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Nonprofit Finance Fund
Where Money Meets Mission

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Board Talking Points: Loan Repayment Challenges

Organizations may have taken on debt when the economy was stronger and it had realistically projected enough income to repay the debt. However, as cash constraints grow, the funds that were thought to be available for debt service may have disappeared. Defaulting on loan obligations can have serious consequences for a nonprofit and should be avoided, if at all possible. Here are some strategies for meeting loan obligations.

Questions:

1. How do we determine our loan repayment obligations?
2. What does it mean to "refinance" a loan?
3. Should we be in contact with our bank about repayment challenges?
4. What are the consequences of defaulting on a loan?
5. Can a loan be converted to a charitable contribution?

Answers:

1. How do we determine what our loan repayment obligations are?

Payment terms for any loan should be contained in the loan documents. The monthly payment maybe fixed or variable depending on the type of loan. A term loan at a fixed interest rate will have set monthly payments while a term loan with a variable interest rate will have fluctuating monthly payment and the lender will have to provide notices of change. At the end of a term loan, it is possible that a "balloon payment" will be due to the lender. The balloon payment relates to the principal amount of the loan that has not been repaid. At the time the loan was taken out a balloon payment may have been appealing because it lowered the amount of the monthly payment. The monthly payment on a line of credit will also fluctuate depending on the outstanding balance.

2. What does it mean to "refinance" a loan?

Refinancing is when a borrower uses money from a new loan to pay off an existing debt obligation or when the provisions of an existing loan are changed. When refinancing, the organization will need to go through an underwriting process to ascertain the financial strength of the enterprise. Refinancing may be appealing under several circumstances:

- The existing loan has a higher interest rate than is now available.
- The remaining time to pay the existing loan is shorter and, therefore, the monthly interest payments are higher than they would be if repayment of the loan could be made over a longer period.

- The organization has more than one loan, and bringing all the existing loans into one loan agreement would help to control costs and make the debt easier to manage. The ability to consolidate may be limited by the total debt exposure a lender can have with a single organization.
- There is a balloon payment due at the end of the existing loan that the organization cannot pay in a lump sum.

Although refinancing might lower the monthly payment, it is not always preferable because:

- If the time to repay the loan is lengthened, even if the interest rate or monthly payment is lowered, the total amount of interest paid over time may be greater.
- Lenders usually charge fees when making or changing the terms of a loan and the cost of those fees may outweigh any savings.
- In order to receive better loan terms, borrowers might be required to pledge additional collateral.
- Given the pressure in the credit markets, some lenders have tightened lending criteria.

3. Should we be in contact with our bank about repayment challenges?

It is always advisable to be in contact with the loan officer if the organization anticipates difficulty in meeting its loan obligations. For the borrower to preserve its relationship with the lender and for the lender to maximize its return on the loan the parties need clear communications and to share accurate information.

A "default" occurs when the borrower fails to meet an obligation established by the loan agreement. The most common serious default is failing to make a payment on time but other events of default include:

- **Breach of certain material representations or covenants.** The loan document contains representations and covenants made by the borrower that describe its business and finances at the time of the loan. Some loans contain ongoing covenants, for example, to retain a certain amount of cash reserves. If one of these representations or covenants was incorrect when made or if an ongoing covenant becomes incorrect during the term of the loan, then the lender maybe able to call a default. Before an event of default can be called (for something other than non-payment), the default must be considered material (i.e., poses a substantial threat to the lender) and the time to cure (fix the problem) has passed.

- **Cross-default.** A cross-default clause is when a loan agreement states a default under another agreement will cause a default under the loan agreement. For example, the borrower has a line of credit and a term loan. The term loan states that an event of default is a failure to make a payment on the line of credit. If the borrower fails to make a payment on the line of credit, the lender on the line of credit and the lender on the term loan maybe able to call an event of default.

- **Insolvency related events.** A filing of a bankruptcy petition will be an event of default. However, some loan agreements will make steps short of filing for bankruptcy including: failure to pay debts as they become due and taking steps to wind-down the organization, events of default.

- **Material adverse change default.** The provision enables the lender to call an event of default when there is a significant negative change in the borrower's business or financial condition. While these clauses can be very broad, and therefore hard to enforce, an example might be the termination of a significant government contract.

Be prepared when calling the lender to comply with requests for additional information that it is seeking to ascertain the organization's financial position including: (i) most recent audited financial statements; (ii) most recent unaudited (internal) financial statements; and (iii) any other additional information the lender may deem necessary for further analysis. Also think about what adjustments the organization needs to the payment schedule or loan agreement in order to avoid additional defaults. Depending on how the lender operates, responsibility for monitoring the loan and amending the loan agreement may shift from the branch loan officer to the loan workout group.

4. **What are the consequences of defaulting on a loan?**

There are several possible consequences of a loan default depending on the terms of the loan agreement. If the loan is a revolving line of credit, the lender can refuse to extend the borrower additional credit. With either a term loan or a revolving line of credit, the lender may have the ability to increase the interest rate charged on the loan by charging a "default" interest rate and/or to accelerate the loan which means the lender has the right to demand the entire outstanding balance be paid immediately. If the loan is a secured loan, the lender can sue the borrower for default and take possession of the collateral. Also, if the loan is guaranteed, the lender may have the right to collect the debt from the guarantor. Defaulting on a loan will have a negative impact on the organization's ability to reestablish credit in the future.

5. Can a loan be converted to a charitable contribution?

Loans made by foundations and individuals at their discretion may be forgiven and taken as a charitable deduction for the amount forgiven if there is valid evidence of an enforceable loan. For example: A board member loans money to a nonprofit organization that the organization cannot repay. In order for the board member to forgive the loan and take a charitable deduction for the amount forgiven there must be a promissory note or loan agreement evidencing the obligation of the organization to repay the board member.[1] Commercial lenders, Community Development Financial Institutions (CDFIs) and credit unions do not convert debt to charitable contributions. When an organization uses debt forgiveness as a strategy, it is not viewed positively by commercial lenders and may be a factor in the organization's ability to reestablish a "normal" borrowing relationship with banking institutions.

This alert is meant to provide general information only, not legal advice. Lawyers Alliance and the Nonprofit Finance Fund can help boards with questions about securing a loan.

For more information please contact:

Lawyers Alliance: Linda Manley, Legal Director, at (212) 219-1800 ext. 239, or lmanley@lawyersalliance.org.

NFF: Emily Guthman, Associate Director, New York Program, at (212) 868-6710, or Emily.Guthman@nffusa.org

[1] A loan from a board member to a nonprofit organization is an interested party transaction and the organization must adhere to its conflict of interest policy when approving the loan.