Debt finance workshop 1-5

**Types of facility, due diligence and credit approval**

This element introduces different types of loan facility and the initial stages of a loan transaction namely due diligence and credit approval.

**Introduction**

Following on from the induction session, this knowledge stream will focus on corporate borrowers. There are many different borrowers with diverse financing needs, but companies are the most prevalent.

Equally there is a wide variety of debt providers (see slide below), going beyond traditional 'banks'. This knowledge stream will focus primarily on bank lending.

As mentioned in the induction session, the initial stage of raising money through a corporate loan will involve the borrower approaching its relationship bank to discuss its financing needs with its relationship manager. For the borrower, the person making this approach may be the finance director (for a small company), or the corporate treasurer (in a large company).

This initial stage will determine the type of facility the borrower requires and will initiate the carrying-out of due diligence by the lender and seeking internal credit approval for the loan. These points are considered below.

**Lending overview**

**Bank Lending:**

• 'Traditional' bank lending from clearing and high street banks.

• Examples include Barclays Bank, HSBC, National Westminster Bank.

• Bank lending will be the main focus on this knowledge stream.

**Alternative Lenders (i.e., lenders that are outside of the bank lending system):**

• Credit Funds – credit funds usually have shorter investment periods with the option to recycle/reinvest investments. These are an increasingly popular choice of lender in the market.

• Institutional Asset Managers -examples such as Legal & General and M&G plc.

• Challenger Banks.

• Funds will be explored further in the Asset and Investment Management module.

**Types of Facility**

One important part of the early negotiations is for the borrower to identify what type of debt facility it requires and that the lender confirms that it is prepared to proceed on such a basis. Which form of debt is suitable for a borrower will largely depend on the purpose for which the money is required and the size of the capital sum required.

We will consider the following loan facilities:

• Overdraft

• Term loan

• Revolving credit facility ('**RCF**')

**Overdraft**

The corporate overdraft is similar to the personal overdraft (which most people are familiar with) in everything but size.

An overdraft permits the borrower to borrow (or literally overdraw from its account) up to a specified limit and interest is charged on the daily overdrawn balance.

The borrower can repay the loan (or repay part of it) and then redraw the money – again up to the specified limit.

It is normally an ‘**uncommitted**’ facility – i.e., the bank is not committed by any contract to continue lending the money and may decide to withdraw the facility at any time and for any reason.

An overdraft is usually granted on the bank’s standard terms and conditions, so there is little room for negotiation of these.

Any overdrawn amount is legally repayable on demand. This means a bank does not have to wait for a breach of the overdraft agreement by the borrower, to require repayment of an on-demand facility.

Little formal documentation is required – often merely a ‘facility’ letter.

An overdraft is a tool to assist cash flow, i.e., to keep the business liquid.

It provides a reserve of easily accessible money to meet any shortfalls in working capital. An overdraft is sometimes known as a working capital facility.

Whilst most companies will have access to an overdraft facility, it is not intended to be a core source of funding but rather a means of dealing with short term funding requirements (e.g., resulting from irregular cash flow due to seasonal fluctuations of the business). Companies which have specific reasons for raising further finance will do so through one, or a combination, of the types of debt facility described below (term loan and revolving credit facility). We will concentrate on these in this knowledge stream.

**Term loan**

This is the most inflexible facility of the three we are looking at. Again, most people will be familiar with a term loan (e.g., student loans are effectively term loans).

A term loan provides a fixed sum for a fixed period.

The borrowed amount may be fully drawn down in one lump sum or in several ‘tranches’, depending on the terms of the loan agreement.

It is usually a ‘**committed**’ facility, i.e., the bank is bound (subject to the terms of the loan agreement) to lend the money and can only demand repayment before the agreed repayment date(s) if there is an event of default under the loan agreement (events of default will be considered in Workshop 3).

It is repayable by the end of the term according to an agreed repayment schedule set out in the loan agreement.

Any prepayments (repayments made earlier than due) are usually final (i.e., they cannot be redrawn by the borrower).

A term loan is most suitable where the borrower needs a specific sum of money for a medium to long period, i.e., for the purchase of property, acquisition of a company, start-up costs.

Repayments can be structured in a variety of ways including:

• ‘**Amortisation’** – repayment of amounts at regular intervals;

• ‘**Balloon repayment’** – repayment in several instalments where the final payment is bigger than the rest; and

• ‘**Bullet repayment’** – repayment in one instalment at the end of the term.

**Revolving credit facility**

A revolving credit facility ('**RCF**') is a commitment by a lender to lend on a recurring basis on predefined terms.

The bank makes a specific amount of capital available over a specific period, typically three to five years.

Unlike a term loan, the RCF allows a borrower to draw down and repay (and draw again) amounts of capital during the availability period (see below), subject to the terms of the loan agreement.

**There are limitations to such drawing down and repayment to ease the administrative burden on the lender:**

• The capital is made available for a set availability period (e.g., 5 years) and, within that period, individual loans (subject to a minimum size (e.g., £500,000)) are borrowed for an ‘Interest Period’ (generally 1, 3 or 6 months at a time) and repaid at the end of that Interest Period.

• Typically, a loan agreement would specify that a borrower can have no more than a certain amount of loans outstanding (e.g., 5 loans) at any one time. The borrower usually has to give a number of days' notice to draw down (this depends on the currency).

• Each loan will have its own Interest Period, so it is common for more than one loan, perhaps with differing Interest Periods, to run concurrently. Different loans under a facility can be drawn down at different times.

• It is usually a **committed** facility so, provided there is no default, the bank is bound to lend the money and cannot demand early repayment.

• The RCF will cease to be available, and any outstanding drawings will be repayable in full at the end of the **Availability Period** (period during which loans may be drawn down).

• The RCF allows a borrower to draw down loans only when it needs the capital and only for the period it needs the capital, thereby keeping interest costs to a minimum.

• A bank will charge a fee called a ‘**commitment fee**’, which is a percentage of the undrawn amounts of the facility from time to time. A bank charges a commitment fee because it has had to put aside a certain amount of capital based on the total committed facility available to the borrower in order to comply with capital adequacy rules.

• Each time funds are drawn down (or ‘rolled over’, which means the same amount is deemed repaid and re-borrowed on the same day), the borrower is deemed to repeat certain representations (‘**Repeating Representations**’) which it originally gave to the lender in the loan agreement.

• Representations in a loan agreement are considered in Workshop 2.

• Consequently, borrowers under an RCF need to check that the Repeating Representations can be given immediately prior to any further drawdown, or they run the risk of triggering an Event of Default (considered in Workshop 3). This would apply equally to a multi-tranche term loan. Also, a bank will have the right to temporarily suspend any further lending ('**drawstop**'), if the borrower is in default.

• A Clean Down provision is often included in an RCF in order to ensure that the RCF is used to manage cash flow and does not become long term core debt. The lender may achieve this, for example, by requiring the borrower to repay the whole of the facility and retain a ‘nil’ balance for at least five business days in any 12 month period (i.e. ‘cleaning down’).

• RCFs are often used for working capital (i.e. to provide liquidity for a company’s day to day operations). An RCF combines the:

• flexibility of an overdraft facility (allowing the borrower to withdraw capital only when it is required); and

• certainty of a term loan (an RCF is usually a committed facility).

• A syndicated RCF can be very large in size.

• The borrower can draw down when the money is needed and pay it back when it is not, thereby saving interest.

• The documentation, timing and negotiation required for an RCF will be very similar to that of a term loan.

• Syndicated facility agreements may include a term loan and an RCF in one document.

**Capital markets instruments**

Instead of taking out a loan, a borrower may decide to raise finance by issuing a capital markets instrument. The term ‘capital markets’ here refers not to a physical or even a single electronic marketplace, but to the whole global market in which investors provide finance to corporations, governments and other types of issuer in the hope of making a profit on the investment.

Bonds are the form of capital markets instrument which we will consider on this knowledge stream (in Workshops 8 and 9).

**Overview of the stages of a loan transaction**

**(NB: This is a general overview for a syndicated loan, by way of an introduction. This structure may differ depending on the transaction)**

Commonly a borrower will approach its **relationship bank** with a need to raise finance.

The arranger bank will commence an initial **due diligence** process (investigation and credit analysis) with the relationship manager putting together an initial package of terms for the loan.

The lender’s **credit committee** will then be consulted for approval of the lending terms.

A**term sheet** will be agreed between the lender and the borrower. Solicitors will be instructed by both parties. (NB: in some circumstances a formal term sheet will not be used).

Solicitors commence **due diligence** & drafting / negotiation of documentation.

Signing and completion. Provided any conditions precedent are satisfied, the borrower can **draw down** funds.

**What is the purpose of due diligence?**

**Due diligence by the lender** is simply a fact-finding exercise. The purpose of collecting information is to ensure the company's financial information is as accurate as possible and to focus attention on factors in the business that will be critical to its future success. The lender will want to ensure that the company will be able to pay the principal amount requested and the interest payments payable under the loan. Due diligence is an exercise carried out by or on behalf of the lender.

The aim is to assess the overall risk of the borrower and any other entity providing security or giving a guarantee for the payment of the loan. Together we call the borrower any such security/guarantee provider the 'Obligors'. This will be a defined term in the loan agreement.

**Legal due diligence** will be carried out at a later stage by the lender’s solicitors. This will involve carrying out a number of searches on the obligors and, if the loan is to be secured, searches on the assets that will be subject to security.

At some point, the information may reveal that the **risk** is too great for a bank to lend unless it is able to take **security**.

In such cases, due diligence would extend to ascertaining what assets are available for the lender to take as security and the value of those assets.

The higher the chance of **default**, the larger the **fees** and **margin** a lender will charge to compensate for this risk and the more stringent the documentary provisions it will seek.

**Due diligence: initial investigation and credit analysis**

**Credit analysis**

There is no ‘standard’ due diligence procedure. The format and extent of due diligence will vary with the identity of the lender and other factors including:

• Size of the loan;

• Type of loan (committed / uncommitted);

• Whether the loan is to be secured;

• Identity of the borrower (credit rating, jurisdictions involved, whether the borrower is known to the lender) ; and

• Whether the loan is part of a larger transaction.

• The lender will then put together a 'basic package' with the borrower, including the headline terms of the deal such as amount and term, repayment dates and main covenants to be given by the borrower in the loan agreement.

• For the purposes of this knowledge stream , this ‘basic package’ will be set out in a term sheet, but other formats could be used by lenders in practice.

**Credit approval**

The Credit Department or Credit Committee of a lender sees all credit requests and takes a view on the overall lending outstanding. It will have the ultimate say as to whether or not the lender is prepared to lend funds on the proposed terms. Credit approval is not automatic and will be viewed within the context of other risks the lender is exposed to in its lending, for example:

• industry sectors;

• geographical / political risks; and

• types of corporate borrowers

The lender’s internal limits and policies on exposure must not be breached.

• The Credit Committee will wish to see as a minimum the company’s annual audited accounts. It may also request to see interim figures, management accounts (i.e. unaudited accounts prepared for internal purposes) and possibly any future business plan.

The Credit Committee may approve, amend or reject the lending proposal.

**Legal due diligence**

Once the lender has instructed solicitors, they will start to carry out detailed due diligence on the borrower (and any other company granting security / giving guarantees).

This will involve carrying out searches (including at Companies House) on all of the companies involved in the transaction.

As a minimum, the lender will want to ensure that there are no restrictions in the relevant company’s constitution on its ability to borrow or give guarantees/grant security (as applicable).

In particular it will be necessary to ensure that a company can grant security over shares in its subsidiaries.

Crucially, if the legal due diligence does reveal any restrictions in the constitutional documents of any relevant company on borrowing and/or giving security/guarantees, the lender will want to ensure such restrictions are removed prior to the lender agreeing to lend (i.e., by the relevant company amending its articles). The lender ensures a borrower does this by requiring that evidence of such steps are listed as 'conditions precedent' in a schedule to the loan agreement. The importance of conditions precedent is discussed further in Workshop 2.

**Further considerations**:

Where the borrower/guarantor is incorporated overseas, local lawyers will be instructed to carry out equivalent due diligence.

If security is to be taken, further due diligence will be carried out in relation to the relevant assets: e.g. report on title (property), review of key contracts and licences, etc.

Lenders will also need to consider the value of the assets over which they will take security and will usually require a valuation report.

**Summary**

• Part of the initial stage of a corporate loan transaction will involve determining what type of facility a borrower requires.

• Overdrafts, term loans and revolving credit facilities have specific features.

• The lender’s initial due diligence and credit analysis will result in proposed lending terms.• Initial terms will be subject to credit committee approval.

• The proposed terms on which a bank is prepared to lend will be set out in a term sheet (though other formats may be used in certain transactions).

• Solicitors will be instructed for both parties and legal due diligence will commence alongside the negotiation and drafting of loan documentation.

**Syndication**

This element introduces syndicated lending: the nature of a syndicated loan; why a loan might be syndicated; the process of syndication; and the parties involved.

N.B. clause references throughout this element are to the LMA Agreement.

**What is a syndicated loan?**

A **bilateral loan** is a loan made available by a single lender.

A **syndicated loan** is a loan made by two or more lenders (together called the **syndicate**) on the same terms and governed by a single loan agreement.

For example: A borrower, XYZ plc, needs a substantial sum of money which a single lender is not able or does not wish to provide. Assuming that XYZ plc wants to borrow this money by way of a loan, rather than in the capital markets, it could borrow the funds from either:

1) a group of lenders using a series of separate bilateral loans (each loan negotiated separately with the individual lender and on different terms); or

2) a group of lenders under one overall agreement (a ‘**syndicated facility**’).

Syndicated facilities are a popular source of funding with facilities ranging from relatively small amounts (e.g. £20 million) with relatively few lenders, to huge ‘jumbo’ facilities involving over 200 lenders.

Bilateral and syndicated loans work on the same basic principles, but with syndication comes additional parties and associated provisions and liabilities.

**Syndicated Loan Structure (pre-signing)**

[Diagram showing a box marked “Single loan agreement signed”. Above this are 4 boxes marked Lender A, Lender B, Lender C and Lender D. An arrow from each box points towards a single box marked “Arranger” (this section is labelled “the Syndicate”). There is an arrow from “Arranger” to a box marked “XYZ Plc (Borrower)”].

**Why syndicate?**

When a lender lends money, it makes a profit made up of fees paid by the borrower and the margin (the difference between its cost of lending and the interest paid by the borrower to it).

So why would a lender that has been approached by a borrower want to form a lending syndicate and be forced to share its profit?

This is due to a number of limitations which impact upon a lender’s lending, including the size of the loan, internal risk policy and large exposure regulations.

**Large loans**

Syndication allows large amounts to be lent to a single entity with large financing needs. Often it would not be feasible for one lender to make available such sums.

Therefore, a borrower will appoint a lender to put together or ‘arrange’ a syndicate of lenders and each member of the syndicate will commit to contributing towards the total facility on signing of the loan agreement.

**Internal risk policy**

Even if it had the cash to do so, one lender would have a considerable credit risk if it were to lend large sums to any one borrower or concentrate its lending in specific sectors or countries.

This is something which the lender’s internal credit committee will look at when the proposed loan is first put forward (see Element 1 of this Topic).

**Large exposure regulations**

Irrespective of a lender’s internal risk policy, it may be prohibited by large exposure regulations (for example, those stemming from the Capital Requirements Directive) from taking so much risk with a single borrower.

Lenders gain fees and prestige from participating in high profile syndicated loans and this could lead to follow on business with the borrower. So even for lenders with small participations in a syndicate, it is a good way of entering the market and being introduced to the borrower.

From a borrower’s point of view, the more lenders, the bigger the potential amount to be borrowed but also the more unwieldy the syndicate becomes to manage. This is somewhat mitigated by the syndicate appointing an ‘agent’. As mentioned below, one of the Agent’s roles is to act as a conduit between the borrower and the syndicate lenders.

**Post-signing syndication**

N.B. the borrower may need funds for a specific project and by a specific time (e.g. to fund a property acquisition). It may not be feasible to form a syndicate prior to the signing of the loan agreement in time for completion. A solution is to enter into a loan agreement with either the Arranger or, more likely, a small group of syndicate lenders so that the borrower has its funds on time. The initial lender(s), **post signing** of the loan agreement, will then syndicate the loan by **transferring** ‘portions’ of it to other lenders, thereby reducing their overall exposure to the borrower.

This is called **post signing syndication**.

We will consider different methods of transferring a loan in Workshop 7.

**Parties to a syndicated loan and their roles**

**Arranger**

The starting point of syndication will be for the borrower to appoint a lender to put a syndicate together. This is known as ‘arranging’ the syndicated loan and the name generally given to the lender taking on this role is that of ‘**Arranger**’.

The Arranger (also known as the ‘lead arranger’ or ‘mandated lead arranger’) is appointed (i.e. ‘mandated’) by the borrower to arrange the raising of the required amount of debt, by organising a syndicate of lenders which is able to provide those funds. Such an appointment or mandate will be confirmed and documented by the**mandate letter** (see element 3). The borrower will usually expect the Arranger to provide a substantial proportion of the total facility.

The Arranger will charge an **arrangement fee** for its role as arranger of the loan This is usually documented in a fee letter so that the exact amount is confidential as between the borrower and the Arranger.

The Arranger will **advise** as to the most appropriate loan structure, key terms and the cost taking into account the borrower’s creditworthiness, the purpose of the loan and prevailing market conditions. The Arranger will advise the borrower generally (if it is not familiar with the syndicated loan market) on how the syndication procedure will move forward.

The Arranger will prepare an **information memorandum** from information provided by the borrower. This is the document used by the Arranger to market the loan to potential syndicate lenders. It will contain, amongst other things, a description of the borrower’s business and financial details.

The role of the Arranger ceases on the signing of the loan agreement (clause 33.4). However, the loan agreement should still contain some clauses which are designed to protect the Arranger, e.g., providing for the ability to enter into other future business with the borrower (see clauses 33.5 & 33.6).

The Arranger will appoint solicitors to draw up the **first draft of the loan agreement** and then will negotiate this and any other documentation, such as security documents, with the borrower on behalf of all syndicate members. If there is more than one arranger, they may agree that one of them assumes this role, in which case they may be referred to as the documentation bank when acting in this capacity.

It has become common for larger borrowers to agree with the Arranger that the borrower's solicitors will draft the loan agreement as the borrower will want the loan agreement to be borrower friendly. Usually, the Arranger's lawyers will prepare the other finance and security documents.

**Syndication – best efforts or underwritten?**

The mandate letter will make it clear whether the Arranger has been appointed on a **best efforts** or **underwritten** basis.

When a loan is mandated on a best efforts basis, the Arranger will promise to use its ‘best efforts’ to assemble a syndicate of lenders willing to lend the required amount. This does not amount to a guarantee that the full amount will be raised. If the Arranger does not succeed, the borrower will not have access to the full funds required.

But the borrower may need certainty of funds…

The borrower can ask the Arranger to **underwrite** the entire loan or arrange for a small group of lenders to underwrite the loan. This means that if the full syndicate of lenders cannot be put together in time, the Arranger (and any fellow co-arrangers) will be obliged to make up any shortfall in the requested amount. The borrower will have to pay an underwriting fee for this as well as the usual arrangement fee. Acquisition finance transactions will usually be underwritten by the Arranger as the borrower needs to be certain that it will have funds available to complete the acquisition.

**Agent ​**

The Agent is typically a bank, usually part of the lending syndicate, appointed by the syndicate lenders under the loan agreement, upon the advice of the Arranger, to administer the facility. The Agent is agent of the lenders and not of the borrower. Note non-bank Agents are becoming increasingly common.​

This is an important role. The Arranger and the syndicate lenders formally appoint the Agent under the terms of the loan agreement (clause 33.1). The Agent administers the mechanics of the loan and will be the main point of contact between the syndicate and the borrower throughout the life of the loan, as far as the mechanics of the loan are concerned. ​

The Agent will be unwilling to assume any discretionary powers to manage the loan on behalf of the syndicate, as this may lead to liability in the event any of their decisions have unfortunate consequences. Agency fees are low and do not reflect risk.

