**Loan Agreement provisions – Undertakings**

This element explains the nature, purpose and effect of undertakings within a loan agreement

Note: Clause references throughout this element are to the LMA Agreement. Unless specifically indicated, you are only required to familiarise yourself with the structure of the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full.

**Undertakings: overview (Clauses 26, 27 and 28)**

• Undertakings are **promises made by the borrower** to either do or not do something.

• There are normally three categories of undertakings within a loan agreement: **information undertakings (clause 26), financial covenants (clause 27) and general undertakings (clause 28)**.

• **Information undertakings** require the borrower to **provide certain specified information** to the lender / its agent.

• **Financial covenants** are promises made by the borrower to **meet certain financial targets** set by the lender.

• **General undertakings** are **the remainder of the undertakings** within a loan agreement, and which do not constitute financial covenants or information undertakings.

**Categories of Undertakings and examples**

**Information Undertakings**

These involve the borrower providing information such as:

• supplying audited accounts within a specified time period (such as within 120 days from the end of the borrower’s financial year);

• supplying details of any litigation started (or threatened) against the borrower or any member of the borrower’s group;

• supplying any documents sent by the borrower to its shareholders;

• Notify lender/agent of any Default.

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• **Financial Covenants (see below)**

• Common covenants being:

• minimum net worth; leverage ratio; gearing; and interest cover.

[Pen symbol] **Task:** In the **EniBank Precedent Loan Agreement,** read clauses 20 and 22 to become familiar with some undertakings you will commonly see included in loan agreements.

**General and Information Undertakings: Lender's perspective**

Undertakings offer the lender **control over how the borrower is run** and allows a lender to **monitor** the borrower through regular information supplied to it by the borrower.

As due diligence is conducted by the lender at the start of the loan, this creates a standard which the lender will monitor the borrower against – the borrower should ensure that it **remains materially the same** throughout the life of the loan.

If the lender believes that an **undertaking has been breached,** then it can take steps to **call an event of default** .

A lender needs to understand the business and specific circumstances of the borrower before it exercises its rights and remedies in respect of an event of default.

A lender should ensure that it **does not become too involved** in the business of the borrower (such as being an active part of its decision making) to be deemed as a **shadow director** (particularly if the borrower experiences financial difficulty and the lender steps up its level of control).

Such involvement could constitute exerting 'material influence' over a borrower, triggering government scrutiny under the National Security and Investments Act 2021, but detailed consideration of this legislation is outside the scope of this knowledge stream.

Also, with such involvement a lender could risk liability for the borrower's defined benefits pension scheme, and it may trigger registration requirements under the PSC regime.

**General and Information Undertakings: Borrower's perspective**

A borrower should ensure that it **keeps the lender informed of any (material) changes to its business** and that it **manages its business in such a way** asto avoid a breach of any undertaking.

Undertakings should be both **realistic and consistent** across any loans entered into by a borrower. For example, any financial thresholds (such as a de minimis threshold for no disposals) should be the same across different loans of the borrower. This will allow a borrower to manage any disposals without having to check every loan agreement.

The lender will often require the borrower to ensure that its subsidiaries (as defined under Companies Act 2006) will comply with the undertakings. The borrower is able to do so as it is the majority shareholder in its subsidiaries and therefore exercises control as a shareholder over them. Again, the borrower may be concerned, if it has a significant number of subsidiaries, about its ability to ensure they all comply with the undertakings, especially if there are subsidiaries that are relatively insignificant in the context of the group as a whole or a large number of overseas subsidiaries. The same point in relation to **Material Subsidiaries**, mentioned in the context of representations, would also apply here.

A borrower can also argue that the undertakings should be drafted to **exclude any breaches which would have an immaterial effect** on its ability to 1) repay the loan and/or 2) comply with its other obligations under the finance documents within the deal.

**Undertakings: financial covenants**

Financial covenants (if they are to be included in the loan agreement - this won't always be the case) are focused on the financial condition of the borrower. Their function is to protect the lender if the business of the borrower declines financially. A lender is able to call an event of default if a financial covenant is breached.

Financial covenants give a clear and objective indication of the borrower’s financial health and performance. These form the base of the financial parameters of the borrower at the outset of the loan. They also set the level of deterioration in the borrower’s financial position that would constitute a material change to the lender.

The figures included in the annual audited accounts of the borrower will be used by the lender to test the financial covenants it has set for the borrower. In addition, the figures in the unaudited quarterly accounts (and sometimes from monthly management accounts) will also be used to ensure financial covenants are tested with sufficient frequency.

**Examples of financial covenants:**

**Minimum net worth**

This is to ensure that the total assets of a borrower do not outweigh its liabilities by a set amount (for example by not less than £10 million).

**Leverage ratio**

This monitors the ratio of the amount of debt a borrower has compared to the amount of its profit – this reassures the lender that the borrower is able to pay its debt obligations.

**Gearing**

This monitors the ratio of the amount of debt of a borrower to its shareholder funds – this is normally expressed as a maximum percentage (for example that gearing to not exceed 50%).

**Interest cover**

This monitors the ratio of a borrower’s operating profits to its cost of borrowing. This helps to indicate how solvent a borrower is. It also helps to control a borrower’s external borrowing as it cannot exceed the limits of the interest cover ratio.

**Loan to value**

This covenant monitors the ratio of the outstanding amount of the loan to the value of the property purchased with the loan, hence why it is usually found in property finance loan agreements. The obligation of the borrower is to ensure the loan amount will not exceed a certain percentage of the market value of the property against which the loan will be secured.

**Financial covenants: Lender's perspective**

A lender will give careful consideration as to which ratios are relevant to the borrower’s particular business. Which particular financial indicators are most likely to reveal problems within the borrower’s business and its ability to service the loan?

The lender should be practical in setting the level of financial covenants to ensure that they are triggered at a point which is early enough to enable a lender to take steps to work with the borrower to turnaround its financial position but also such that it is not always reacting to premature and inconsequential breaches.

The lender should aim to be in a position where it can monitor the ability of the borrower to maintain a specified level of financial performance (which may be based on predictions in the borrower's business plan).

**Financial covenants: Borrower's perspective**

• A borrower should ensure that the financial covenants are **appropriate and achievable**.

• A borrower will want to ensure that financial covenants are **not easy to trigger**, especially where a borrower is not likely to default on any payments or be in any financial difficulty.

• A borrower should ensure that financial covenants **do not restrict its ability to run its business efficiently**.

• Financial covenants require an **agreement** between a borrower and the lender to ensure that these work throughout the **lifetime of the loan**.

**Summary**

• Undertakings are **promises made by the borrower** to either do or not do something – the three categories of undertakings within a loan agreement are **information undertakings**, **financial covenants and general undertakings**.

• Information undertakings require the borrower to **provide certain information** to the lender/agent – this helps the lender to monitor the borrower throughout the lifetime of the loan.

• **Financial covenants** are promises made by the borrower to **meet certain financial targets** set by the lender.

• General undertakings are made up of the **remaining undertakings** that do not constitute financial covenants or information undertakings.