

New Trends in Commercial Lending

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In recent years, major changes have occurred in the commercial lending market. Two of the most important changes are (1) the emergence of new classes of lenders as an important source of financing and (2) the increasing use of nontraditional lending structures. These changes have created new opportunities and challenges for commercial lenders.

NEW CLASSES OF LENDERS

Banks and commercial finance companies have long been significant sources of commercial loans. Although they remain significant, hedge funds and private equity firms are playing an increasingly important role in this area. These new lenders often take different approaches to loans than do traditional commercial lenders. Whereas traditional commercial lenders tend to carefully monitor their loans, some of the new lenders are “traders” who buy and sell their interests in loans in the secondary markets, and are less inclined to carefully monitor the loans.

Traditional lenders make their loans with the primary objective of earning interest and fees, and getting repaid the loan balance at maturity. Some new lenders make loans with the realization that there is a significant possibility that the borrower will be unable to repay, and with the plan to convert their debt to equity if that happens—sometimes referred to as the “loan-to-own” model. Often, multiple lenders will be involved with the same borrower. When they have different motivations and objectives, that can create challenges in administering the loans both in good times and if problems develop later.

NEW LOAN STRUCTURES

Aside from the new types of lenders entering the market, the increased competition among lenders has led to increasingly innovative loan structures. These structures can be helpful in meeting the needs of the borrower, but a lender should, if possible, include provisions to minimize the risks inherent in such approaches.

(a) One new approach is the so-called “covenant-light” loan, in which many of the covenants—including financial covenants—that lenders traditionally use to restrict the activities of borrowers and to trigger events of default in case of a deterioration in a borrower’s financial condition, are omitted from the loan documents. This obviously creates a risk that the lender will not be able to take action to protect itself until the

borrower’s financial condition has deteriorated so significantly that it is unable to make monthly payments on the loan. Even if the lender’s ability to declare a default is restricted, it is important to address the circumstances under which a lender may stop making loan advances to the borrower, since it may otherwise be obligated to continue to make loan advances even as the borrower’s financial condition deteriorates.

(b) It has also become common for multiple lenders to provide separate loans to the same borrower, with each lender getting a security interest in different assets of the borrower. Thus, one lender’s loan may be secured by accounts receivable and inventory, another lender’s loan may be secured by equipment, and a third lender’s loan may be secured by intellectual property. It is important for a lender in such a transaction to consider how it will work with the other lenders if a problem arises, because a non-cooperative lender who chooses to foreclose on its collateral which is necessary to the operation of the borrower’s business, or who threatens to do so, can prevent any workout from succeeding.

Conversely, a lender who does want to foreclose on its collateral may find that the value of the collateral is significantly reduced because the lender is unable to sell, or provide the right to use, other assets of the borrower necessary to maximize the value of the collateral (e.g., a sale of inventory without the right to use or incorporate the borrower’s brand name or trademarks).

(c) Second-lien lending (sometimes referred to as “Tranche B lending”) has also become more common, pursuant to which a new lender takes a lien on a borrower’s assets subordinate to a senior lender’s security interest. Second-lien loans first were used for borrowers having financial problems, but have become increasingly popular as a means by which healthy companies can obtain additional funds to finance acquisitions or for other purposes.

Intercreditor agreements between the two classes of lenders are typical, but the terms of such intercreditor agreements differ depending on the parties and the nature of the transaction. Items that should be addressed include, among other things, the ability of each lender to modify the terms of its loan (e.g., increasing the loan amount, making covenants more restrictive, shortening maturity dates), circumstances in which the second lien lender would be required to release its lien to

facilitate a loan workout by the senior lender, and limitations, including standstill periods, on the rights of the second-lien lender to enforce its rights against the borrower and its collateral.

(d) Another approach is to modify the traditional syndicated loan structure, in which all lenders have a pro rata interest in a single loan, to take into account the different types of lenders. In these “uni-tranche loans,” the different lenders agree among themselves in an intercreditor agreement as to the rights and priorities of each in administering and collecting on the loan. This structure can be more attractive to a borrower because it is less complicated and expensive than multiple loan facilities. It can have some disadvantages to the lenders, however, because the existence of a single loan agreement may make it more difficult for any class of lenders to modify the loan documents without the consent of all lenders. If there is a default, the agent may have conflicting loyalties because it may be acting on behalf of more than one class of lenders. If the lenders decide to use the “unitranche” structure, they should be mindful of these and other issues that will arise.

It is inevitable that some of the commercial loans that have been made in recent years, and will be made in the future, will go bad. One of the best strategies for dealing with a “problem loan” is to structure the loan at the outset in such a way as to increase the likelihood of success if a problem later does develop.

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