In addition, the syndicate lenders are generally unwilling to delegate management functions to the Agent and deprive themselves of influence in decision-making.

The result is that the Agent’s duties are precisely defined and documented and are mainly restricted to administrative tasks (clause 33.3 (a)). The Agent will protect itself by seeking instructions from all or the requisite group of syndicate lenders, e.g.' the ‘**Majority Lenders**’. The Agent will not be liable for any actions it takes in accordance with those instructions (clause 33.2 (a)(i) (A) and (D)).

See below for the Agent’s main functions which include receiving and paying loan advances from the syndicate to the borrower and vice versa for payments of interest and principal from the borrower; receiving and forwarding documents and notices; determining the applicable interest rate; taking action on default; interpreting the provisions of the loan agreement; and administering loan transfers.

[Diagram with arrows from Main functions in the centre pointing to the following paragraphs in boxes – clockwise in the following order:

Paying agency (cl. 36.1)

Postman (cl. 33.3(b) and (d))

Determining interest rate

Limited monitoring (e.g. cl. 33.3(d)

Pro rata sharing (cl. 35)

Interpretation of loan agreement (see also cl. 33.7(c) to (e))

Action on default (cl. 29.20, cl. 33.3 (e) and (f))

Checking conditions precedent (cl. 4.1)

Administering loan transfers (cl. 30 and Sch 4 and 5)

**Majority Lenders**

A democracy exists within the syndicate. Most decisions tend to be delegated to majority control, usually set at 66 2/3% of total syndicate commitments (referred to as the ‘**Majority Lenders**’ – see definitions clause to check the majority threshold). Once a decision is made it is binding on all syndicate members.

This style of decision making by Majority Lenders speeds up the process and prevents one minor lender effectively having a veto. A drawback of syndicated loans is the potential divergence of interests of the syndicate members. It is important both for lenders and the borrower that amendments and waivers can be made relatively easily, without one minor lender being able to block the process.

**Task: Read clauses 42.2 and 42.3 of the LMA Agreement and consider whether all decisions taken by a syndicate of lenders are by way of majority or whether some must involve unanimity.**

**Majority Lender decisions v unanimous consent**

Matters which usually require a Majority Lender decision include waiving certain defaults, amending the loan agreement (cl. 42.2(a)), determining whether a material adverse change has occurred regarding the borrower and directing the Agent to accelerate the facility (cl. 29.20).

However, a few matters are considered so important that they require unanimous consent. These will be specified in the loan agreement but usually include a change of borrower, a reduction in any amount paid to the lenders, an extension of payment dates or an increase in the total of the lenders’ commitments (see clause 42.3).

**Parties to a syndicated loan – correct the incorrect table!**

Cl. 33.1(a) The Arranger does not enter obligations under the Loan Agreement; its role ceases on signing.

Cl. 33.2(a) Neither the Arranger nor the Agent owes fiduciary duties under the Loan Agreement and are therefore not obliged to account for profits made.

Cl. 33.3(a) Neither the Agent or Arranger will be responsible for accuracy of information in the Information Memorandum.

Cl. 33.4 The Agent is appointed by the Arranger and Lenders as its agent.

Cl. 33.5 The Agent will not be liable for any exercise of its power if it acts in accordance with Majority Lender / all Lender instructions.

Cl. 33.8 The Agent’s duties are solely mechanical and administrative.

[Pen Symbol]

**Task:**

The clauses and statements do not match; take a moment to read the LMA clauses listed and match them to the correct descriptions in the table.

**Parties to a syndicated loan – correct table**

Cl. 33.1(a) The Agent is appointed by the Arranger and Lenders as its agent.

Cl. 33.2(a) The Agent will not be liable for any exercise of its power if it acts in accordance with Majority Lender / all Lender instructions.

Cl. 33.3(a) The Agent’s duties are solely mechanical and administrative.

Cl. 33.4 The Arranger does not enter into obligations under the Facility Agreement; its role ceases on signing.

Cl. 33.5 Neither the Arranger nor the Agent owes fiduciary duties under the Loan Agreement and are therefore not obliged to account for profits made.

Cl. 33.8 Neither the Agent or Arranger will be responsible for accuracy of information in the Information Memorandum.

[Pen Symbol]

**Task:**

The clauses and statements now match. Read on to explore in detail the roles of these parties in a syndicated loan.

**Security Trustee**

Where a syndicated loan is secured, a security trustee (sometimes labelled a 'Security Agent') will be appointed to hold the security effectively for the benefit of all the syndicate lenders.

One major advantage of this arrangement is that when a syndicate lender transfers its participation, the benefit of the security can be also transferred without the need for a separate formal arrangement. To achieve this the security must be created in favour of the security trustee for the benefit of the ‘Lenders’, defined as the lenders from time to time lending under the loan agreement.

This is sufficiently precise under English law for the creation of security for the benefit of the syndicate as a whole, notwithstanding that the identity of the lenders may change during the life of the loan. Local legal advice should be taken if security is being created other than under English law. Loan transfers will be considered in Workshop 7.

**Summary**

• A syndicated loan involves a group of lenders lending to a borrower under the umbrella of one single syndicated facility agreement. Syndicate lenders may join a syndicate to gain prestige/fees.

• Syndication may be necessary due to the size of a loan, limits imposed by individual lenders’ internal risk policies and large exposure regulations.

• The Arranger will be mandated to arrange the syndicated facility; this role will include advising the borrower, marketing the loan to attract potential syndicate members and negotiating the terms of the loan and any security.

• The Agent will be appointed to administer the mechanics of the facility during its term. This role is limited in scope and the Agent will, as far as possible, act in accordance with Majority Lender instructions to limit its own potential liability.

• A Security Trustee will be necessary if the facility is secured.

**Documentation- mandate letter, information memorandum and potential liabilities of an arranger and agent**

This element explores some of the preliminary documentation involved in syndicated lending, namely the mandate letter and information memorandum. It also considers some potential liabilities of an arranger and an agent, and how they protect themselves.

N.B. clause references throughout this element are to the LMA Agreement.

**Syndicated Loan Structure (pre-signing)**

[Diagram showing a box marked “Single loan agreement signed”. Above this are 4 boxes marked Lender A, Lender B, Lender C and Lender D. An arrow from each box points towards a single box marked “Arranger” (this section is labelled “the Syndicate”). There is an arrow from “Arranger” to a box marked “XYZ Plc (Borrower)”].

**Mandate letter**

A term sheet will generally be the starting point for both bilateral and syndicated loans (see Element 4).

Where a syndicated loan is used, additional provisions relating to the arranging of the loan may be included in a separate letter known as a mandate letter (also known as a commitment letter). There is an LMA standard form mandate letter which is widely accepted in the market.

The mandate letter will be provided by the Arranger (see element 2) and will set out the terms on which the borrower appoints it and on the basis of which the Arranger has agreed to arrange the syndicated loan (either on a best efforts or underwritten basis - see Element 2).

It will also include provisions designed to assist the Arranger in marketing the loan/setting up the syndicate (see below). The term sheet will usually be attached to the mandate letter, with any legally binding provisions set out in the mandate letter rather than in the term sheet.

As mentioned previously, the mandate letter will make it clear whether the Arranger has been appointed on a best efforts or underwritten basis. It is important for the Arranger that the syndication is successful, so the mandate letter will contain a number of provisions to facilitate syndication, including:

A '**clear market**' clause in which the borrower is restricted from issuing any other finance whilst this facility is being arranged. This is to ensure the Arranger is not competing with other attempted financing by the same borrower;

A '**market flex**' clause in which the Arranger can change terms of the facility to attract other banks to participate. This could include increasing the pricing and/or fees of the loan (and sometimes changing provisions such as the structure of the facility) to enhance the prospects of successful syndication. These clauses are unpopular amongst borrowers but have become more accepted and widespread. It is in a borrower’s interest to try to limit the changes the Arranger can make to pricing only (with a cap on any rise in pricing); and

A '**material adverse change'** provision (not to be confused with a ‘MAC’ event of default). A material adverse change provision in a mandate letter effectively enables the Arranger to terminate its mandate and walk away from the deal if either:

• there has been an event in the syndicated loan markets which has materially and adversely impacted the primary syndicate; or

• something happens which has an adverse impact on the business or financial condition of the borrower.

**Information Memorandum**

The information memorandum is the main marketing document prepared by the borrower and the Arranger and sent by the Arranger to potential syndicate members. The Arranger will assist the borrower in writing the information memorandum on the basis of information provided by the borrower during the due diligence process.

As the lenders are lending to a particular business for a particular purpose, they need to assess the risk of doing so. To do this they need to know all they can about the business. The information memorandum sets out the details of the borrower’s business, management and accounts, as well as the details of the proposed loan facility and any security and inter-creditor arrangements. It is not a public document and all potential lenders (whether pre- or post-signing of the loan agreement) who wish to receive it must sign a confidentiality undertaking.

The confidentiality undertaking tends to be drafted by the Arranger, although the LMA has produced forms of confidentiality letters which are common in the market.

[Pen Symbol] **Task:** Having considered the Arranger’s role set out in Element 2 and also in relation to the Information Memorandum, can you think of any areas of potential liabilities for the Arranger?

**Task:** Having considered the Arranger’s role set out in Element 2 and also in relation to the Information Memorandum, can you think of any areas of potential liabilities for the Arranger?

• The Arranger could be liable for **fraudulent / negligent misrepresentation** or **negligent misstatement** (Hedley Byrne v Heller) in relation to any misinformation about the borrower provided to syndicate lenders.

• The Arranger could have potential liability to the syndicate lenders if it were acting as their agent and breached its **fiduciary duties**.

**Potential liabilities of Arranger and Protections**

Misinformation about the borrower to the syndicate lenders:

If the Arranger has provided inaccurate information to the lenders, it is likely that there will also be a misrepresentation event of default by the borrower (to be considered in Workshop 3). The facility could therefore be accelerated, and any funds advanced to the borrower immediately reclaimed.

However, it may be that the borrower is insolvent or in serious financial difficulties by then. Hence the syndicate lenders’ attention will turn to the Arranger, to see if it is liable to pay compensation for misrepresenting the borrower’s financial condition in the information memorandum, claiming fraudulent/negligent misrepresentation or negligent misstatement.

**Exclusion of liability**

The Arranger’s mandate is to organise the syndicate, and not to take responsibility for the information in the information memorandum or for syndicate lenders’ investment decisions. The Arranger will therefore attempt to exclude liability. At the start of the info memo is a disclaimer entitled ‘Important Notice’, stating that:

• the borrower is solely responsible for the information memorandum, and the Arranger is not responsible for the information contained in it;

• the Arranger has not independently verified the contents;

• the syndicate lenders will not rely on the memorandum to make their investment decision, and each bank should undertake its own assessment in deciding whether to participate in the loan; and

• the Arranger is not responsible for updating the information.

**Protections under the loan agreement**

**Indemnity**: The Arranger may take an indemnity from the borrower for any liability it may incur as a result of the borrower's action or default.

**Exclusion of fiduciary duties**: The Arranger is not a fiduciary of the syndicate lenders. Therefore, the Arranger's only duty is not to withhold any information from the syndicate.

**Waiver of conflict of interests**: This enables the Arranger to pursue other business with the borrower.

**Waiver of any requirement to account for any profit made**: This enables the Arranger to avoid any allegations of secret profit.

The agent has the following potential liabilities to the syndicate lenders:

• Breach of fiduciary duties including:

o No conflict of interest – the agent should not put itself in a position where its duty conflicts with its own self-interest or the interest of a syndicate member;

o Not to make a secret profit; and

o Due diligence in the exercise of its powers.

• Breach of terms of the loan agreement.

• Negligence – breach of duty to act with reasonable skill and care.

**Agency fees are low and do not reflect the risks involved. The agent will therefore seek to protect itself by limiting the scope of its duties and its potential liabilities in the facility agreement, as follows:**

**Duties narrowly defined**: and are expressed to be solely mechanical and administrative in nature (clause 33.3(a)).

**Fiduciary duties excluded**: (clause 33.5(a)), so that, for instance, the agent does not have to account to the lenders for any profit (clause 33.5(b)) and can carry on other business with the borrower (clause 33.6).

**Majority Lender instructions**: the loan agreement expressly provides that the agent is protected if it acts in accordance with these instructions (clause 33.2(a)).

**Conditions precedent (‘CPs’)**: the agent will want the advice of lawyers (clause 33.7(c)) and the instructions of the lenders as to any commercial CPs before confirming the CPs are satisfactory.

**Professional advisers**: in all matters the agent will want the right to appoint professional advisers if it considers this necessary to carry out its duties (and be compensated for the legal expenses) (clause 33.7(c) to (e)).

**No responsibility for checking accuracy/adequacy of documents**: the agent is simply acting as a postman in relation to any documents it forwards or information it supplies to other parties (clauses 33.3(d) & 33.8).

**Exclusion of liability**: (subject to the reasonableness test) for all liability except gross negligence or wilful misconduct (clause 33.10(a)(i)).

**Indemnity from lenders**: for all liability, costs and expenses incurred in the carrying out of its duties (clause 33.11).

**Indemnity from borrower**: e.g. for investigating Defaults (clause 21.3).

**Summary**

• The terms of the Arranger’s appointment are set out in the mandate letter.

• The mandate letter includes terms to assist the Arranger achieve a successful syndication, such as clear market and market flex clauses. In addition, the material adverse change clause gives the Arranger an exit if syndication does not go well.

• The information memorandum is the marketing document prepared by the borrower and Arranger. This contains information about the borrower to help potential syndicate lenders in their investment decision.

• The Arranger will protect itself against liability for misinformation by including the Important Notice disclaimer in the information memorandum as well as exculpatory provisions in the loan agreement. It may also seek an indemnity from the borrower.

• The Agent will also seek to protect itself from potential liability for the consequences of any decisions it takes in performance of its role by narrowly defining its role and through 'exculpatory provisions' in the loan agreement.

**Documentation – term sheet**

This element presents the key elements of a term sheet for a loan transaction and how this will form the basis for drafting the facility agreement.

N.B. clause references throughout this element are to the LMA Agreement.

**What is a term sheet ?**

A term sheet is a document setting out the principal terms of the facility agreement between the parties – it can be referred to as ‘heads of terms'. It will be attached to the mandate letter, which will be signed by both lender (Arranger if the loan is syndicated) and borrower.

Term sheets can be anything between 2 and 80 pages long (and in some very complex transactions, even longer than this). Broadly speaking, the lender’s in-house counsel (for less complex deals) or the lender’s external lawyers (for more complex transactions) will usually draft the term sheet (as well as the mandate letter and fee letter). It is also common for the borrower’s counsel to draft these documents, so the loan documents reflect a more borrower friendly position from the beginning. In general, a straightforward bilateral or syndicated loan (‘plain vanilla’) will have a short-term sheet and structured transactions (such as those involving acquisitions or project finance) will have a longer, more detailed term sheet.

The more non-specific the terms of the term sheet and the simpler the structure, the less important it is that lawyers be involved at this stage. However, borrowers will usually want their external lawyers to review the term sheet before it is agreed.

**What is the legal effect of a term sheet?**

A term sheet is non-binding save for the provisions relating to confidentiality and costs and should therefore contain the wording ‘**subject to contract**’ clearly at the top of it. However, it is normally considered to be morally binding.Where there is a mandate letter, provisions relating to confidentiality and costs are usually included in the mandate letter, which is legally binding.

**Function of the term sheet**

The term sheet provides an overview of the deal before the parties start working on the loan agreement itself. It is unlikely to contain detailed drafting. It serves as the initial summary of the fundamental terms of the loan. It assists the solicitors in estimating their fees for the transaction. The lender's lawyers will use it to draft the loan agreement, and the borrower's lawyers will use it when reviewing the draft to check that it reflects the terms agreed between the parties.

Alternatively, the borrower's lawyers may draft the loan agreement in which case the loan agreement will be considerably more borrower friendly. Note that in some deals, e.g. where the documentation from a previous deal is agreed to be used as a precedent, a formal term sheet may not be prepared. However, on this knowledge stream, you will be encountering a term sheet prepared by the lender.

[Pen Symbol]

**Task:** What do you think a term sheet would contain? Take a brief moment to draw yourself a mind map of possible areas you think the term sheet should cover, remembering that it provides an overview of the fundamental loan terms.

NB: You will see a completed term sheet in Workshop 1.

**Mind map**

[Diagram: shows “Contents of a term sheet” in centre with arrows pointing to

· Boilerplate clauses

· Date and parties

· Type and amount of facility/ies

· Availability Period and termination date of facility

· Dates for repayment / schedule of repayments

· Voluntary/ mandatory prepayments

· Interest payments and other pricing

· Conditions precedent

· Representations and warranties

· Undertakings

· Events of default

· Guarantees and security

· Costs

**Contents of the term sheet**

**The term sheet comprises clauses which are both deal specific and boilerplate, including the following:**

Date, parties (including any guarantor(s)), type, amount, availability period and termination of the facility;

Repayment and prepayment of principal and payment of interest including:

o dates or schedule for repayment as applicable;

o voluntary prepayments (when, notice period and minimum amounts);

o any mandatory prepayment requirements in certain situations, e.g. change of control of the borrower normally gives rise to a prepayment obligation; and

o terms of interest payments; and

· Conditions precedent, representations and warranties, undertakings, events of default.

The term sheet will typically only explicitly state any unusual / deal-specific provisions, referring to all others as those “usually included in this type of facility”.

The main exceptions or carve-outs to undertakings may be stated “to be agreed” or a borrower may try to get these agreed at the term sheet stage, if they feel strongly about a particular exception or carve-out.

It is important that where a list of provisions is not exhaustive, a clear phrase such as “…including but not limited to” is used as a preface.

**Confidentiality issues**

The borrower will be subject to an obligation not to disclose the contents of the term sheet other than to their legal and financial advisers for the purposes of the transaction. If there is no mandate letter, this should be included in the term sheet and be expressed as legally binding.

In addition, the borrower will be keen to ensure the lender treats all information gathered about the borrower during the due diligence process as confidential. Accordingly, a separate confidentiality agreement (also known as a non-disclosure agreement or NDA) will be entered into containing an undertaking given by the lender not to disclose confidential information about the borrower other than in restricted circumstances to aid syndication. Any lender considering participating in the syndicate will be required to sign a 'back-to-back' confidentiality agreement before receiving any information about the borrower.

**Costs**

If the loan does not go ahead, substantial costs may already have been incurred (e.g. legal fees). The term sheet should, therefore, include an obligation on the borrower to pay the lender’s costs whether or not the loan is completed, together with any fees charged by the bank (e.g. a cancellation fee).

Again, this obligation on the part of the borrower should be expressly stated to be legally binding, which is why it is usually set out in the mandate letter instead of the term sheet.

**Boilerplate clauses**

These are clauses that are standard terms and which appear in some form or other in all loan agreements. They are provisions which govern the relationship between the parties and enforcement of the agreement including fees, governing law and jurisdiction etc.

The term sheet will state at the top that it is **subject to contract.**

**Subject to contract- Disclaimer in LMA form of term sheet**

'Please note that the terms set out in this term sheet are indicative only and do not constitute an offer to arrange or finance the Facility/ies. The provision of the Facility/ies is subject to due diligence, credit committee approval, the terms and conditions of the Mandate Letter (if one is used) and satisfactory documentation.'

**Term sheet terminology**

‘**Facility’ or ‘Facilities’**- This can, depending on the context, mean the overall facility under which monies will be lent and, at the same time, the individual RCF or term loan facility comprised within the overall facility / facilities.

‘**Utilisation’ or ‘Drawdown'**- The borrowing of money under a loan facility.

