

Managing Your Bank Relationship in Times of Financial Covenant Violations

Bank and other lender credit agreement terms usually include covenants that require a company to meet various financial ratios (minimum or maximum ratios on leverage, interest coverage, profitability, etc.) to be measured on a periodic basis. Companies negotiate the requirements based on their internal projections of financial performance and try to build in some cushion in the event of financial underperformance.

All companies go through business cycles, so it is not an uncommon event for a company to fall short of the required ratios and violate the related financial covenants. However, it is a serious matter and must be handled appropriately. In the event of a financial covenant violation, it is important to have a clear plan of communication with your bank. Communication, information and management availability are the key ingredients in overcoming covenant violation issues and maintaining a trusting relationship with your bank. Just like investors and boards of directors, banks do not like financial missteps and certainly do not like to be surprised by them.

The best time to notify your bank about a financial covenant violation may be before it actually occurs. When your company's financial performance is trending towards a violation, you should consider placing a call to your bank loan officer. On that call, let them know that the current path of your financial performance may result in a breach of the covenant violations. You should be prepared on that call to give some background on the issues in your business that are impacting the ratio calculations. You should remain confident and be able assure them that things are under control and that you are preparing an action plan to get your company back on track. You should request a face-to-face meeting with the bank to make sure they are fully informed about the business and the potential violations. Providing this initial insight will go a long way to alleviate their initial concerns.

When you meet with your bank be prepared with the following:

- Executive attendance who will provide clear details on business operations and the impact issues or trends have had resulting in the violations;
- Clear explanation of what the company is doing to rectify the situation;
- Financial details on the issues;
- Financial projections including income statement, balance sheet, cash flows, and covenant calculations for the next twelve months at a minimum; and
- Other information that the bank may have requested.

If you didn't notify the bank in advance of the possibility of covenant violations but now know you are in violation as you prepare your next covenant certificate, make a phone call to your banker to lay the groundwork. Let them know that you are about to submit the certificate, that it is going to show a violation, and you want to set up a follow-up call to give them more detailed information and provide assurances that you have the situation under control.

In all such circumstances, before you take any steps contacting the bank, you should consult with your attorney to understand the impact of notification to the bank of the possible or actual covenant violations as well as any moves you make after you become aware that you may or will violate the financial covenants. Advance notification may provide the bank with some remedies that may be detrimental to the company. It may also start the clock on certain required actions by the company.

Understanding your rights and responsibilities and their ramifications are important in planning an effective communication plan with the bank.

Providing timely communication and information as well as direct access to management is the best course to ensure maximum understanding and cooperation from the bank. The appearance of full disclosure sets the tone for a more trusting relationship and for future discussions and negotiations regarding waivers of the violations and/or amendments of the credit agreement.

Written by Steven Bell