banking relationship, such as the administrative agent on your facility. Doing so builds trust and, in the face of a default or other adverse developments, your bankers are more likely to work with you if they are not caught off guard.

Six key steps to compliance

Treasury professionals can follow a simple process to make sure their organization is in compliance with its credit agreement.

1. Read the credit agreement and key security documents—early and often.
2. Create a checklist of key compliance terms.
3. Don't agree to provisions with which you cannot comply.
4. Maintain an open dialogue with your relationship bankers—it builds trust.
5. Educate management on the types of business decisions that can lead to covenant violations.
6. Review compliance on an ongoing basis, ideally quarterly.

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Focus Areas for Treasury's Review of Term Sheets and Credit Agreements

- Financial covenants and related definitions, especially accounting terms (which often have negotiated, non-GAAP meanings)
- For ABL facilities, terms used in calculating the borrowing base (such as eligible accounts, eligible inventory and reserves)
- Representations and warranties, especially in facilities with revolving loans where representations must be refreshed with every draw
- Periodic and occurrence-based reporting obligations
- Negative covenants (a.k.a. all of the things your company is prohibited from doing without lender consent during the term of the loan)
- Events of default, especially "hair trigger" events of default and any change-of-control trigger
- Borrowing mechanics—minimum advance amounts, notice requirements and funding cut-offs.

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