**‘General corporate purposes’**- Usually seen in the ‘Purpose’ clause of a facility agreement in relation to an RCF.

**‘Availability Period’ or ‘Commitment Period’ -** Usually seen near the beginning of the term sheet.- The period in which the loan may be drawn down by the borrower, e.g. for a term loan, say three months after execution. For an RCF, the availability should be until shortly prior to termination of the facility because the borrower can draw down, repay and later re-draw part or all of the facility throughout the life of the loan. This is the nature of an RCF.

‘**Acceptance’ / ‘Available’** – usually seen near the end of the term sheet. The period for which the terms of the loan contained in the term sheet will be available to the borrower to accept. After this time the term sheet may need to be renegotiated.

‘**Repayments’ As opposed to….** The scheduled repayments set out in the repayment schedule, i.e., principal repaid to the lender.

**‘Prepayments’-** The borrower repaying the loan early:

· Voluntary: sums repaid to the lender voluntarily in order to reduce the loan. Voluntary prepayments are generally subject to a minimum amount. Prepayment fees may also be charged.

· Mandatory: payable on the occurrence of certain events, e.g., change of control of the borrower - to be considered in a later Workshop.

**‘Fees’ -** The lender’s fees, e.g. arrangement fee, commitment fee etc. The exact amounts may appear in a separate fee letter in order to preserve confidentiality.

**‘Costs’ -** The expense of setting up the deal e.g. advisers’ fees. If loan negotiations break down and the deal does not go ahead the borrower will be obliged to pay the costs that the lender has incurred. This term will be expressed to be binding whether it is in the term sheet or the mandate letter or indeed a separate fees letter.

**From term sheet to loan agreement**

Once a term sheet is agreed and signed by both parties, work on drafting the loan agreement will start.

Although no two loan agreements will be the same, as a starting point each one should be able to answer the 6W questions: Who owes What to Whom, When, Where and Why?

· Who? The borrower (and any guarantor);

· What? Loan amount, type of facility, definitions clause;

· Whom? Correct details and capacity of lender(s);

· When? Date of loan, repayment and interest payment dates, CPs to be satisfied;

· Where? Availability of facility; and

· Why? Purpose of the facility.

Naturally, loan agreements contain many more provisions than these, as you will come to see over the next few workshops.

**Drafting of the loan agreement**

**Lender’s perspective on drafting the loan agreement**

Lenders will try to minimise the **risk** of not getting their money back by finding out as much as possible about the borrower and its business before granting the loan – see **due diligence** (Element 1).

Lenders will also use their **internal credit assessment** to determine the level of interest and fees charged, and whether security is required. The rigidity of the undertakings, financial covenants, representations etc. will also be determined by this internal credit assessment of the borrower. The higher the risk for the lenders, the higher the fees and interest charged, the more onerous the provisions in the documentation and the more likely guarantees and security will be required.

Lenders base their credit assessment on the borrower undertaking a certain kind of business with certain assets and will want the borrower to maintain this status quo throughout the life of the loan. In order to protect itself, the lender will ensure the loan agreement expressly states the purpose of the loan (restricting other use of the funds) as well as **restricting any change** in the nature of the borrower and its assets. It is likely to prohibit significant disposal of assets and the creation of security so that no other interested party can take priority or compete with the lender’s claim against the borrower’s assets.

**Drafting of the loan agreement will be explored in Workshops 2 and 3**

**Borrower’s perspective on drafting the loan agreement**

A borrower will want the cheapest available funds from a lender while retaining **flexibility** to run its business as it currently does. A borrower will be concerned about excessively onerous provisions which restrict the day to day running of its business (and indeed the expansion of its business). It would be administratively burdensome on the borrower and will slow-down its day to day operations if it is regularly required to seek waivers from the lenders..

A borrower will want the ability to keep hold of the funds until maturity of the loan and to run its business without the interference of the lender.

**Compromise position**

Both parties to a commercial deal will understand the tension between the borrower’s desire for funds ‘without strings’ and the lender’s desire for control. In order to get the deal done, compromises will have to be made by both sides.

As a debt finance solicitor, you need to be able to advise from both perspectives, so that the loan can be put together constructively and co-operatively. Respective bargaining positions and the state of the market will both play a part.

**Summary**

• The term sheet sets out in overview the principal terms of the loan agreement between the parties. Subject to certain specific exceptions (e.g. confidentiality and costs), it is not intended to be legally binding.

• The term sheet will serve as a basis for drafting the loan agreement. It will also be used for marketing the loan, in conjunction with the information memorandum. Advisers will use the term sheet in order to estimate fees.

• The term sheet will cover areas including parties, facility amount, duration, payments of interest and capital, prepayments, fees, guarantees, security, conditions precedent, representations, undertakings, events of default etc.

• There is a natural tension between the perspectives of the borrower and lender in drafting the loan agreement. The lender will wish to protect itself against risk and therefore impose significant restrictions on the borrower, whereas the borrower will seek flexibility. The compromise position ultimately reached will also be influenced by respective bargaining power and the current state of the lending market.

**Loan Agreement provisions – Purpose, Facility, Conditions Precedent and Fees**

This element starts exploring the provisions in a loan agreement, focussing on the purpose, facility, condition precedent and fees clauses.

Note: Any clause references throughout this element refer 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.

**Introduction**

Once the terms have been agreed, attention can turn to drafting and negotiating the loan agreement and security documentation (if loan is to be secured).

Although every deal is different and the loan agreement needs to be tailored to the requirements of the transaction, these slides seek to highlight common clauses found in a loan agreement, as a starting point.

If the loan agreement is based on an LMA standard form (which will be the case for most corporate loans) the guarantee(s) (if given) will be incorporated into the loan agreement, so you will not expect to see a separate document for the guarantee(s).

The key clauses of a loan agreement are set out below and will be considered in the next few elements.

Finally, as a more general point, where you have a group of companies and there are separate loans at different levels of the group, this gives rise to the risk of subordination, which will be also be considered at the end of the discussion of clauses in a loan agreement.

**Loan Agreements – overview of key clauses**

**[Flowchart – with “Contents of a Loan Agreement” at the centre with arrows pointing towards the following terms clockwise in order]**

- Facility

- Purpose

- Conditions Precedent

- Governing Law and Enforcement

- Interest and Interest Periods

- Fees

- Withholding tax and tax gross up

- Increased Costs provision

- Representations

- Undertakings

- Financial Covenants

- Events of Default

**Purpose clause (clause 3)**

The purpose behind the loan shapes the transaction. It needs to be consistent with each lending bank’s policy. It also focuses the lender’s mind as to what the documentation must contain in order to protect its position. This clause also restricts the borrower to ensure the funds are used for agreed purposes only.

If there is an obvious violation of the purpose clause, the borrower will be in default and may hold the monies subject to a resulting trust in favour of the lender. This gives the lender an advantage in the event that insolvency follows default, because the money may be deemed to be held on trust for the lender and not to form part of the assets of the borrower on a winding-up *(Barclays Bank Ltd. v. Quistclose Investments Ltd* [1970] AC 567, HL*).*

In practice it is usual for the purpose clause to include a general statement relating to the purpose, for example that the funds must be used ‘towards the borrower’s working capital requirements’ or ‘towards general corporate purposes’.

**Purpose clause**

If the lender knows a facility is for an unlawful purpose, e.g. it will breach government imposed sanctions, then English law will treat the facility as void and unenforceable and will disallow any action to recover the funds advanced. Subsequent illegality of an initially lawful agreement, however, is treated differently and the lender can recover the funds by calling a **mandatory prepayment event** for **illegality** in the loan agreement (see clause 12.1 of the LMA Agreement).

**Facility clause (clause 2)**

Generally, a term loan can be drawn down during a relatively short period of time after the loan agreement is signed (called the ‘commitment’ or ‘availability’ period ). If the borrower does not draw down the funds in that period, the lender’s obligation to lend ceases. Compare this to the position with an overdraft or a revolving credit facility (‘**RCF**’) that can generally be drawn on at any time during the term of the loan, up to the specified loan amount.

In some transactions, the lender will agree to make the money available in a number of separate facilities or tranches (i.e. portions) all in the same loan agreement. Each facility and/or tranche may have different characteristics relating to maturity dates, availability, interest periods and repayment terms.

The existence of more than one facility and/or tranche in the loan agreement will be reflected in the mechanical provisions of the agreement such as the drawdown, repayment and interest provisions. The remaining terms of the agreement, such as representations, undertakings and the events of default, will apply to the agreement as a whole, irrespective of the different facilities and/or tranches.

**Facility clause**

The clauses mentioned below are only found in syndicated facilities:

• **Several obligations (clause 2.4(a)).** Each lender’s obligation to lend under a syndicated loan is several and not joint. As a result, syndicate members are responsible for their commitment only. This means syndicate members do not guarantee that the other lenders will provide their share of the loan. Conversely, the failure of one syndicate member to satisfy its obligations does not allow the others to back out.

• Each lender has a separate right of enforcement (clause 2.4(c)). However, in practice this right is subject to the decision of the Majority Lenders to accelerate the loan (clauses 29.20 ) and to the syndicate members’ obligation to share any amounts received under the pro rata sharing clause (clause 35).

• **Separate loans (clause 2.4(b)).** Legally, each lender agrees to make a separate loan to the borrower up to the maximum amount it has agreed to lend (its **commitment**).

• You might also hear about a lender’s ‘proportion’ or ‘participation’. This is simply the ratio of its commitment against total syndicate commitments. Lenders’ contributions to loan advances and payments of principal and interest made by a borrower are divided amongst the lenders in this proportion.

• For example, a syndicate of banks is put together to provide a borrower with a term loan of £25,000,000. There are 5 banks in the syndicate, each of whom has agreed to lend up to £5,000,000 (their individual commitment). If the borrower decides to drawdown £20,000,000 then each syndicate lender will have a participation of £4,000,000.

**Conditions Precedent (‘CPs’) (clause 4 and schedule 2 Part 1B)**

**Conditions Precedent (or ‘CPs’)** are conditions that a borrower has to fulfil before a lender becomes obliged to lend. A borrower is therefore unable to draw down any funds from a loan until the CPs are either a) satisfied or b) waived by the lender / agent (if a syndicated loan). These are explained below:

**CPs to first utilisation:**

These are mainly documentary in nature and are intended to ensure all legal and certain other matters (such as commercial, regulatory and practical matters) are in order and that, for a secured loan, any security is in place before the lender is obliged to lend any money. For an acquisition finance transaction, the security package granted by the target group companies will be put in place after the acquisition has been funded and completed.

**Further conditions precedent:**

These are also known as 'drawstops'.

It will be a condition to each new advance that certain of the representations (i.e. statements of fact) made on the original signing date are true and correct. These are known as the 'Repeating Representations'.

It will also be a condition to each new advance that no **actual or potential** event of default is outstanding. This applies to all advances under any loan except a 'rollover' loan under an RCF

For a 'rollover' under an RCF, the condition to the further advance will be (less onerously) no **actual** event of default is outstanding.

**Conditions Precedent: Function**

A lender is not obliged to make loan advances immediately upon the signing of the loan agreement – any loan advances are subject to satisfaction of the CPs. The CPs are included in the loan agreement to ensure that all legal matters are in order and that a lender is not obliged to lend if the borrower has become a greater credit risk than when the financial terms were agreed. However, certain fees will accrue from the date of signing so it is not in a borrower’s interests to sign the loan agreement unless it is confident it will be in a position to meet all CPs at the point it requires the monies. Accordingly, the process of agreeing, collecting and approving CPs takes place before the completion date as far as possible.

Very often it is a trainee’s responsibility to organise, agree and check CPs in connection with any loan agreement. If there is an international element to the transaction, this can involve liaising with overseas companies and lawyers.

**Examples of Conditions Precedent**

CPs vary according to the circumstances of the borrower and should be altered for each transaction. The following are examples of common CPs:

- constitutional documents (e.g. the company’s articles);

- **legal opinion(s);**

- insurance policies;

- financial information and auditors’ reports;

- any licences/consents relevant to that borrower;

- board resolutions or other corporate authorisations;

- compliance with KYC (‘know your client’) requirements (although this is normally dealt with internally by the lender’s compliance team); and

- evidence that all fees have been paid.

- Depending on the circumstances of the particular deal there may also be deal-specific CPs, for example in a real estate finance deal (where a property purchase is being financed) there will be property related CPs such as valuation reports, reports on title and environmental reports.

**What is a legal opinion?**

Broadly, a legal opinion is a letter confirming the corporate capacity of the borrower (and, if relevant, any guarantor or security provider) and that the finance documents (i.e. the loan agreement and, where relevant, any security agreement or guarantee) are legally valid, binding and enforceable. It is another way for the bank to reduce the risk of non-payment.

It is usually the bank’s solicitors who will be asked to give the opinion but it may, on occasion, be the borrower’s solicitors. In a bilateral loan the opinion will be addressed to the bank whereas in a syndicated loan it will be addressed to the agent (where the agent is the agent of the syndicate) and may also be addressed to the original syndicate lenders.

The opinion will only apply to matters of law and not of fact. The statements of opinion will often reflect the kind of legal representations given by the borrower in the loan agreement, e.g. that the documents associated with the loan are legally valid and enforceable.

An opinion does not give the bank any assurance that the borrower will be able to service the loan (i.e. pay the interest payments) or repay the loan (capital). It merely offers another level of comfort for the bank by confirming the further legal due diligence carried out on the borrower. It also provides the bank with an alternative course of action if the opinion is incorrect (i.e. against its lawyers).

For the above reason, legal opinions will always contain qualifications limiting the scope of the legal opinions and assumptions as to certain facts by the lawyers providing them.

If the lender is lending to a borrower incorporated in a foreign jurisdiction or a foreign subsidiary of the borrower is granting security over its assets, the lender will require a legal opinion from local lawyers. This opinion will generally cover the corporate capacity of the company in that jurisdiction and the validity of its choice of English law to govern any English law documents it enters into and (to the extent any of the documents entered into by the company are governed by the local law of its country of incorporation) the enforceability of any documents governed by the relevant local law.

**Legal opinions**

**Two situations where legal opinions are invariably required:**

• **Secured lending:** Banks will usually want an opinion to confirm the enforceability of the security, and to outline any risks associated with the security.

• **Overseas jurisdictions:** If the bank is lending to a borrower incorporated in a foreign jurisdiction or is taking security over assets in a foreign jurisdiction (e.g. the assets of a foreign subsidiary of the borrower), the bank will require a legal opinion from local lawyers. This opinion will generally cover the corporate capacity of the company in that jurisdiction and the enforceability, legality and priority of the documents which that company is entering into.

**Conditions Precedent: Lender perspective**

Lender solicitors should suggest and draft appropriate CPs to achieve that lender’s **commercial objectives** based, in particular, on the outcome of its **due diligence process**. CPs are important to the lender as they protect it and reduce its risk by allowing it to withdraw from the loan commitment if something is wrong or if the documentation is not to its satisfaction.

Completed CPs are **evidence** that the borrower’s position is as the credit committee anticipated at the outset of the deal. Lenders commonly demand a letter from their solicitors confirming that each CP has been satisfied (‘CP Satisfaction Letter’).

Notwithstanding the above, the lender / its agent can nonetheless waive a requirement for a CP if it is not capable of being satisfied prior to initial utilisation. The waiver would usually be documented in a CP waiver letter and the lender / its agent may specify that the condition must be met within a certain time period of completion. This condition will then be known as a ‘**condition subsequent’.** It is therefore important that the **CPs are always specified as being in form and substance satisfactory to the lender (in a bilateral loan) or the agent (in a syndicated loan).**

**Conditions Precedent: Borrower perspective**

A borrower will need to **exercise caution** when agreeing to CPs. As the borrower will not be able to draw down funds until CPs are satisfied (or waived), this could be disastrous if the funds are needed on time for a specific project (e.g. to fund an acquisition). therefore, the borrower should seek to have as many CPs as possible satisfied **before the loan agreement is signed**.

The list of CPs should be as **clear and objective** as possible so that the borrower knows exactly what is needed in order to satisfy **each individual CP**. In some circumstances certain CPs cannot be satisfied before the loan agreement is signed, so a borrower would be advised to have as many of such CPs in agreed form before signing.

**Practicalities**

**When drafting or reviewing the CPs, remember to check:**

Timing- Although no contractual time limits, will it be possible to satisfy the relevant CP in the time available before the funds need to be drawn down?

Approval- Who will decide if a CP is met - and are they to act reasonably? This is usually at the lender’s or its agent’s discretion: for example, “in form and substance satisfactory to the agent, acting reasonably”.

Control If third parties are involved (e.g. report providers), what control can be exercised over such parties to get the required information/documents delivered on time?

It is often a trainee’s responsibility to create a list of the CPs on the deal (‘CP Checklist’), including:

· making a list of the CPs in the order as they are drafted in the loan agreement; and

· documenting the status of each individual CP for information.

**Fees (clause 18)**

The fees to be paid by the borrower are set out in a fee clause (and, for syndicated loans, separate fee letter(s)) and usually comprise:

Commitment fee: This fee reflects the cost to the lenders of having set aside money to lend (rather than actually having handed over the money) during the availability period of the loan.

Arrangement fee/participation fee: Only relevant for syndicated loans. The arranger will charge a one-off fee, sometimes referred to as a front end fee, for its role as arranger of the loan. Although the loan agreement specifies that the arranger is to receive a fee, the actual amount of the arrangement fee is set out in a separate fee letter addressed to the arranger so it is kept confidential from the syndicate members

The arranger will decide, as part of the syndication strategy, how much of this fee to share amongst the lenders and how much to keep for itself. The amount each of the other lenders receives, often known as a participation fee, will usually depend on the amount of money that lender has committed to lending. These amounts are set out in the invitation letter sent out by the arranger to solicit banks to join the syndicate.

**Fees**

**Agent’s fee**: Only relevant for syndicated loans. This is the fee paid to the agent for its administrative services. It is normally paid annually but may be paid quarterly in some cases. Similarly to the arranger’s fee, the loan agreement specifies that the agent is to receive a fee and that it is for its own account. The actual amount of the agency fee is not disclosed in the loan agreement, but is set out in a separate fee letter addressed to the agent for the purpose of confidentiality. Note that even though the agent is appointed on behalf of the syndicate lenders it is the borrower that is responsible for paying this fee.

**Underwriting fee:** Only relevant for syndicated loans. This fee is paid to the arranger (and co-arrangers, if any) if a loan is underwritten. As seen previously, underwriting a loan means that the arranger (and co-arrangers, if any) will guarantee to provide the total loan amount to the borrower if it is/they are unable to fully syndicate the loan. This will be paid in addition to the arrangement fee. Again, it will be set out in a separate fee letter between the arranger and the borrower

**Security Trustee fee:** This will be paid by the borrower to the security trustee (or security agent) on a secured deal. Like the agent’s fee, it will be set out in a separate fee letter.

**Summary**

• The Purpose clause sets out what the loan monies can be used for.

• The Facility set out the type of facility the lender is prepared to provide under the loan agreement.

• Conditions Precedent (or ‘CPs’) are conditions that a borrower must fulfil before a lender becomes obliged to lend.

• A borrower is therefore unable to draw down any funds from a loan until the CPs are either satisfied or waived by the lender / its agent.

• The Fees clause set out the fees the borrower will have to pay in connection with the facility, but the actual amount of the fees will be set out in a separate fee letter, to ensure confidentiality from other syndicate members.

**Green Loan Principles**

The green loan market aims to facilitate and support environmentally sustainable economic activity. The Green Loan Principles (GLP) have been developed by an experienced working party, consisting of representatives from leading financial institutions active in the global syndicated loan markets, with a view to promoting the development and integrity of the green loan product.

**Guidance on Green Loan Principles (GLP)**

The Green Loan Principles (GLP) were originally published in 2018 and provide a framework for what is recognized as an increasingly important area of finance. In order to promote the development of this product, and underpin its integrity, the APLMA, LMA, and LSTA considered it appropriate to produce Guidance on the GLP, to provide market practitioners with clarity on their application and promote a harmonized approach.

**Sustainability Linked Loan Principles (SLLP)**

Sustainability-linked loans aim to facilitate and support environmentally and socially sustainable economic activity and growth. The Sustainability-Linked Loan Principles (SLLP) have been developed by an experienced working party, consisting of representatives from leading financial institutions active in the global syndicated loan markets.

**Guidance on Sustainability Linked Loan Principles (SLLP)**

The Sustainability-Linked Loan Principles (SLLP) were originally published in 2019 and provide a framework for what is recognized as an increasingly important area of finance. The SLLP underwent a structural revision in 2021, to provide a clear delineation between the selection of key performance indicators (KPIs) and the calibration of sustainability performance targets (SPTs).

In order to promote the development of this product, and underpin its integrity, the APLMA, LMA and LSTA considered it appropriate to produce Guidance on the SLLP, to provide market practitioners with clarity on their application and promote a harmonized approach.

This Guidance note should be read alongside the [**SLLP**](https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/). Guidance is also available for the [**Green Loan Principles (GLP)**](https://www.lsta.org/content/guidance-on-green-loan-principles-glp/) and [**Social Loan Principles (SLP)**](https://www.lsta.org/content/guidance-on-social-loan-principles-slp/). Both sets of Guidance are intended to highlight the differences between, and suitability of application of, the SLLP, GLP, and SLP to any particular deal.

**Loan Agreement provisions – Purpose, Facility, Conditions Precedent and Fees**

This element starts exploring the provisions in a loan agreement, focussing on the purpose, facility, condition precedent and fees clauses.

Note: Any clause references throughout this element refer 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.

**Introduction**

Once the terms have been agreed, attention can turn to drafting and negotiating the loan agreement and security documentation (if loan is to be secured).

Although every deal is different and the loan agreement needs to be tailored to the requirements of the transaction, these slides seek to highlight common clauses found in a loan agreement, as a starting point.

If the loan agreement is based on an LMA standard form (which will be the case for most corporate loans) the guarantee(s) (if given) will be incorporated into the loan agreement, so you will not expect to see a separate document for the guarantee(s).

The key clauses of a loan agreement are set out below and will be considered in the next few elements.

Finally, as a more general point, where you have a group of companies and there are separate loans at different levels of the group, this gives rise to the risk of subordination, which will be also be considered at the end of the discussion of clauses in a loan agreement.

**Loan Agreements – overview of key clauses**

**[Flowchart – with “Contents of a Loan Agreement” at the centre with arrows pointing towards the following terms clockwise in order]**

- Facility

- Purpose

- Conditions Precedent

- Governing Law and Enforcement

- Interest and Interest Periods

- Fees

- Withholding tax and tax gross up

- Increased Costs provision

- Representations

- Undertakings

- Financial Covenants

- Events of Default

**Purpose clause (clause 3)**

The purpose behind the loan shapes the transaction. It needs to be consistent with each lending bank’s policy. It also focuses the lender’s mind as to what the documentation must contain in order to protect its position. This clause also restricts the borrower to ensure the funds are used for agreed purposes only.

If there is an obvious violation of the purpose clause, the borrower will be in default and may hold the monies subject to a resulting trust in favour of the lender. This gives the lender an advantage in the event that insolvency follows default, because the money may be deemed to be held on trust for the lender and not to form part of the assets of the borrower on a winding-up *(Barclays Bank Ltd. v. Quistclose Investments Ltd* [1970] AC 567, HL*).*

In practice it is usual for the purpose clause to include a general statement relating to the purpose, for example that the funds must be used ‘towards the borrower’s working capital requirements’ or ‘towards general corporate purposes’.

**Purpose clause**

If the lender knows a facility is for an unlawful purpose, e.g. it will breach government imposed sanctions, then English law will treat the facility as void and unenforceable and will disallow any action to recover the funds advanced. Subsequent illegality of an initially lawful agreement, however, is treated differently and the lender can recover the funds by calling a **mandatory prepayment event** for **illegality** in the loan agreement (see clause 12.1 of the LMA Agreement).

**Facility clause (clause 2)**

Generally, a term loan can be drawn down during a relatively short period of time after the loan agreement is signed (called the ‘commitment’ or ‘availability’ period ). If the borrower does not draw down the funds in that period, the lender’s obligation to lend ceases. Compare this to the position with an overdraft or a revolving credit facility (‘**RCF**’) that can generally be drawn on at any time during the term of the loan, up to the specified loan amount.

In some transactions, the lender will agree to make the money available in a number of separate facilities or tranches (i.e. portions) all in the same loan agreement. Each facility and/or tranche may have different characteristics relating to maturity dates, availability, interest periods and repayment terms.

The existence of more than one facility and/or tranche in the loan agreement will be reflected in the mechanical provisions of the agreement such as the drawdown, repayment and interest provisions. The remaining terms of the agreement, such as representations, undertakings and the events of default, will apply to the agreement as a whole, irrespective of the different facilities and/or tranches.

**Facility clause**

The clauses mentioned below are only found in syndicated facilities:

• **Several obligations (clause 2.4(a)).** Each lender’s obligation to lend under a syndicated loan is several and not joint. As a result, syndicate members are responsible for their commitment only. This means syndicate members do not guarantee that the other lenders will provide their share of the loan. Conversely, the failure of one syndicate member to satisfy its obligations does not allow the others to back out.

• Each lender has a separate right of enforcement (clause 2.4(c)). However, in practice this right is subject to the decision of the Majority Lenders to accelerate the loan (clauses 29.20 ) and to the syndicate members’ obligation to share any amounts received under the pro rata sharing clause (clause 35).

• **Separate loans (clause 2.4(b)).** Legally, each lender agrees to make a separate loan to the borrower up to the maximum amount it has agreed to lend (its **commitment**).

• You might also hear about a lender’s ‘proportion’ or ‘participation’. This is simply the ratio of its commitment against total syndicate commitments. Lenders’ contributions to loan advances and payments of principal and interest made by a borrower are divided amongst the lenders in this proportion.

• For example, a syndicate of banks is put together to provide a borrower with a term loan of £25,000,000. There are 5 banks in the syndicate, each of whom has agreed to lend up to £5,000,000 (their individual commitment). If the borrower decides to drawdown £20,000,000 then each syndicate lender will have a participation of £4,000,000.

**Conditions Precedent (‘CPs’) (clause 4 and schedule 2 Part 1B)**

**Conditions Precedent (or ‘CPs’)** are conditions that a borrower has to fulfil before a lender becomes obliged to lend. A borrower is therefore unable to draw down any funds from a loan until the CPs are either a) satisfied or b) waived by the lender / agent (if a syndicated loan). These are explained below:

**CPs to first utilisation:**

These are mainly documentary in nature and are intended to ensure all legal and certain other matters (such as commercial, regulatory and practical matters) are in order and that, for a secured loan, any security is in place before the lender is obliged to lend any money. For an acquisition finance transaction, the security package granted by the target group companies will be put in place after the acquisition has been funded and completed.

**Further conditions precedent:**

These are also known as 'drawstops'.

It will be a condition to each new advance that certain of the representations (i.e. statements of fact) made on the original signing date are true and correct. These are known as the 'Repeating Representations'.

It will also be a condition to each new advance that no **actual or potential** event of default is outstanding. This applies to all advances under any loan except a 'rollover' loan under an RCF

For a 'rollover' under an RCF, the condition to the further advance will be (less onerously) no **actual** event of default is outstanding.

**Conditions Precedent: Function**

A lender is not obliged to make loan advances immediately upon the signing of the loan agreement – any loan advances are subject to satisfaction of the CPs. The CPs are included in the loan agreement to ensure that all legal matters are in order and that a lender is not obliged to lend if the borrower has become a greater credit risk than when the financial terms were agreed. However, certain fees will accrue from the date of signing so it is not in a borrower’s interests to sign the loan agreement unless it is confident it will be in a position to meet all CPs at the point it requires the monies. Accordingly, the process of agreeing, collecting and approving CPs takes place before the completion date as far as possible.

Very often it is a trainee’s responsibility to organise, agree and check CPs in connection with any loan agreement. If there is an international element to the transaction, this can involve liaising with overseas companies and lawyers.

**Examples of Conditions Precedent**

CPs vary according to the circumstances of the borrower and should be altered for each transaction. The following are examples of common CPs:

- constitutional documents (e.g. the company’s articles);

- **legal opinion(s);**

- insurance policies;

- financial information and auditors’ reports;

- any licences/consents relevant to that borrower;

- board resolutions or other corporate authorisations;

- compliance with KYC (‘know your client’) requirements (although this is normally dealt with internally by the lender’s compliance team); and

- evidence that all fees have been paid.

- Depending on the circumstances of the particular deal there may also be deal-specific CPs, for example in a real estate finance deal (where a property purchase is being financed) there will be property related CPs such as valuation reports, reports on title and environmental reports.

**What is a legal opinion?**

Broadly, a legal opinion is a letter confirming the corporate capacity of the borrower (and, if relevant, any guarantor or security provider) and that the finance documents (i.e. the loan agreement and, where relevant, any security agreement or guarantee) are legally valid, binding and enforceable. It is another way for the bank to reduce the risk of non-payment.

It is usually the bank’s solicitors who will be asked to give the opinion but it may, on occasion, be the borrower’s solicitors. In a bilateral loan the opinion will be addressed to the bank whereas in a syndicated loan it will be addressed to the agent (where the agent is the agent of the syndicate) and may also be addressed to the original syndicate lenders.

The opinion will only apply to matters of law and not of fact. The statements of opinion will often reflect the kind of legal representations given by the borrower in the loan agreement, e.g. that the documents associated with the loan are legally valid and enforceable.

An opinion does not give the bank any assurance that the borrower will be able to service the loan (i.e. pay the interest payments) or repay the loan (capital). It merely offers another level of comfort for the bank by confirming the further legal due diligence carried out on the borrower. It also provides the bank with an alternative course of action if the opinion is incorrect (i.e. against its lawyers).

For the above reason, legal opinions will always contain qualifications limiting the scope of the legal opinions and assumptions as to certain facts by the lawyers providing them.

If the lender is lending to a borrower incorporated in a foreign jurisdiction or a foreign subsidiary of the borrower is granting security over its assets, the lender will require a legal opinion from local lawyers. This opinion will generally cover the corporate capacity of the company in that jurisdiction and the validity of its choice of English law to govern any English law documents it enters into and (to the extent any of the documents entered into by the company are governed by the local law of its country of incorporation) the enforceability of any documents governed by the relevant local law.

**Legal opinions**

**Two situations where legal opinions are invariably required:**

• **Secured lending:** Banks will usually want an opinion to confirm the enforceability of the security, and to outline any risks associated with the security.

• **Overseas jurisdictions:** If the bank is lending to a borrower incorporated in a foreign jurisdiction or is taking security over assets in a foreign jurisdiction (e.g. the assets of a foreign subsidiary of the borrower), the bank will require a legal opinion from local lawyers. This opinion will generally cover the corporate capacity of the company in that jurisdiction and the enforceability, legality and priority of the documents which that company is entering into.

**Conditions Precedent: Lender perspective**

Lender solicitors should suggest and draft appropriate CPs to achieve that lender’s **commercial objectives** based, in particular, on the outcome of its **due diligence process**. CPs are important to the lender as they protect it and reduce its risk by allowing it to withdraw from the loan commitment if something is wrong or if the documentation is not to its satisfaction.

Completed CPs are **evidence** that the borrower’s position is as the credit committee anticipated at the outset of the deal. Lenders commonly demand a letter from their solicitors confirming that each CP has been satisfied (‘CP Satisfaction Letter’).

Notwithstanding the above, the lender / its agent can nonetheless waive a requirement for a CP if it is not capable of being satisfied prior to initial utilisation. The waiver would usually be documented in a CP waiver letter and the lender / its agent may specify that the condition must be met within a certain time period of completion. This condition will then be known as a ‘**condition subsequent’.** It is therefore important that the **CPs are always specified as being in form and substance satisfactory to the lender (in a bilateral loan) or the agent (in a syndicated loan).**

**Conditions Precedent: Borrower perspective**

A borrower will need to **exercise caution** when agreeing to CPs. As the borrower will not be able to draw down funds until CPs are satisfied (or waived), this could be disastrous if the funds are needed on time for a specific project (e.g. to fund an acquisition). therefore, the borrower should seek to have as many CPs as possible satisfied **before the loan agreement is signed**.

The list of CPs should be as **clear and objective** as possible so that the borrower knows exactly what is needed in order to satisfy **each individual CP**. In some circumstances certain CPs cannot be satisfied before the loan agreement is signed, so a borrower would be advised to have as many of such CPs in agreed form before signing.

**Practicalities**

**When drafting or reviewing the CPs, remember to check:**

Timing- Although no contractual time limits, will it be possible to satisfy the relevant CP in the time available before the funds need to be drawn down?

Approval- Who will decide if a CP is met - and are they to act reasonably? This is usually at the lender’s or its agent’s discretion: for example, “in form and substance satisfactory to the agent, acting reasonably”.

Control If third parties are involved (e.g. report providers), what control can be exercised over such parties to get the required information/documents delivered on time?

It is often a trainee’s responsibility to create a list of the CPs on the deal (‘CP Checklist’), including:

· making a list of the CPs in the order as they are drafted in the loan agreement; and

· documenting the status of each individual CP for information.

**Fees (clause 18)**

The fees to be paid by the borrower are set out in a fee clause (and, for syndicated loans, separate fee letter(s)) and usually comprise:

Commitment fee: This fee reflects the cost to the lenders of having set aside money to lend (rather than actually having handed over the money) during the availability period of the loan.

Arrangement fee/participation fee: Only relevant for syndicated loans. The arranger will charge a one-off fee, sometimes referred to as a front end fee, for its role as arranger of the loan. Although the loan agreement specifies that the arranger is to receive a fee, the actual amount of the arrangement fee is set out in a separate fee letter addressed to the arranger so it is kept confidential from the syndicate members

The arranger will decide, as part of the syndication strategy, how much of this fee to share amongst the lenders and how much to keep for itself. The amount each of the other lenders receives, often known as a participation fee, will usually depend on the amount of money that lender has committed to lending. These amounts are set out in the invitation letter sent out by the arranger to solicit banks to join the syndicate.

**Fees**

**Agent’s fee**: Only relevant for syndicated loans. This is the fee paid to the agent for its administrative services. It is normally paid annually but may be paid quarterly in some cases. Similarly to the arranger’s fee, the loan agreement specifies that the agent is to receive a fee and that it is for its own account. The actual amount of the agency fee is not disclosed in the loan agreement, but is set out in a separate fee letter addressed to the agent for the purpose of confidentiality. Note that even though the agent is appointed on behalf of the syndicate lenders it is the borrower that is responsible for paying this fee.

**Underwriting fee:** Only relevant for syndicated loans. This fee is paid to the arranger (and co-arrangers, if any) if a loan is underwritten. As seen previously, underwriting a loan means that the arranger (and co-arrangers, if any) will guarantee to provide the total loan amount to the borrower if it is/they are unable to fully syndicate the loan. This will be paid in addition to the arrangement fee. Again, it will be set out in a separate fee letter between the arranger and the borrower

**Security Trustee fee:** This will be paid by the borrower to the security trustee (or security agent) on a secured deal. Like the agent’s fee, it will be set out in a separate fee letter.

**Summary**

• The Purpose clause sets out what the loan monies can be used for.

• The Facility set out the type of facility the lender is prepared to provide under the loan agreement.

• Conditions Precedent (or ‘CPs’) are conditions that a borrower must fulfil before a lender becomes obliged to lend.

• A borrower is therefore unable to draw down any funds from a loan until the CPs are either satisfied or waived by the lender / its agent.

• The Fees clause set out the fees the borrower will have to pay in connection with the facility, but the actual amount of the fees will be set out in a separate fee letter, to ensure confidentiality from other syndicate members.

**Loan Agreement provisions – Representations**

This element explains the nature, purpose and effect of representations 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.

**Representations: overview (Clause 25)**

Representations are **statements of fact** about the borrower and its business – they are **based on the day of signing and certified as true** by the borrower as at that date.

Representations constitute the **contractual basis** on which a lender makes and continues to make a loan available.

‘Representations’ and ‘warranties’ are **interchangeable terms** in respect of loan agreements. These are treated in the same way since the loan agreement provides a contractual remedy for both under what would be a misrepresentation at common law.

The difference between representations and warranties at common law is very important where common law and/or statutory remedies are relied on, but this is only rarely the case under a loan agreement. Under a loan agreement, a **breach of any of the representations and warranties is an event of default** which has **specific contractual remedies**.

**Representations are split into two basic categories:**

**Legal matters**

These representations cover:

• a borrower’s legal status;

• its capacity to enter into the agreement; and

• the validityor enforceability of the agreement

**Commercial matters**

These representations cover the credit standing and financial condition of the borrower.

**Representations: the basics**

Certain representations occur in every loan agreement. For example:

The borrower stating that there is no current, threatened or pending litigation against it as this is fundamental information.

Other matters are deal specific and relate to the particular borrower’s business. These are linked to the lender’s decision to lend or might have arisen as a result of due diligence and are viewed as problematic.

**What if the borrower cannot make the representation as it is untrue?**

If a borrower is unable at the outset of the loan to make a certain representation (namely because it is untrue), it will need to qualify the drafting of the representation in the loan agreement itself. Sometimes a borrower will disclose a problem to the lender in a disclosure letter prior to signing the loan agreement, but this is less common.

As a misrepresentation will trigger an **event of default**, the borrower will want to limit the scope of the representations.

**Examples of representations**

Status (i.e., that the borrower has been duly incorporated)

All information provided by the borrower is correct and is not misleading

There is no litigation either ongoing, threatened or pending against the borrower

Power and authority (i.e. that the borrower has the power and authority to enter into the loan agreement)

No event of default currently exists in respect of the borrower

[Pen Symbol]

**Task:** Read the following representations in clause 25 of the LMA Agreement: Status (25.2), Power and authority (25.5), No default (25.11), No misleading information (25.12) and No proceedings (25.14).

Who is giving these representations?

**Representations: Repetition**

The lender will want some or all of the representations to be **repeated at regular intervals** (given that there is an ongoing relationship between the lender and the borrower through the loan agreement).

Typically, the representations are made on the **date of the signing of the loan agreement,** and they are then usually repeated:

on the **date of each request for a loan** (a utilisation request); and

on the **first day of each Interest Period** (see Element 4 for more details on an interest period).

There will be a **balancing exercise** between the lender wanting as many representations repeated as possible; and the borrower seeking to limit the number of representations being repeated (for both practical and factual reasons).

In relation to repetition of representations, the **borrower will commonly argue** that:

- certain matters cannot or are **unlikely to change** (e.g. that it is validly incorporated);

- some statements are **only relevant upon signing,** such as information contained within original financial statements;

- the content of the representation is covered under a **separate undertaking**; and/or

- the lender is afforded **protection by an indemnity** (particularly relevant in the case of withholding of tax whereby if the law is changed leading to a deduction, the lender is protected through a ‘gross-up’ provision within the loan agreement).

**Representations: Lender's perspective**

For the lender, a representation helps to **reduce the risk** of entering into the loan. It forces the borrower to disclose certain information about itself under the representation (and this is done ahead of signing the loan agreement).

The lender also **gains control** here as a breach of any representation leads to an **event of default.**

The borrower’s inability to repeat any representation also **triggers a drawstop event** which leads to the borrower being **suspended** from any further borrowing under the loan agreement (see clause 4.2(b)).

**Representations: Borrower perspective**

A borrower should try to **resist repetition** as much as possible. It should always refuse to repeat the representation that there is no ‘potential event of default’ (note that a ‘Default’ in the LMA Agreement includes both an actual event of default and a potential event of default). An inability to say there is no potential event of default will then amount to an actual event of default for misrepresentation. See Topic- Loan agreements (II) Element 2 (Lender's options) for more detail on potential events of default.

A borrower should also **be wary of making absolute statements** – as it will not want an immaterial inaccuracy to be a misrepresentation.

Any borrower with a **significant number of subsidiaries** will need to ensure that, if required to make the same representations about these subsidiaries, that they are able to establish adequate reporting lines and to carry out the required due diligence.

An objection may arise from the borrower to make a representation on behalf of minor or irrelevant group companies. A compromise, in those circumstances, is to limit the representation to only specific subsidiaries or **‘Material Subsidiaries’**.

The borrower then has less administrative obligations to monitor all subsidiaries. The lender does, however, still gain comfort that the more important subsidiaries comply with the representation.

‘Material Subsidiaries’ are often defined as the Obligors and any company that constitutes a **certain percentage of the group’s turnover, profit or asset value** (each of these being specific to the deal).

A common response from the borrower is to also attempt to limit its representations and warranties with a **knowledge qualification** (i.e., such as stating that each representation is ‘**to the best of its knowledge and belief’**).

A lender is often **reluctant** to accept this, other than in very specific situations. This is because it undermines the very object of representations; the borrower should accept the risk and monitor both itself and any subsidiaries to ensure that it stays roughly the same entity throughout the loan period (therefore keeping the lender comfortable).

**Summary**

• Representations are **statements of fact** about the borrower and its business – they are **based on the day of signing and certified as true** by the borrower as at that date.

• Representations constitute the **contractual basis** on which a lender makes (and continues to make) a loan available.

• Certain representations occur in every loan agreement while others are ‘deal specific’ and are linked to the commercial elements of a particular deal.

• Representations are typically made on the **date of the signing of the loan agreement,** and they are then usually repeated (1) on the **date of each request for a loan** (a utilisation request) and (2) on the **first day of each Interest Period.**

• There will be a **balancing exercise** between (1) the lender wanting as many representations repeated as possible (2) the borrower seeking to limit the number of representations being repeated for practical and factual reasons and (3) the borrower seeking to limit the scope of the representations through, for example, materiality qualifications.

**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.

**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.

• **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.

**Loan Agreement Provisions –**

**Interest, Margin Protection Provisions and Subordination**

This element explains how interest is calculated is a loan agreement and the purpose of margin protection provisions. It then goes on to consider the concept of subordination.

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.

**Interest and Interest Periods (clauses 15 and 16)**

**Interest**

In addition to the repayment of the initial amount of the loan itself, a lender will charge interest on the loan during its term. The interest rate is key here and we will look at this later in this element.

**Interest Period**

Before we look at the different rates of interest, we must clarify what we mean by an interest period:

**Term Loan:** The loan is drawn down by a borrower in the ‘Availability Period’ and the loan remains outstanding until the ‘Maturity Date’. Interest is then calculated under successive interest periods, the first of which starts on the drawdown date with the remaining interest periods beginning on the last date of the preceding period.

**Revolving Credit Facilities:** The loan is available for drawdown at any time and monies can be repaid and redrawn over the period of the loan. Each advance of the loan has its own interest period, with the advance being either repaid or rolled over on the last day of that interest period.

**Interest Rate**

• A **fixed rate** is a rate of interest that is unchanging for the life of the loan. It will provide the lender (and the borrower) with certainty. However, this certainty comes at a cost. If the base rate of interest rises, the lender may find that its own cost of funds increases meaning the cost to the lender exceeds the amount of interest it is receiving from the borrower. To offset this risk, a fixed rate of interest tends to be higher than the floating rate available to the borrower at the time the loan agreement is entered into and is therefore, less attractive to the borrower. Therefore, **fixed rate interest is rare in corporate lending**.

• Most corporate loans will bear interest at a **floating rate.** At the simplest level, banks, like any other business, make their profit on the difference between the price of the product they sell and the cost of making that product available. Applying this concept to loans, the “cost” of the loan is the lender’s cost of borrowing the money (known as its 'cost of funds').

• The interest rate charged by a lender on a loan will generally be a benchmark rate plus the 'margin' as will be discussed below. This means the interest rate will vary throughout the life of the loan to broadly reflect the fluctuating cost to the lender of providing the finance to the borrower. Benchmarks are calculated by independent bodies, so create an element of standardisation and transparency in the market.

**Floating rate interest benchmark: LIBOR - RFRs**

• Until recently, LIBOR (which stands for the London Interbank Offered Rate) was the main interest benchmark rate used around the world for corporate lending.

• Set in London, LIBOR is a screen rate derived by the LIBOR administrator (ICE Benchmark Association, which is supervised by the FCA) from panel banks submitting daily their own internal rates for lending in one of the five LIBOR currencies (sterling, US dollars, the euro, the Swiss franc and the Japanese yen) for each of seven interest periods (overnight, one week, one month, two months, three months, six months and twelve months).

• As a result of the LIBOR manipulation scandal, and the fact that changes in the interbank market have meant that many LIBOR settings are not grounded in sufficient transactional data (because there is so little trading for certain currencies), confidence in the reliability and robustness of existing interbank benchmark interest rates was undermined. As a result, the Financial Stability Board recommended in 2014 that stakeholders around the world should identify Risk Free Rates ('**RFR**s') that might be used as alternative benchmark interest rates to LIBOR.

**Floating rate interest benchmark: relevant RFR – SONIA**

• The replacement to LIBOR is the relevant risk-free rate (‘**RFR**’).

• The relevant RFR for sterling loans is the Sterling Overnight Index Average ('**SONIA**'). This is what we will use for the purposes of this Workstream. Other currencies have different RFRs (e.g. US dollar loans have the Secured Overnight Financing Rate (‘**SOFR**’), while Euro loans have the Euro Short-Term Rate (‘**€STR**’), though EURIBOR continues to be used as an alternative benchmark to LIBOR for euro loans).

• The dates for the discontinuation of LIBOR differs depending on the currency, but sterling LIBOR ceased to be published from 31 December 2021 on its original basis.

• SONIA is administered by the Bank of England and broadly reflects the average of the actual interest rates the banks have paid to borrow sterling overnight, on an unsecured basis, from other financial institutions in circumstances where credit, liquidity and other risks are minimal.

• Unlike LIBOR, the RFRs are only produced as overnight backward-looking rates. SONIA for a given London business day is published by the Bank of England at 9 am on the following London business day.

**Floating rate interest benchmark: relevant RFR**

• At a very basic level, the lender (or agent in a syndicated loan) will work out the relevant RFR at the end of each interest period and will notify the borrower of the amount of interest to be paid (which will be the RFR plus margin (see below)).

• A lender may use its own base rate as the cost of funds as an alternative to the relevant RFR. The lender’s base rate will vary as it will usually track whatever the Bank of England’s base interest rate is. The borrower will still have to pay a specified margin above this (see below). However, it is rare for base rates to be used in corporate lending.

**Interest rate components**

**Floating Rate** This is the rate that we will use in this knowledge stream and is made up of:

**RFR**

• The costs of funding by a lender fluctuate and so an element of the interest that is to be paid will float (in that it will be calculated for a set interest period).

• The lender (or the agent in a syndicated loan) will work out the relevant RFR at the end of each interest period and notify the borrower of the amount of interest to be paid.

• The amount of interest will be the RFR combined with the margin.

[AND]

**Margin**

• This is broadly the profit made by the lenders. The margin will usually be a fixed rate on top of the relevant RFR (or the base rate). The level of the margin will depend on the risk associated with the particular borrower/transaction as well as general market conditions.

• The margin is usually expressed as a percentage per annum based on the lender’s quote which is usually in basis points per annum. You need to be able to translate between the two (100 basis points = 1%, so a margin rate of 1.9% per cent per annum = 190 basis points).

**Default Interest**

• Default interest is a specific rate of interest which protects the lender against any late or non-payment of interest (or, as applicable, capital).

• The default rate is usually expressed as a fixed rate above the normal contractual rate: e.g., 1% above the interest rate payable on the loan. This is a higher rate of interest as - upon late or non-payment - a borrower becomes a higher credit risk and so the lender requires **compensation**.

• Default interest covers any additional borrowing costs of a lender and reflects the change in the credit risk of the borrower.

• A concern for the lender is, if the default interest clause is challenged, the court may judge it to be unenforceable as a penalty. Whether a clause is held by a court to be unenforceable would depend on whether the level of interest would be out of all proportion to any ‘legitimate interest’ of the lender. When setting the level of default interest, therefore, the lender has to be careful not to set it too high.

**Margin protection provisions: Overview**

• As seen the interest rate charged by a lender is usually calculated by adding a margin to the floating rate element. If the cost of lending rises, the lender needs to be able to pass that increase onto the borrower to protect its profit.

• The main 'threats' to a lenders margin include **withholding tax** and **increased costs**.

• Margin protection provisions within a loan agreement are those which aim to protect a lender against such events which could erode their margin and thereby ensure the lender is not out of pocket.

• This will be achieved by including in the loan agreement margin protection provisions, namely a '**tax gross-up**' clause to deal with the imposition of withholding tax and an '**increased costs**' clause to deal with the imposition of increased costs. These will be considered below.

• Such clauses are potentially disadvantageous to a borrower. However, the loan agreement also provides some protections for the borrower.

• Any interest that a lender will receive from a borrower will comprise income for the lender. This income will fall within the lender’s computation for UK corporation tax.

• A payment of UK source interest is subject to UK ‘withholding tax’ unless the lender falls within one of a number of exceptions.

• ‘**Withholding tax**’ is a mechanism for tax authorities to collect tax at source, so the corporation tax liability of the lender will be deducted (or withheld) at source by the borrower and paid directly to HMRC.

• The lender would then receive its interest payment net of (i.e. reduced by) the withholding tax.

• Subject to specific conditions being met, an exemption may be available where the lender is a UK bank, or where the lender is a UK corporate. If an exemption applies, the lender will be able to receive interest from the borrower **gross** of any tax (i.e. the borrower will not have to withhold tax).

**Withholding tax and banks**

• The LMA Agreement refers to a '**Qualifying Lender**', which includes UK banks and UK corporates subject to the exemption mentioned above, and lenders in jurisdictions with which the UK has a double tax treaty, referred to as a '**Treaty Lender'.**

**Purpose of a tax gross-up clause (clause 19.2(a)-(d))**

• The commercial terms agreed between a UK bank lender and borrower will usually assume that the full amount of interest will be paid to the bank (without any withholding).

• However, the ‘**Tax Gross Up**’ clause protects the lender in a scenario whereby tax is deducted, for example if the **borrower ceases to be exempt from its withholding tax obligation**, or if **there is a change in law.**

• The 'Tax Gross Up' clause usually makes the borrower responsible for the cost of any withholding tax, by requiring the borrower to ‘gross up’ (i.e. increase) the amount of any interest paid so that, after tax has been deducted, the lender receives the original amount which it would have received if the deduction had not been made. Therefore, the lender is not out of pocket.

**Purpose of increased costs clause (clause 20)**

• This clause protects a lender in a situation where its underlying costs relating to a loan facility increase **as a result of a change in law**. In such a scenario, the borrower will be required under the increased costs clause to compensate the lender for the increase.

• Where any costs associated with the loans do rise unexpectedly, this will have a knock-on effect on margin. This, in turn, could lead to the profits of the lender suffering.

**Increased costs and banks**

**What kinds of cost are envisaged?**

• Costs arising from changes in rules relating to maintaining regulatory capital in accordance with capital adequacy rules. Broadly, these rules require lenders to maintain a sufficient proportion of capital compared to loans, to protect depositors in case those loans are not repaid.

• Costs arising from any other changes in law or regulation to which the lender is subject.

**What kind of costs would not be recoverable from the borrower?**

• Costs arising from non-compliance/breach of any law or regulation the bank is subject to.

• Costs arising from changes in tax law. The lender would be protected by the tax gross-up provisions.

**Protections for the borrower**

• If the borrower is obliged to pay additional amounts under either the gross-up clause or the increased costs clause, there may be certain protections available to it in the loan agreement.

• The Borrower may have the right to prepay the affected lender if withholding tax would be required to be paid in respect of that lender and the borrower would have to gross-up its interest payment to that lender or if increased costs were payable by the borrower (clause 12.6(a)). Note, under clause 2.3 a borrower can request that another lender takes on the amounts that would otherwise be cancelled under clause 12.6(a).

• For gross-up only, the borrower may be entitled to receive from the lender the amount paid to HMRC if the lender receives an equivalent amount in the form of a tax credit and can attribute that tax credit to the amount the borrower paid (clause 19.4).

• There are certain circumstances where loans are transferred between lenders in which the tax gross-up clause or increased costs clause will not be triggered.

• Finally, clause 22 (‘**Mitigation**’) sets out a duty on the lender to act so as to minimise any application of the tax gross up and increased costs clauses. This is designed to give a borrower some comfort that a lender will not rely on the open-ended protection which those clauses afford and make no attempt to minimise or avoid the increased tax or other costs.

**Subordination**

• We have now considered the key clauses in a loan agreement.

• The remaining slides focus on a problem that arises when there is a group of companies and there are loans at different levels of the group.

• This is known as **structural subordination.**

**Structural Subordination**

• It is very common for companies to operate under a group structure where a holding company has 100% shareholdings in subsidiaries. These subsidiaries may be operating companies, running businesses and owning assets or themselves intermediate holding companies of operating companies. Lenders may lend to the holding company which then filters the money down to the subsidiary(y/ies).

• This can cause problems for the lender which lends to the holding company if the subsidiaries have existing loans or later take out loans. This is because of the statutory order of repayment of creditors on the winding-up of a company.

**The repayment of creditors on a winding-up is made in the following order (note: this is a deliberately simplified list):**

• fixed chargeholders;

• preferential creditors;

• payments out of the ring-fenced fund;

• floating chargeholders;

• unsecured creditors; and finally

• shareholders.

**Subordination**

**Example:**

*[Diagram: Bank X arrow under box “Lends” to Hold Co ; line from Hold Co to Company A and line from Hold Co Company B (under box “100% subsidiaries”) ; Arrow from Bank Y to Company B under box “Lends 18 months later”].*

**Structural Subordination**

**Example:**

• Companies A and B are wholly-owned subsidiaries of HoldCo. Companies A and B are the operating companies owning the majority of the group’s assets and generating the income for the group. HoldCo’s only assets of value are the shares in its subsidiaries and it does not generate any of its own income.

• Bank X lends money to HoldCo. 18 months later, Bank Y lends money to Company B.

• On a winding up of the group, the assets of Company B will not be available to satisfy the debt owed by HoldCo to Bank X until Bank Y (and any other creditors of Company B) has been paid in full. This is because HoldCo only has a claim to the assets of Companies A and B as a shareholder – and, as can be seen from the above list, shareholders are the last to be paid on a winding up.

• Note that the issue is the existence of the **loan** to Bank Y. **It does not matter if this loan between Company B and Bank Y is secured or not** because Bank Y, whether as a fixed chargeholder (if the loan is secured) or an unsecured creditor (if the loan is unsecured), will still rank above Holdco as shareholder.

• Because of the group structure, and the order of claims imposed by the statutory order of payments on a winding up, **Bank X is said to be ‘structurally subordinated’ to Bank Y**.

**Structural Subordination- solutions**

**Unsurprisingly, this situation is unsatisfactory to Bank X. To reduce the effect of a situation like the one in the example, Bank X can:**

• Insist on HoldCo giving (1) no financial indebtedness, (2) negative pledge and (3) no disposals undertakings to Bank X in the loan agreement. These would restrict HoldCo and HoldCo’s subsidiaries from (1) creating more than a certain amount of debt; (2) granting security over their assets; and (3) selling any of their assets. The aim is to limit the amount owed to creditors that would rank ahead of Bank X on a winding up of the group and to retain as many assets as possible in the group which are unsecured and available to pay off creditors. These would also ensure that no further debt could be taken on at Company B level, meaning that Bank X is not further structurally subordinated in respect of additional lenders to Company B.

• Take a guarantee and/or take security from Company B so Bank X has a direct claim against Company B or its assets.

• Require a subordination agreement between the respective lenders (i.e., contractual subordination) (see slides below).

**Contractual Subordination**

• Where there are different lenders either in a group structure (as above) or within a transaction (e.g. there may be a loan from a syndicate as well as a separate loan being given by a shareholder or the directors) then these lenders can decide amongst themselves the order in which they will be paid by a defaulting borrower.

• The document which governs this arrangement is invariably either called a subordination agreement, an intercreditor deed or a deed of priorities.

• There are various ways that contractual subordination can be structured but the most common is when the junior lender agrees that it will not demand the junior debt from the borrower until such time as the senior lender has been paid in full.

• This might be drafted to include all monies owed to the junior lender or just the amount of principal owed (so the junior lender is able to receive any fees or interest owed to it).

• Only when the senior lender has been paid in full will all amounts outstanding to the junior lender be paid in the agreed contractual order of priority.

• If the junior lender receives money from the borrower before the senior lender has been paid in full the agreement usually provides that the junior lender will hold this money on trust for the senior lender.

• It is sometimes the case that all of the lenders who have entered into a contractual subordination agreement have taken security for their loans. In this instance, the senior lender will not want a junior lender being able to enforce its security (and thereby forcing the senior lender’s hand) so the agreement will also include a provision restricting when the junior lender can enforce its security.

• Enforcement of security is often only allowed with the consent of the senior lender.

• The agreement should also provide that all parties are restricted from amending the loan agreement in specified ways without the other lenders’ consent. This will primarily relate to changes such as increasing amounts due under the respective loan agreement (interest and principal) or making the terms of the loan agreement materially more onerous for the borrower.

• This will help to maintain the level of indebtedness due to any party and the terms with which the borrower has to comply.

• You might be wondering why a junior lender would agree to these terms which, in effect, means they are more exposed to potentially not having their debt repaid in full or even at all. However, to reflect this increased risk of non-payment a junior lender will be able to charge the borrower higher fees and/or margin.

• The order of priority under a subordination agreement will only be relevant if the borrower becomes insolvent or enters into financial difficulty. Most of the time, the borrower will be able to pay both the senior and junior lenders in accordance with the repayment schedule in their respective loan agreements.

• Another reason why a junior lender might agree to entering into a subordination agreement is if there is a need for a cash injection into the borrower/group. Agreeing to be subordinated to another lender might be the only way to attract a new lender. This is one of the reasons why a lender to a subsidiary might agree to give up their priority in a structural subordination situation (as in the example above).

**Summary**

• The interest clause will set out the interest rate a lender will charge on the loan. This will be made up of a floating rate (based on a benchmark rate) with a margin added.

• A lender will want to protect itself from anything which may erode its margin, as this would mean the lender not getting the full amount of interest it is expecting.

• Events such as imposition of withholding tax or an increase in underlying costs could threaten a lender's margin.

• **Tax gross-up and increased costs** provisions in the loan agreement help to **protect a lender** against erosion of the margin, by effectively allocating the risk of imposition of withholding tax to the borrower and passing on any increased underlying costs to the borrower.

• This is counter-balanced with certain protections for the borrower, which will also be included in the loan agreement.

• A lender will be concerned about structural subordination, which may arise where there is a group of companies and separate lending at different levels of the group. Contractual subordination may be used as one of the possible solutions to this problem.

**Loan Agreement provisions –**

**Lender's options following Events of Default**

This element explains what steps/options are available to a lender when the borrower triggers an event of default.

Note: Unless otherwise specified, clause references throughout this element are to the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full, only to broadly familiarise yourself with them.

**What are a lender’s options following an EoD?**

**Acceleration (clause 29.20):** This clause provides a lender with the following remedies:

i) Cancel its obligations to make any further loans to a borrower (this will be relevant where there are numerous tranches of a loan or if the loan is a revolving credit facility; see clause 29.20(a)(i).

ii) Demanding immediate repayment of some or all of its outstanding loans including any outstanding interest and fees; see clause 29.20(a)(ii). This is what is meant in practice by ‘accelerating’ a loan.

iii) Place all of the remaining outstanding loans on demand meaning that these will now be payable on demand; see clause 29.20(a)(iii).

**‘Drawstop’ (clause 4.2):** If a lender is obliged under the loan agreement to lend further money to the borrower, it can also call a **drawstop.** This will be a temporary measure taken by the lender until the EoD is rectified. Under a drawstop, a lender **suspends** further tranches of the loan being drawn down until the relevant situation is rectified. This is different to cancellation of a loan; cancellation is permanent whereas a drawstop is temporary.

**Enforcement of security**

By the Lender or (in a syndicated deal) by the Security Agent/Security Trustee under the terms of the relevant security document.

**The Agent's role in a 'Default' situation**

In a syndicated loan, the agent has duties (clauses 33.3(e) and (f) of the LMA Agreement) to notify the syndicate lenders promptly if it receives a notice of a Default under the loan and also to notify the syndicate lenders promptly if it is aware of any non-payment under the loan (remember non-payment is an EoD).

Under clause 29.20 of the LMA Agreement, in an EoD situation the agent has the **power** to exercise any of the remedies under the ‘Acceleration’ provisions of the EoD clause and the **obligation** to do so if instructed by the '**Majority Lenders**'. (See Workshop 1 element 2).

The borrower will be keen to ensure the Agent can only exercise the remedies under the 'Acceleration' clause in respect of an EoD 'which is continuing'.

See EniBank Precedent Loan Agreement for definition of 'Default'.

**Potential event of default**

**A potential EoD is a situation which would be an EoD but for the fact:**

• the EoD has a contractual grace period which the borrower is currently in; or

• the EoD clause requires the giving of a notice or making of a determination which has not happened yet.

**In the EniBank Precedent loan Agreement (which reflects the LMA position) the term ‘Default’ includes:**

• **an EoD; and**

• **a potential EoD** (“… any event or circumstance specified in clause 23 (Events of Default) which would (with the expiry of a grace period, the giving of notice, the making of any determination under the Finance Documents or any combination of any of the foregoing) be an EoD”).

**The term ‘Event of Default’ means only an EoD. There is no separate definition of a potential EoD.**

**Example (see also diagram at the end of the example)**

On 1 December the borrower signs a term loan agreement with Lender X.

On 2 March a winding-up petition is served upon the borrower by a creditor who is only owed £1,000. This would fall under the ‘Insolvency proceedings’ EoD which in this loan agreement contains a carve-out allowing the borrower a 14-day grace period in which to discharge frivolous or vexatious proceedings. So, on 2 March this situation is only a potential EoD as the 14-day grace period starts running.

The borrower is due to send a utilisation request on 5 March to draw down further funds on 8 March. Both of these would occur during the 14-day grace period.

During the grace period, while there is only a ‘**potential event of default**’, Lender X *cannot* call an EoD and *cannot* use its remedies under the ‘Acceleration’ provisions of the EoD clause.

However, under clause 4.2(a), Lender X *can* exercise a drawstop of the term loan (i.e. suspend lending any further tranches) if a ‘Default’ is continuing (as explained above, ‘Default’ in the LMA includes both an EoD and a potential EoD). So for our term loan above, during the grace period while the potential EoD is continuing, the borrower cannot draw down further funds. N.B. you will see in clause 4.2 that if the loan is a rollover loan (which occurs only in RCF’s), drawstop can only be exercised if there is an actual EoD.

If the borrower rectifies the situation by quashing the petition within the grace period, then the *potential* event of default never becomes an EoD (and the drawstop would be lifted).

**Potential event of default (example)**

[Diagram Timeline]

1 December - Loan Agreement signed

2 March - 'vexatious' insolvency proceedings brought against borrower. 14-day grace period begins.

5 March – utilisation request due to be sent. Representations deemed repeated

Note that in this situation, submitting the utilisation request is likely to be within the borrower's control. However, the same problem would arise if 5 March were to be the first day of an interest period.

**Potential event of default**

A problem can arise for the borrower however (in both term loans and RCF’s) if it is deemed to repeat its representations while it is in a potential EoD situation. As previously discussed, in most loan facilities the borrower will be deemed to repeat representations on the date of each utilisation request and the first day of each interest period under clause.

One of the representations the lender will require the borrower to repeat is the representation that there is no EoD. However, the lender may also try to get the borrower to repeat a representation that there is no **potential**EoD i.e. using the LMA definitions, the lender may ask the borrower to repeat a representation that there is no ‘Default’.

**A borrower should never agree to repeat a representation that there is no ‘Default’ or should amend the representation so it refers only to an EoD** i.e. using the LMA definitions, the representation would refer to there being no ‘Event of Default’ instead of no ‘Default’. **Why?**

Using the scenario above, imagine that the loan agreement contains a representation that there is no **Default**. As we have seen, the issuing of a utilisation request to the lender will trigger deemed repetition of the representation.

On 5 March with their repeated representation that there is no **Default** the borrower would be representing both that there is no EoD (which is true as it is in the grace period for the insolvency proceedings) *and* no potential event of default (which is incorrect because the grace period has started).

So on 5 March, the borrower would be making a**misrepresentation**, and this would trigger the misrepresentation EoD. The misrepresentation EoD would entitle Lender X to accelerate the loan if it chose to (even though the potential EoD for insolvency proceedings may never become an actual EoD if the proceedings are dismissed within the grace period).

**Summary**

• A lender’s possible courses of action following an EoD include cancelling its obligation to make further loans, requiring immediate repayment of outstanding loans plus any accrued interest and fees, and placing outstanding loans on demand. This is known as 'Acceleration'.

• In a syndicated loan, the agent has certain duties on occurrence of a 'Default'. The 'Majority Lenders', will usually be consulted before the agent takes any action to accelerate the loan.

• It is important to appreciate the distinction between events of default, potential events of default and the term 'Default' in a loan agreement.

*EniBank precedent loan agreement extract to be used in workshops 2 and 3*

**DATED [ ]**

# INFINITY MANUFACTURING LIMITED

as Borrower

**INFINITY GROUP PLC**

As Original Guarantor

and

# ENIBANK PLC

as Arranger, Agent and Security Trustee

and

[insert names of other Lenders]

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**LOAN AGREEMENT**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

|  |
| --- |
| This loan agreement is based on Loan Market Association’s recommended form of primary document (‘**LMA Agreement’**). The Loan Market Association owns the copyright in the recommended form of primary document.  This is an extract and is to be used for teaching purposes only. Various definitions, clauses and schedules have been deliberately changed or omitted from this document. |

### DATE [ ]

**PARTIES**

1. **INFINITY MANUFACTURING LIMITED**, a company incorporated under the laws of England and Wales with registered number [ ] and having its registered office at [ ] (the “**Borrower**”);

(2) **INFINITY GROUP PLC**, a company incorporated under the laws of England and Wales with registered number [ ] and having its registered office at [ ] (the “**Original Guarantor**”);

(3) **ENIBANK PLC** as mandated lead arranger (the “**Arranger**”);

(4) **THE FINANCIAL INSTITUTIONS** listed in Part II and Part III of Schedule [•] as lenders (the “**Original Lenders**”) [*N.B. Schedule not attached*];

(5) **ENIBANK PLC** as agent of the other Finance Parties(the“**Agent**”); and

(6) **ENIBANK PLC** as security trustee for the Lenders (the “**Security Trustee**”).

**IT IS AGREED AS FOLLOWS:**

### 1 Definitions and Interpretation

1.1 **Definitions**

In this Agreement:

**‘Authorisation’** means an authorisation, consent, approval, resolution, licence, exemption, filing or registration;

**‘Available Commitment’** means a Lender’s Commitment minus:

1. the amount of its participation in any outstanding Loan; and
2. in relation to any proposed Utilisation, the amount of its participation in any Loans that are due to be made on or before the proposed Utilisation Date.

**‘Business Day’** means a day (other than a Saturday or Sunday) on which banks are open for general business in London;

**‘Commitment’** means:

1. in relation to an Original Lender, the amount set opposite its name under the heading “Commitment” in Part II of Schedule [•] [*N.B. Schedule not attached*] and the amount of any other Commitment transferred to it under this Agreement; and
2. in relation to any other Lender, the amount of any Commitment transferred to it under this Agreement,

to the extent not cancelled, reduced or transferred by it under this Agreement.

**‘Debenture’** means a debenture executed by the Borrower in favour of the Security Trustee and dated the date of this Agreement;

**‘Default’** means an Event of Default or any event or circumstance specified in Clause 23(*Events of Default*) which would (with the expiry of a grace period, the giving of notice, the making of any determination under the Finance Documents or any combination of any of the foregoing) be an Event of Default;

**‘Disruption Event’** means either or both of:

* 1. a material disruption to those payment or communications systems or to those financial markets which are, in each case, required to operate in order for payments to be made in connection with the Facility (or otherwise in order for the transactions contemplated by the Finance Documents to be carried out) which disruption is not caused by, and is beyond the control of, any of the Parties; or
  2. the occurrence of any other event which results in a disruption (of a technical or systems-related nature) to the treasury or payments operations of a Party preventing that, or any other Party:

1. from performing its payment obligations under the Finance Documents; or

(ii) from communicating with other Parties in accordance with the terms of the Finance Documents,

and which (in either such case) is not caused by, and is beyond the control of, the Party whose operations are disrupted;

**‘Event of Default’** means any event or circumstance specified as such in Clause 23(*Events of Default*);

**‘Facility’** means the term loan facility made available under this Agreement as described in Clause 2 (*The Facility*);

**‘Fee Letter’** means any letter or letters dated on or about the date of this Agreement between the Arranger and the Borrower (or the Agent and the Borrower or the Security Trustee and the Borrower) setting out any of the fees referred to in Clause [•] (*Fees*); [*N.B. Clause not attached*]

**‘Finance Document’** means this Agreement, the Debenture, any Fee Letter, the Share Charge and any other document designated as such by the Agent and the Borrower;

**‘Finance Party’** means the Agent, the Arranger, the Security Trustee or a Lender;

**‘Financial Indebtedness’** means any indebtedness for or in respect of:

1. moneys borrowed;
2. any amount raised by acceptance under any acceptance credit facility or dematerialised equivalent;
3. any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;
4. the amount of any liability in respect of any lease or hire purchase contract which would, in accordance with GAAP, be treated as a balance sheet liability;
5. receivables sold or discounted (other than any receivables to the extent they are sold on a non-recourse basis);
6. any amount raised under any other transaction (including any forward sale or purchase agreement) of a type not referred to in any other paragraph of this definition having the commercial effect of a borrowing;
7. any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price (and, when calculating the value of any derivative transaction, only the marked to market value (or, if any actual amount is due as a result of the termination or close-out of that derivative transaction, that amount) shall be taken into account);
8. any counter-indemnity obligation in respect of a guarantee, indemnity, bond, standby or documentary letter of credit or any other instrument issued by a bank or financial institution; and
9. the amount of any liability in respect of any guarantee or indemnity for any of the items referred to in paragraphs (a) to (h) above;

**‘GAAP’** means generally accepted accounting principles in the United Kingdom;

**‘Group’** means the Parent, the Borrower and each of their respective Subsidiaries (if any) for the time being;

**‘Guarantor’** means an Original Guarantor or an Additional Guarantor, unless it has ceased to be a Guarantor in accordance with Clause [•] *(Changes to the Obligors)*; [*N.B. Clause not attached and you do not need to know the definition of Additional Guarantor*]

**‘Information Memorandum’** means the document in the form approved by the Borrower concerning the Group which, at the Borrower’s request and on its behalf, was prepared in relation to this transaction and distributed by the Arranger to selected financial institutions [during [ ]]/[before the date of this Agreement];

**‘Interest Period’** means, in relation to a Loan, each period determined in accordance with Clause [•] (*Interest Periods*) and, in relation to an Unpaid Sum, each period determined in accordance with Clause [•] (*Default interest*);

[*N.B. Clause not attached*]

**‘Lender’** means:

1. any Original Lender; and
2. any bank, financial institution, trust, fund or other entity which has become a Party as a ‘Lender’ in accordance with Clause [•] (*Increase*) or Clause [•] (*Changes to the Lenders*), [*N.B. Clauses not attached*]

which in each case has not ceased to be a Party as such in accordance with the terms of this Agreement;

**‘Loan’** means a loan made or to be made under the Facility or the principal amount outstanding for the time being of that loan;

**‘Majority Lenders’** means a Lender or Lender whose Commitments aggregate more than [66⅔] per cent of the Total Commitments (or, if the Total Commitments have been reduced to zero, aggregated more than [66⅔] per cent of the Total Commitments immediately prior to the reduction);

**‘Material Adverse Effect’** means in the reasonable opinion of the Majority Lenders a material adverse effect on:

(a) the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or

(b) the ability of an Obligor to perform its obligations under the Finance Documents; or

(c) the validity or enforceability of any Security granted pursuant to any of the Finance Documents.

**‘Material Subsidiary’** means, at any time:

(a) an Obligor; or

(b) a Subsidiary of the Parent which has gross assets, net assets or turnover (excluding intra-group items) representing 5% or more of the gross assets, net assets or turnover of the Group, calculated on a consolidated basis.

**‘Obligor’** means a Borrower or a Guarantor;

**‘Original Financial Statements’** means:

(a) in relation to the Parent the audited consolidated financial statements of the Group for the financial year ended [ ]; and

(b) in relation to the Borrower its audited financial statements for its financial year ended [ ].

**‘Parent’** means the Original Guarantor;

**‘Party’** means a party to this Agreement;

**‘Permitted Disposals’** means any sale, lease, transfer or other disposal:

(a) made in the ordinary course of trading of the disposing entity;

(b) of assets in exchange for other assets comparable or superior as to type, value and quality (other than an exchange of a non-cash asset for cash);

(c) of obsolete or redundant vehicles, plant and equipment for cash; or

(d) where the higher of the market value or consideration receivable (when aggregated with the higher of the market value or consideration receivable for any other sale, lease, transfer or other disposal, other than any permitted under paragraphs (a) or (c) above) does not exceed £[ ] (or its equivalent in another currency or currencies) in any financial year;

**‘Permitted Financial Indebtedness’** means:

1. the Financial Indebtedness listed in Schedule [•] (*Existing Financial Indebtedness*) [*N.B. Schedule not attached*]; or
2. any Financial Indebtedness entered into pursuant to any Finance Document; or
3. Financial Indebtedness incurred to meet working capital requirements arising in the ordinary course of business, provided that such Financial Indebtedness does not exceed £[ ] (or its equivalent in another currency or currencies) in aggregate at any time;

**‘Permitted Security’** means:

1. Security created pursuant to the Debenture;
2. the Share Charge;
3. any Security listed in Schedule [•] (*Existing Security*) [*NB: Schedule not attached*];
4. any netting or set-off arrangement entered into by any member of the Group in the ordinary course of its banking arrangements for the purpose of netting debit and credit balances;
5. any lien arising by operation of law and in the ordinary course of trading;

(e) any Security over or affecting any asset of any company which becomes a member of the Group after the date of this Agreement, where the Security is created prior to the date on which that company becomes a member of the Group, if:

(i) the Security was not created in contemplation of the acquisition of that company;

(ii) the principal amount secured has not been increased in contemplation of or since the acquisition of that company; and

(iii) the Security is removed or discharged within six months of that company becoming a member of the Group; or

(f) any Security securing indebtedness the principal amount of which (when aggregated with the principal amount of any other indebtedness which has the benefit of Security given by any member of the Group other than any permitted under paragraphs (a) to (e) does not exceed £50,000 (or its equivalent in another currency or currencies).

**‘Property’** means each of [ ] as more particularly described in the schedule to the Debenture;

**‘Repeating Representations’** means each of the representations and warranties set out in Clause 19;

**‘Security’** means a mortgage, charge, pledge, lien or other security interest securing any obligation of any person or any other agreement or arrangement having a similar effect;

**‘Share Charge’** means the charge given by the Original Guarantor to the Security Trustee over the Borrower’s shares and dated the date of this Agreement;

**‘Subsidiary’** means a subsidiary within the meaning of section 1159 of the Companies Act 2006;

**‘Tax’** means any tax, levy, impost, duty or other charge or withholding of a similar nature (including any penalty or interest payable in connection with any failure to pay or any delay in paying any of the same);

**‘Total Commitments’** means the aggregate of the Commitments, being £40,000,000 at the date of this Agreement;

**‘Utilisation’** means a utilisation of the Facility;

**‘Utilisation Date’** means the date of a Utilisation, being the date on which the relevant Loan is to be made;

**‘Utilisation Request’** means a notice substantially in the form set out in Part I of Schedule [•] (*Utilisation Requests*); [*N.B. Schedule not attached*]

**‘Valuation’** means a valuation of each Property by the Valuer on the basis of the lower of open market value and estimated realisation price as those terms are defined in the then current Statements of Asset Valuation Practice and Guidance Notes issued by the Royal Institution of Chartered Surveyors; and

**‘Valuer’** means [ ] or such other surveyor or valuer as may be appointed by the Agent.

1.2 **Construction**

1.2.1 Unless a contrary indication appears, any reference in this Agreement to:

(a) the ‘Agent’, the ‘Arranger’, any ‘Finance Party’, any ‘Lender’, any ‘Obligor’, or any ‘Party’ shall be construed so as to include its successors in title, permitted assigns and permitted transferees to, or of, its rights and/or obligations under the Finance Documents;

(b) ‘assets’ includes present and future properties, revenues and rights of every description;

(c) a ‘Finance Document’ or any other agreement or instrument is a reference to that Finance Document or other agreement or instrument as amended, novated, supplemented, extended or restated;

(d) a ‘group of Lenders’ includes all the Lenders;

(e) ‘indebtedness’ includes any obligation (whether incurred as principal or as surety) for the payment or repayment of money, whether present or future, actual or contingent;

(f) a ‘person’ includes any individual, firm, company, corporation, government, state or agency of a state or any association, trust, joint venture, consortium or partnership (whether or not having separate legal personality);

(g) a ‘regulation’ includes any regulation, rule, official directive, request or guideline (whether or not having the force of law) of any governmental, intergovernmental or supranational body, agency, department or regulatory, self-regulatory or other authority or organisation;

(h) a provision of law is a reference to that provision as amended or re-enacted; and

(i) unless a contrary indication appears, a time of day is a reference to London time.

1.2.2 Section, Clause and Schedule headings are for ease of reference only.

1.2.3 Unless a contrary indication appears, a term used in any other Finance Document or in any notice given under or in connection with any Finance Document has the same meaning in that Finance Document or notice as in this Agreement.

1.2.4 A Default (other than an Event of Default) is ‘**continuing**’ if it has not been remedied or waived and an Event of Default is ‘**continuing**’ if it has not been waived.

1.3 **Third Party Rights**

A person who is not a Party has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce or enjoy the benefit of any term of this Agreement.

### 2 The Facility

Subject to the terms of this Agreement, the Lenders make available to the Borrower a secured term loan facility in an aggregate amount equal to the Total Commitments.

### 3 Purpose

3.1 **Purpose**

The Borrower shall apply all amounts borrowed by it under the Facility towards

[ ].

* 1. **Monitoring**

No Finance Party is bound to monitor or verify the application of any amount borrowed pursuant to this Agreement.

**4 Conditions of Utilisation**

4.1 **Initial conditions precedent**

1. The Borrower may not deliver a Utilisation Request unless the Agent has received all of the documents and other evidence listed in Schedule [•] (*Conditions precedent*) [*N.B. Schedule not attached*] in form and substance satisfactory to the Agent. The Agent shall notify the Borrower and the Lenders promptly upon being so satisfied.
2. Other than to the extent that the Majority Lenders notify the Agent in writing to the contrary before the Agent gives the notification described in paragraph (a) above, the Lenders authorise (but do not require) the Agent to give that notification. The Agent shall not be liable for any damages, costs or losses whatsoever as a result of giving any such notification.

4.2 **Further conditions precedent**

The Lenders will only be obliged to fund a proposed Utilisation if on the date of the Utilisation Request and on the proposed Utilisation Date:

(a) no Default is continuing or would result from the proposed Loan; and

(b) the Repeating Representations to be made by each Obligor are true in all material respects.

### ………

### 19 Representations

Each Obligor makes the representations and warranties set out in this Clause 19 to each Finance Party on the date of this Agreement.

19.1 **Status**

(a) It is a corporation, duly incorporated and validly existing under the laws of England and Wales.

(b) It and each of its Subsidiaries (if any) has the power to own its assets and carry on its business as it is being conducted.

19.2 **Binding obligations**

The obligations expressed to be assumed by it in each Finance Document are, subject to any general principles of law limiting its obligations which are specifically referred to in any legal opinion delivered pursuant to Clause 4 (*Conditions of Utilisation*) or Clause [•] *(Changes to the Obligors)* [*N.B. Clause [•] not attached]* legal, valid, binding and enforceable obligations.

19.3 **Non-conflict with other obligations**

The entry into and performance by it of, and the transactions contemplated by, the Finance Documents do not and will not conflict with:

(a) any law or regulation applicable to it;

(b) its or any of its Subsidiaries’ constitutional documents; or

(c) any agreement or instrument binding upon it or any of its Subsidiaries or any of its or any of its Subsidiaries’ assets.

19.4 **Power and authority**

It has the power to enter into, perform and deliver, and has taken all necessary action to authorise its entry into, performance and delivery of, the Finance Documents to which it is a party and the transactions contemplated by those Finance Documents.

19.5 **Validity and admissibility in evidence**

All Authorisations required or desirable:

(a) to enable it lawfully to enter into, exercise its rights and comply with its obligations in the Finance Documents to which it is a party; and

(b) to make the Finance Documents to which it is a party admissible in evidence in its jurisdiction of incorporation,

have been obtained or effected and are in full force and effect.

19.6 **Deduction of Tax**

It is not required to make any Tax Deduction (as defined in Clause [• ] (*Definitions*) [*N.B. clause not attached*]) for or on account of Tax from any payment it may make under any Finance Document to a Lender which is:

(a) a Qualifying Lender:

(i) falling within paragraph (a)(i) of the definition of “Qualifying Lender”; or

(ii) except where a Direction has been given under section 931 of the ITA in relation to the payment concerned, falling within paragraph (a)(ii) of the definition of “Qualifying Lender”); or

(iii) falling within paragraph (b) of the definition of “Qualifying Lender”; or

(b) a Treaty Lender and the payment is one specified in a direction given by the Commissioners of Revenue & Customs under Regulation 2 of the Double Taxation Relief (Taxes on Income) (General) Regulations 1970 (SI 1970/488).

19.7 **No registration requirements, filing or stamp taxes**

Except for due registration of the Debenture and the Share Charge under section 859A of the Companies Act 2006 and the Debenture under the Land Registration Act 2002, it is not necessary that the Finance Documents be filed, recorded or enrolled with any court or other authority or that any stamp, registration or similar tax be paid on or in relation to the Finance Documents or the transactions contemplated by the Finance Documents.

19.8 **No default**

(a) No Default is continuing or might reasonably be expected to result from the making of any Utilisation.

(b) No other event or circumstance is outstanding which constitutes a default under any other agreement or instrument which is binding on it or any of its Subsidiaries or to which its (or its Subsidiaries’) assets are subject which might have a Material Adverse Effect.

19.9 **No misleading information**

(a) Any factual information provided by any member of the Group for the purposes of the Information Memorandum was true and accurate in all respects as at the date it was provided or as at the date (if any) at which it is stated.

(b) Any financial projections contained in the Information Memorandum have been prepared on the basis of recent historical information and on the basis of reasonable assumptions.

(c) Nothing has occurred or been omitted from the Information Memorandum and no information has been given or withheld that results in the information contained in the Information Memorandum being untrue or misleading in any respect.

19.10 **Financial statements**

(a) Its Original Financial Statements were prepared in accordance with GAAP consistently applied.

1. Its Original Financial Statements fairly present its financial condition as at the end of the relevant financial year and operations during the relevant financial year.

(c) There has been no material adverse change in its business, assets or financial condition of the Group taken as a whole since the publication of its most recent audited financial statements.

19.11 **No proceedings**

1. No litigation, arbitration or administrative proceedings of or before any court, arbitral body or agency which, if adversely determined, might have a Material Adverse Effect has or have been started or threatened against it or any of its Subsidiaries.
2. No judgment or order of a court, arbitral body or agency which might have a Material Adverse Effect has been made against it or any of its Subsidiaries.

19.12 **Ranking of security**

The security conferred by the Debenture and the Share Charge has or will have first ranking priority and it is not subject to any prior ranking or pari passu ranking Security.

19.13 **Good title to assets**

It and each of its Subsidiaries has a good, valid and marketable title to, or valid leases or licences of, and all appropriate Authorisations to use, the assets necessary to carry on its business as presently conducted.

19.14 **Legal and beneficial ownership**

It and each of its Subsidiaries is the legal and beneficial owner of the respective assets over which it purports to grant Security.

19.15 **Shares**

(a) The shares of any member of the Group which are subject to the Share Charge and Debenture are fully paid and not subject to any option to purchase or similar rights.

(b) The constitutional documents of companies whose shares are subject to the Share Charge and the Debenture do not and could not restrict or inhibit any transfer of those shares on creation or enforcement of the Share Charge or Debenture.

19.16 **Repetition**

The Repeating Representations are deemed to be repeated and made by each Obligor by reference to the facts and circumstances then existing on the date of each Utilisation Request and the first day of each Interest Period.

**20 Information Undertakings**

The undertakings in this Clause 20 remain in force from the date of this Agreement for so long as any amount is outstanding under the Finance Documents or any part of the Facility Commitment is in force.

20.1 **Financial statements**

The Parent shall supply to the Agent in sufficient copies for all the Lenders:

(a) as soon as the same become available, but in any event within 120 days after the end of each of its financial years, its audited consolidated financial statements for that financial year and the audited financial statements of each Obligor for that financial year and the audited financial statements of any other Material Subsidiary for that financial year if requested by the Agent; and

(b) as soon as the same become available, but in any event within 60 days after the end of each half of each of its financial years, its financial statements for that financial half year and the financial statements of each Obligor for that financial half year.

20.2 **Compliance certificate**

(a) The Parent shall supply to the Agent, with each set of financial statements delivered pursuant to Clauses 20.1 (*Financial statements*), a compliance certificate setting out (in reasonable detail) computations as to compliance with Clause 21 (*Financial Covenants*) as at the date as at which those financial statements were drawn up.

(b) Each compliance certificate shall be signed by two directors of the Parent and, if required to be delivered with the financial statements delivered pursuant to Clause 20.1(a) (*Financial statements*), shall be reported on by the Parents’ auditors in the form agreed by the Parent and all the Lenders before the date of this Agreement.

20.3 **Requirements as to financial statements**

(a) Each set of financial statements delivered pursuant to Clause 20.1 (*Financial statements*) shall be certified by a director of the Parent as fairly presenting its (or, as applicable, the Group’s) financial condition as at the date as at which those financial statements were drawn up.

(b) The Parent shall procure that each set of financial statements delivered pursuant to Clause 20.1 (*Financial statements*) is prepared using GAAP.

20.4 **Information: miscellaneous**

The Parent shall supply to the Agent (in sufficient copies for all the Lenders, if the Agent so requests):

1. copies of all documents dispatched by the Parent or any Obligors to its shareholders generally (or any class of them) or its creditors generally (or any class of them) at the same time as they are dispatched;
2. promptly upon becoming aware of them, the details of any litigation, arbitration or administrative proceedings which are current, threatened or pending against any member of the Group, and which might, if adversely determined, have a Material Adverse Effect;
3. promptly upon becoming aware of them, the details of any judgement or order of a court, arbitral body or agency which is made against any member of the Group, and which might have a Material Adverse Effect; and

(d) promptly, such further information regarding the financial condition, business and operations of the Group and/or any member of the Group as any Finance Party (through the Agent) may request.

20.5 **Notification of default**

(a) Each Obligor shall notify the Agent of any Default (and the steps, if any, being taken to remedy it) promptly upon becoming aware of its occurrence (unless that Obligor is aware that a notification has already been provided by another Obligor).

(b) Promptly upon a request by the Agent, the Parent shall supply to the Agent a certificate signed by two of its directors or senior officers on its behalf certifying that no Default is continuing (or if a Default is continuing, specifying the Default and the steps, if any, being taken to remedy it).

### 21 Financial Covenants

**[DELIBERATELY OMITTED]**

|  |  |
| --- | --- |
|  |  |

### 22 General Undertakings

The undertakings in this Clause 22 remain in force from the date of this Agreement for so long as any amount is outstanding under the Finance Documents or any part of the Facility Commitment is in force.

22.1 **Authorisations**

Each Obligor shall promptly:

(a) obtain, comply with and do all that is necessary to maintain in full force and effect; and

(b) supply certified copies to the Agent of,

any Authorisation required under any law or regulation of its jurisdiction of incorporation to enable it to perform its obligations under the Finance Documents to which it is a party and to ensure the legality, validity, enforceability or admissibility in evidence in its jurisdiction of incorporation of any Finance Document to which it is a party.

22.2 **Compliance with laws**

Each Obligor shall (and the Parent shall ensure that each member of the Group will) comply in all respects with all laws to which it may be subject.

22.3 **Negative pledge**

(a) No Obligor shall (and the Parent shall ensure that no other member of the Group will) create or permit to subsist any Security over any of its assets.

(b) No Obligor shall (and the Parent shall ensure that no other member of the Group will):

(i) sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an Obligor [or any member of the Group];

(ii) sell, transfer or otherwise dispose of any of its receivables on recourse terms;

(iii) enter into any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or

(iv) enter into any other preferential arrangements having a similar effect,

in circumstances where the arrangement or transaction is entered into primarily as a method of raising Financial Indebtedness or of financing the acquisition of an asset.

22.4 **No Financial Indebtedness**

No Obligor shall (and the Parent shall ensure that no other member of the Group will) incur or permit to subsist any Financial Indebtedness other than Permitted Financial Indebtedness.

22.5 **Disposals**

No Obligor shall (and the Parent shall ensure that no other member of the Group will) enter into a single transaction or a series of transactions (whether related or not) and whether voluntary or involuntary to sell, lease, transfer or otherwise dispose of any asset (including, without limitation, the Property).

22.6 **Merger**

1. No Obligor shall (and the Parent shall ensure that no other member of the Group will) enter into any amalgamation, demerger, merger or corporate reconstruction.
2. Paragraph (a) above does not apply to any sale, lease, transfer or other disposal permitted pursuant to Clause 22.5 (*Disposals*).

22.7 **Change of business**

The Parent shall procure that no substantial change is made to the general nature of the business of the Parent, the Obligors or the Group taken as a whole from that carried on at the date of this Agreement.

22.8 **Insurances**

Each Obligor shall (and the Parent shall ensure that each other member of the Group will) maintain insurances on or in relation to its business and assets (including, without limitation, the Property) with underwriters and insurance companies of repute against such risks customarily insured against by, and in amounts reasonably and commercially prudent for, companies carrying on a similar business.

### 23 Events of Default

Each of the events or circumstances set out in Clause 23 is an Event of Default (save for Clause 23.12 (*Acceleration*)).

23.1 **Non-payment**

An Obligor does not pay on the due date any amount payable pursuant to a Finance Document at the place and in the currency in which it is expressed to be payable unless:

(a) its failure to pay is caused by:

(i) administrative or technical error; or

(ii) a Disruption Event; and

(b) payment is made within two Business Days of its due date.

* 1. **Financial Covenants**

Any requirement of Clause 21 (*Financial Covenants*) is not satisfied.

23.3 **Other obligations**

(a) An Obligor does not comply with any provision of the Finance Documents (other than those referred to in Clause 23.1 (*Non-payment*)and clause 23.2 (*Financial Covenants*)).

(b) No Event of Default under Clause 23.3(a) will occur if the failure to comply is capable of remedy and is remedied within five Business Days of the earlier of (a) the Agent giving notice to the Parent or relevant Obligor and (b) the Parent or an Obligor becoming aware of the failure to comply.

23.4 **Misrepresentation**

Any representation or statement made or deemed to be made by an Obligor in the Finance Documents or any other document delivered by or on behalf of any Obligor under or in connection with any Finance Document is or proves to have been incorrect or misleading in any material respect when made or deemed to be made.

23.5 **Cross-default**

(a) Any Financial Indebtedness of any member of the Group is not paid when due nor within any originally applicable grace period.

(b) Any Financial Indebtedness of any member of the Group is declared to be or otherwise becomes due and payable prior to its specified maturity as a result of an event of default (however described).

(c) Any commitment for any Financial Indebtedness of any member of the Group is cancelled or suspended by a creditor of any member of the Group as a result of an event of default (however described).

(d) Any creditor of any member of the Group becomes entitled to declare any Financial Indebtedness of any member of the Group due and payable prior to its specified maturity as a result of an event of default (however described).

(e) No Event of Default will occur under this Clause 23.5 if the aggregate amount of Financial Indebtedness or commitment for Financial Indebtedness falling within paragraphs (a) to (d) above is less than £500,000 (or its equivalent in any other currency or currencies).

23.6 **Insolvency**

(a) A member of the Group is unable or admits inability to pay its debts as they fall due, suspends making payments on any of its debts or, by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors (excluding any Finance Party in its capacity as such) with a view to rescheduling any of its indebtedness.

(b) The value of the assets of any member of the Group is less than its liabilities (taking into account contingent and prospective liabilities).

(c) A moratorium is declared in respect of any indebtedness of any member of the Group.

23.7 **Insolvency proceedings**

Any corporate action, legal proceedings or other procedure or step is taken in relation to:

(a) the suspension of payments, a moratorium of any indebtedness, winding-up, dissolution, administration or reorganisation (by way of voluntary arrangement, scheme of arrangement or otherwise) of any member of the Group other than a solvent liquidation or reorganisation of any member of the Group;

(b) a composition, compromise, assignment or arrangement with any creditor of any member of the Group;

(c) the appointment of a liquidator (other than in respect of a solvent liquidation of a member of the Group), receiver, administrative receiver, administrator, compulsory manager or other similar officer in respect of any member of the Group or any of its assets; or

(d) enforcement of any Security over any assets of any member of the Group,

or any analogous procedure or step is taken in any jurisdiction.

This clause 23.7 shall not apply to any winding-up petition which is frivolous or vexatious and is discharged, stayed or dismissed within 14 days of commencement.

23.8 **Creditors’ process**

Any expropriation, attachment, sequestration, distress or execution affects any asset or assets of a member of the Group having an aggregate value of [ ] and is not discharged within 14 days of commencement.

23.9 **Unlawfulness**

It is or becomes unlawful for an Obligor to perform any of its obligations under the Finance Documents to which it is a party.

23.10 **Repudiation**

An Obligor repudiates a Finance Document or evidences an intention to repudiate a Finance Document.

23.11 **Material adverse change**

Any event or series of events occurs which the Majority Lenders believe could have a Material Adverse Effect.

23.12 **Acceleration**

On and at any time after the occurrence of an Event of Default the Agent may, and shall if so directed by the Majority Lenders, by notice to the Borrower:

(a) cancel the Available Commitment of each Lender whereupon each such Available Commitment shall immediately be cancelled and the Facility shall immediately cease to be available for further utilisation;

(b) declare that all or part of the Loans, together with accrued interest, and all other amounts accrued or outstanding under the Finance Documents be immediately due and payable, whereupon they shall become immediately due and payable; and/or

Recycle(c) declare that all or part of the Loans be payable on demand, whereupon they shall immediately become payable on demand by the Agent on the instructions of the Majority Lenders.

**END OF EXTRACT**

**Loan Agreement provisions – Events of Default**

This element explains the nature and the purpose of the events of default clause within a loan agreement. It also considers the concept of mandatory prepayment events, and how these are treated differently from events of default. Finally, the concept of 'potential event of default' is addressed and how this differs from an event of default.

Note: Unless otherwise specified, clause references throughout this element are to the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full, only to broadly familiarise yourself with them.

**Introduction**

* The Events of Default ('**EoD**') clause is included in a loan agreement to set out clearly a lender’s remedies if (i) a borrower breaches a clause in the loan agreement or (ii) any of the set events contained in the EoD clauses occur.
* The EoD clause provides clear contractual remedies allowing the lender to stop further lending and take steps to recover its loan, negating the need to rely on usual common law remedies where there is a breach of a term of the loan agreement.
* The EoD clause (clause 29) identifies certain clauses in the loan agreement that, when breached, trigger an EoD. Breach may be immediate or only once certain ‘grace periods’ detailed in that clause have elapsed. A summary of common EoD clauses are listed on slide 4. You should familiarise yourself with this clause in the LMA Agreement.
* An EoD usually needs to be 'continuing' for a lender to take action.
* A lender’s possible courses of action following an EoD are also set out in the EoD clause itself. This is known as the **acceleration clause** and includes the right for the lender to cancel any proposed or future drawdowns of the loan; to require the immediate repayment of the full amount of the loan that the borrower has previously drawn down (plus any accrued interest that is payable); or to put the loan 'on demand', which will convert it from a committed facility to an uncommitted facility going forward.

**Common EoD clauses include the following:**

[*Diagram box arrows pointing towards “Events of Default” at centre of page- connecting with (clockwise starting with)]:*

* Non-payment (clause 29.1)
* Breach of Financial Covenants (clause 29.2)
* Breach of other obligations in the loan agreement (clause 29.3)
* Misrepresentation (clause 29.4)
* Cross-default (clause 29.5)
* Insolvency (clause 29.6)
* Insolvency Proceedings (clause 29.7)
* Creditors' Process (clause 29.8)
* Unlawfulness (clause 29.9)
* Material Adverse Change (clause 22.19)

**We will now review each of the EoD clauses in more detail:**

Please refer to the EoD in the EniBank Precedent Loan Agreement (clause 23). These are adapted EoD based on the LMA Agreement.

**Non-payment of principal and/or interest**

Any non-payment is a crucial EoD to a lender as a non-payment could be an early sign of possible insolvency of a borrower or could raise issues with its creditworthiness. It could also be the case that the lender itself has borrowed money (on the interbank market) to fund the loan. It might, therefore, have its own repayments to make (which incur costs if it fails to repay as agreed).

**Remember -** any non-payment will cause **default interest** to accrue as a result of this. The default rate is usually expressed as a fixed rate above the normal contractual rate. For example: 1% above the interest rate payable on the loan.

**Negotiation points?**

A short grace period of 2-3 days is usually accepted but only for non-payment due to technical or administrative reasons.

**Breach of financial covenants**

This EoD occurs where a borrower does not satisfy each of the specific financial covenant tests contained in the loan agreement on any specified testing date.

As financial covenant tests are calculated by reference to the financial accounts of the business over the testing period and tested by reference to specified periods of time, it would be inappropriate for a borrower to ask for grace periods within which to satisfy those tests.

Note in some loan agreements a borrower may negotiate 'equity cure' rights which permit the shareholders of the borrower to inject additional equity into the borrower to 'cure' certain financial covenant breaches.

**Breach of other obligations (other than non-payment and financial covenants)**

This EoD is triggered where a borrower breaches any other term of the loan agreement.

To help avoid a flood of breaches, a catch-all grace period will be drafted into this EoD for a ‘breach of any other obligation which is capable of remedy’. It is also common for the lender and borrower to negotiate an agreed grace period into a particular clause.

The length of any grace period will depend on how fundamental a breach may be. A very cautious lender may exclude certain clauses from any general grace period (but this is unusual).

**Misrepresentation**

This EoD can catch any representations made by a borrower in the loan agreement or any document delivered to the Agent by or on behalf of the borrower. Where a borrower is unable to repeat a representation when due, it is the breach of the deemed representation which triggers the EoD, *not* the occurrence of the event leading to the inability to repeat the representation.

**Negotiation points?**

A lender may agree to add a materiality threshold into the wording of the representation clause itself (to ensure that representations that are deemed to be non-material representations do not trigger an EoD).

**Example:**

A borrower under a revolving credit facility represented on entry into the loan agreement (and is deemed to repeat) the representation that there is no litigation over £100,000. Before the next utilisation request - when the relevant representation is due to be repeated - the borrower is served with a claim form indicating it is being sued for £170,000. If the borrower is deemed to repeat the representation at the date of the next utilisation request, that will be a misrepresentation. Therefore, the EoD would occur when the borrower makes the misrepresentation (in other words, when it would repeat the representation) rather than when it received notice of the claim.

**Cross default**

Any breach by a borrower (or any subsidiary of a borrower) of any other ‘financial agreements’, aside from the loan agreement with the lender will trigger 'alarm bells' for the lender, even in situations where the borrower is not in breach of the loan agreement itself.

The borrower’s failure to honour its obligations with other creditors could point to future problems repaying the loan and interest to the lender. To take advantage of this ‘alarm bell’, a lender will insist on a ‘cross default’ EoD in a loan agreement.

Looking at the definition of Financial Indebtedess in the LMA, you can see it is widely drafted to include most types of indebtedness (although the LMA wording does not include trade creditors because these are debts owing in the ordinary course of trade rather than true borrowings).

For the purposes of this knowledge stream, you only need to focus on 'moneys borrowed', i.e the first item in the Financial Indebtedness definition, which will catch other loan agreements a borrower may have entered into.

**Unless otherwise stated, clause references in the remainder of these slides are to the clauses found in the EniBank Precedent Loan Agreement (which is based on the LMA Agreement).**

**A lender’s rights under an (unamended) LMA style cross default EoD can arise in one of three situations:**

* Where the borrower or any of its subsidiaries *fails to pay* any Financial Indebtedness when it is due (or after any relevant grace period has ended) – see clause 23.5(a).
* When any creditor of the borrower or any of its subsidiaries:
* ***declares any Financial Indebtedness is due and payable before the date originally agreed or it becomes otherwise due and payable; or***
* ***cancels or suspends any outstanding commitment to lend*,**

and the creditor’s right to do so arises because the borrower (or any of its subsidiaries) has committed an EoD under the agreement creating Financial Indebtedness with that creditor – see clauses 22.5(b) and(c).

* When any creditor of the borrower or any of its subsidiaries ***becomes entitled to declare* *any Financial Indebtedness due and payable before the date originally agreed*** because of an EoD under the agreement creating Financial Indebtedness between the creditor and the borrower (or any of its subsidiaries) – see clause 22.5(d).
* The impact of the drafting of clause 22.5(d) is that the borrower (or subsidiary of the borrower) merely has to breach another financial agreement to cause an EoD under the loan agreement even if the creditor under the other financial agreement takes no action under its agreement. This is more fully explained in the example below.

**Cross default – borrower concerns**

**These are best explained by example.**

**Imagine a borrower has two loan agreements – one with Lender X and one with Lender Y. The clauses which are key to explaining the borrower’s objections to the cross default clause are summarised below.**

**Example:**

A borrower has two separate loan agreements (with Lender X and Lender Y) with the following clauses:

Loan Agreement X: No disposals of assets worth more than £250,000 with no cross default provision included.

Loan Agreement Y: No disposals of assets worth more than £500,000 with a cross default provision included.

The borrower disposes of an asset for the value of £325,000. This has the following effect:

It is a **breach** of **Loan Agreement X** as this disposal is of an asset over £250,000 (this is clear on the facts), leading to a default of this loan agreement.

It is a **breach** of **Loan Agreement Y** as, despite this being a disposal of an amount that is lower than the £500,000 threshold, due to (1) the inclusion of a cross default provision; and (2) the fact that the borrower here has defaulted on Loan Agreement X, this will trigger the cross default clause leading to an EoD under this loan too.

By inserting a cross default EoD clause into its agreement with the borrower, Lender Y has indirectly taken advantage of the stricter undertakings in Lender X’s agreement, even though Lender Y’s agreement appears more lenient.

The effect of having a cross default EoD clause in one of the borrower’s loan agreements is known as the **‘domino effect’** – i.e. the borrower being in breach of one agreement means it is at risk of being in breach of any of its other loan agreements which contain cross default EoD clauses.

To prevent this occurring, the borrower should try to ensure that there are identical undertakings in all its loan agreements. So, if in the example above the restrictions on disposals in the two loan agreements had had the same threshold figure of £1,000,000, the sale of the asset would not have breached either loan agreement.

**Cross default – possible amendments**

**Limiting ‘Financial Indebtedness’:**

A borrower may try to limit the impact of a cross default clause by limiting the clause to default under documents that provide for ‘financial indebtedness’ only (for example: documents such as loan agreements; bonds; or hire purchase agreements). In these circumstances, the definition of ‘Financial Indebtedness’ in a loan agreement is key and the LMA Agreement definition is already limited in this way.  This could also be limited to the Obligors only or the material companies (as opposed to the whole group).

**‘De Minimis Basket’:**

A common borrower ‘tool’ is to include a ‘de minimis basket’ which - in practical terms - means the inclusion of wording to allow insignificant defaults to not trigger a cross default clause. Typically, the wording stipulates that individual defaults under a certain amount (for example, £50k) and the overall total of any default do not go over a threshold (such as £250k) – in such cases, neither would trigger the general cross default clause. The level of appropriate de minimis will be deal specific.

**Cross default – possible amendments: Cross acceleration**

The borrower would prefer the cross default EoD to contain cross acceleration wording rather than cross default wording. Regardless of whether it contains cross default or cross acceleration wording the EoD is almost always called the cross default EoD. (Clause 1.2(b) makes it clear “… Clause … headings are for ease of reference only” so even if the heading says ‘cross default’, if the clause has been amended to cross acceleration wording the clause will be treated as a cross acceleration clause).

*Cross default* wording means the cross default EoD is triggered if the borrower defaults under an agreement it has with another creditor irrespective of whether that other creditor takes any action in relation to that default.

*Cross acceleration* wording however requires a further step to be taken by that other creditor before the cross default EoD is triggered – it requires the other creditor whose agreement has been breached to take steps to exercise its remedies under the ‘Acceleration’ provisions of its agreement with the borrower e.g. for the other lender to insist on immediate repayment of the loan and all interest due on it, or to exercise drawstop.

Going back to our earlier example involving Lenders X and Y, if the cross default EoD in Lender Y’s loan agreement had pure cross acceleration wording, rather than cross default wording, Lender X must take the extra step of using a remedy under the ‘Acceleration’ provisions of its loan agreement or calling a drawstop before the cross default EoD clause in Lender Y’s loan agreement is triggered. Only then would Lender Y be able to call a cross default EoD and insist on its remedies in *its* ‘Acceleration’ clause or to call a drawstop.

The borrower may argue (in favour of cross acceleration wording) that the breach under the other creditor’s agreement may be minor and therefore likely to be waived by that other creditor without the borrower’s financial position being affected at all; such a situation should not trigger a cross default EoD in other agreements the borrower has entered into.

The lender’s counter-argument to having cross acceleration wording would be that waiting to see if another lender accelerates its loan when the borrower is in default will not give the lender sufficient warning of the borrower’s problems with its finances, which would be too great a risk for the lender to accept.

The lender would rather the borrower was technically in default of its loan agreement earlier on in the process (i.e. when it defaults under any of its other financial agreements) because then the lender will be in a better position to assess the borrower’s position and the risk to the lender’s investment, and negotiate an outcome which is more favourable to the lender.

If the borrower was to argue successfully for cross acceleration in the loan agreement, clause 23.5(d) would need to be deleted. Note that no lender would accept the deletion of 23.5(a) so there will *always* be cross default for non-payment.

It is rare for most borrowers to be successful in negotiating the deletion of 23.5(d) in the cross default EoD.

Given clause 23.5(d) is rarely deleted, one question commonly asked is why clauses 23.5(a) – (c) are included given they are redundant as they are covered by 23.5(d). The clauses are in the LMA because the LMA includes the wording for all the commercially acceptable cross default EoD drafting options but it is also common practice to leave (a) – (c) in the loan agreement from a ‘belt and braces’ viewpoint, even though, strictly speaking, (a) – (c) are superfluous because of (d).

Clause 23.5(e) is the de minimis basket (as explained above) and borrowers and lenders normally agree some level of de minimis. The appropriate level will depend on the relevant factual scenario.

**Insolvency**

If a borrower (or any of its subsidiary entities) are insolvent (as defined), an EoD will be triggered.

‘Insolvency’ is where an entity cannot pay its debts as they fall due, though the definition in clause 23.6 is broader. In the situations contemplated by clause 23.6, the lender’s concern is that the borrower will be unable to pay back both the principal and interest payments under a loan agreement.

There is no availability for any amendments or a grace period if an insolvency situation occurs.

**Insolvency Proceedings**

The ‘Insolvency proceedings’ EoD aims to catch every step in relation to an insolvency procedure (liquidation; administration; administrative receivership; suspension of payments; and enforcement of any security over the borrower’s, or any of its subsidiaries’, assets).

This enables the lender to take action as early as possible and not wait for the actual appointment of an administrator, receiver, etc.

A creditor needs to be owed at least £750 to be able to petition for a borrower’s liquidation (which is easily triggered). This is wide enough to mean that a creditor could attempt to enforce a relatively small debt through a winding-up petition.

A borrower will want to ensure that its position is **adequately protected from any ‘frivolous or vexatious petitions’** which are then discharged within a set grace period. Take a look at the exception wording at the end of clause 23.7 to see an example of this.

**Creditors' Process**

The inclusion of a ‘Creditors’ Process’ provision will mean that any remedy that is exercised by a creditor over an asset of the borrower or any of its subsidiaries (e.g. execution of a judgment debt, distress, etc) will trigger an EoD.

**Task:** Do you think it is possible to amend or include a grace period within either of the ‘Insolvency Proceedings’ or ‘Creditors’ Process’ EoD clauses?

If so, think of some possible amendments to clauses 23.7 and 23.8.

**Insolvency Proceedings and Creditors’ Process: Amendments/grace periods**

**Limiting the enforcement of any security:** A borrower might seek carve-outs for an agreed threshold value relating to the potential enforcement of security over any of its assets which will be enforced as a result of the Insolvency Proceedings EoD (see clause 23.7(d)).

**Limitation surrounding the seizing of any assets:** A similar carve-out can also be seen in clause 23.8 to ‘Creditors' process’ where the assets seized must have an aggregate threshold value for the clause to be triggered and/or a grace period is given to discharge the creditor’s process.

**Protection against similar proceedings:** Analogous (or similar) proceedings could be brought if a borrower deals overseas and has overseas creditors. Here a lender will want to protect its own ability to call the ‘Insolvency Proceedings’ EoD against these analogous proceedings and so will include language such as the last line of clause 23.7 to do try to do so.

**Unlawfulness**

It is important to distinguish **unlawfulness** (where it is unlawful for the ***borrower***or any guarantor to perform their obligations) from illegality (where it is illegal for the ***lender*** to perform its obligations).

Unlawfulness will always be an EoD and a lender will not agree to make unlawfulness a mandatory prepayment event (see below). A borrower can argue that it being unlawful for the borrower to perform its obligations could be something which is outside the control of the borrower and so it is unfair that it could trigger cross default. A lender’s response to this would be that this is an issue of risk allocation – the risk must stay with a borrower in such a situation and so unlawfulness for the borrower will remain as an EoD (under clause 23.9).

If it becomes **illegal** for the *lender* to perform its obligations or allow the loan to remain outstanding, the lender will want to be repaid the loan and any outstanding interest immediately. This is because if the lender’s obligations are illegal, the loan is unenforceable. This may be treated as an event of default or a **mandatory prepayment event** rather than an event of default (see below).

**Material Adverse Change (‘MAC’)**

Despite a solicitor’s best efforts, it is impossible to pre-empt every circumstance or event that could lead to a significant effect on a borrower’s ability to comply with its payment obligations under a loan agreement.

To counteract such an event happening, a lender will require the inclusion of a catch-all provision in a loan agreement. A ‘MAC’ EoD is also a requirement of most lenders’ internal credit committees – no lending will be allowed unless this EoD clause is included in a loan agreement.

A lender rarely uses its rights under the ‘Acceleration’ clause to call an EoD and demand immediate repayment based solely on a MAC. It is generally difficult to prove that they were justified in doing so - i.e; that a MAC had definitely occurred.

**Example of a lender drafted MAC clause:**

Each of the events or circumstances set out below is an Event of Default:

Any event or series of events occurs which in the opinion of the Lender could have a material adverse effect on:

(a) the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or

(b) the ability of an Obligor to comply with its obligations under the Finance Documents.

**Negotiation points relating to MAC clause example above:**

A borrower may want to restrict the clause to events that *have* or *will have* a material adverse effect on the borrower's *ability to repay the loan* and such that only the effect on the *borrower's* position is taken into account, rather than those of the wider 'Group'. The borrower could therefore**:**

* change the word 'could' in the first line to 'will', although it could compromise at 'is reasonably likely to';
* change reference to the lender's opinion to 'in the *reasonable* opinion of the Lender' so that the test requires some element of objective careful consideration even if it is still ultimately a subjective determination;
* delete paragraph (a) (which is unlikely to be accepted), or limit to the Group's financial condition; and/or
* insert the words 'material payment' or 'material' before the word 'obligations' in paragraph (b).

**Mandatory Prepayment Events**

As there are certain events which are outside the control of a borrower, it will not want such events to be treated as events of default because then something not within the borrower's control could be an EoD and could trigger a cross-default in the borrower's other loan agreements.

A lender will still require the ability to cancel its commitment under a loan agreement to make further funds available to a borrower and will instead require prepayment of all money currently borrowed if any of these certain events occur.

This is achieved by stipulating certain events as '**mandatory prepayment events**' in the loan agreement.

The following events are most commonly (but not always) deemed as mandatory prepayment events.

* + **Illegality**: Where it becomes illegal for the lender to continue lending to the borrower (see clause 12.1 of the LMA  Agreement).
  + **Change of control**: For example, a scenario where a borrower company has no control over its parent shareholder selling its shares (see clause 13.1(b)(ii) of the LMA Agreement). In some loans this may instead be treated as an event of default.

**Mandatory Prepayment Event - Illegality**

**Illegality:** Whereby it is illegal for a **lender** to perform its obligations under the loan agreement

If a scenario occurs where it becomes illegal for a lender to either perform its obligations or allow the loan to remain outstanding – in such a situation a lender will want to be repaid the loan alongside any outstanding interest immediately. This is because if the lender’s obligations are illegal, the loan is unenforceable.

The lender’s starting position may (rarely) be to treat illegality for the lender to perform its obligations as an EoD. However, as this is an event beyond the borrower’s control and it does not seem fair to allocate the risk of lender illegality to the borrower, the borrower would prefer it to be a ‘mandatory prepayment event’. This would prevent it from triggering any cross default provisions in the borrower’s other financial agreements. In the LMA **illegality** for the *lender* is a mandatory prepayment event (see clause 12.1 of the LMA Agreement).

**Mandatory Prepayment Event - Change of Control**

A borrower’s wider group structure (such as its parent or subsidiaries) can be of particular interest to a lender and could have played a key part in the lender’s decision to provide the loan. If so, a lender will want to ensure that this group structure does not change throughout the life of the loan.

If the ownership of a borrower changes, this will be deemed to be a **change in the control of the borrower** and a lender may want to treat this as an EoD. This will allow a lender to assess the change and negotiate with the borrower.

One possible consequence of a 'change of control of the borrower' being treated as an EoD, is it  may help a borrower to prevent a hostile takeover bid ('poison pill'). A hostile takeover would itself trigger an EoD and the party seeking to take over the borrower would then risk the lender accelerating the loan. This is risky as the loan could be key to the borrower’s business (meaning that any acceleration of the loan would need to be re-financed by the takeover party, which is not an ideal situation).

A borrower can say that a change of control is something that is outside its control and therefore unfair for this to be deemed as an EoD (as it could trigger a cross default EoD in its other loan agreements, as discussed earlier).

Instead, a borrower would prefer change of control to be deemed as a **mandatory prepayment event** as mentioned.  Clause 13.1(b)(ii) of the LMA Agreement treats it as this.

The likelihood of a change of control being treated as an EoD will depend on how creditworthy that borrower is – the less creditworthy it is, then the more likely it is to see a change of control treated as an EoD. If the current ownership of the borrower is very important to the lender’s credit assessment, the lender will want the change of control to be an EoD.

**Summary**

* Events of Default (‘EoD’) in loan agreements set out a lender’s remedies if a borrower breaches a clause in a loan agreement or if any of the set events contained in the EoD clause occur.
* The EoD clause identifies certain clauses in the loan agreement that, when breached, trigger an EoD either immediately or on expiry of ‘grace periods’ (as detailed in that clause).
* There are certain events which are outside the control of a borrower and so it will not want such events to be treated as EoD.  They are treated as ‘mandatory prepayment events’ which on occurrence will allow a lender to require prepayment of all money currently borrowed and cancel any further lending obligations.

**Loan Agreement provisions –**

**Lender's options following Events of Default**

This element explains what steps/options are available to a lender when the borrower triggers an event of default.

Note: Unless otherwise specified, clause references throughout this element are to the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full, only to broadly familiarise yourself with them.

**What are a lender’s options following an EoD?**

**Acceleration (clause 29.20):** This clause provides a lender with the following remedies:

i) Cancel its obligations to make any further loans to a borrower (this will be relevant where there are numerous tranches of a loan or if the loan is a revolving credit facility; see clause 29.20(a)(i).

ii) Demanding immediate repayment of some or all of its outstanding loans including any outstanding interest and fees; see clause 29.20(a)(ii). This is what is meant in practice by ‘accelerating’ a loan.

iii) Place all of the remaining outstanding loans on demand meaning that these will now be payable on demand; see clause 29.20(a)(iii).

**‘Drawstop’ (clause 4.2):** If a lender is obliged under the loan agreement to lend further money to the borrower, it can also call a **drawstop.** This will be a temporary measure taken by the lender until the EoD is rectified. Under a drawstop, a lender **suspends** further tranches of the loan being drawn down until the relevant situation is rectified. This is different to cancellation of a loan; cancellation is permanent whereas a drawstop is temporary.

**Enforcement of security**

By the Lender or (in a syndicated deal) by the Security Agent/Security Trustee under the terms of the relevant security document.

**The Agent's role in a 'Default' situation**

In a syndicated loan, the agent has duties (clauses 33.3(e) and (f) of the LMA Agreement) to notify the syndicate lenders promptly if it receives a notice of a Default under the loan and also to notify the syndicate lenders promptly if it is aware of any non-payment under the loan (remember non-payment is an EoD).

Under clause 29.20 of the LMA Agreement, in an EoD situation the agent has the **power** to exercise any of the remedies under the ‘Acceleration’ provisions of the EoD clause and the **obligation** to do so if instructed by the '**Majority Lenders**'. (See Workshop 1 element 2).

The borrower will be keen to ensure the Agent can only exercise the remedies under the 'Acceleration' clause in respect of an EoD 'which is continuing'.

See EniBank Precedent Loan Agreement for definition of 'Default'.

**Potential event of default**

**A potential EoD is a situation which would be an EoD but for the fact:**

• the EoD has a contractual grace period which the borrower is currently in; or

• the EoD clause requires the giving of a notice or making of a determination which has not happened yet.

**In the EniBank Precedent loan Agreement (which reflects the LMA position) the term ‘Default’ includes:**

• **an EoD; and**

• **a potential EoD** (“… any event or circumstance specified in clause 23 (Events of Default) which would (with the expiry of a grace period, the giving of notice, the making of any determination under the Finance Documents or any combination of any of the foregoing) be an EoD”).

**The term ‘Event of Default’ means only an EoD. There is no separate definition of a potential EoD.**

**Example (see also diagram at the end of the example)**

On 1 December the borrower signs a term loan agreement with Lender X.

On 2 March a winding-up petition is served upon the borrower by a creditor who is only owed £1,000. This would fall under the ‘Insolvency proceedings’ EoD which in this loan agreement contains a carve-out allowing the borrower a 14-day grace period in which to discharge frivolous or vexatious proceedings. So, on 2 March this situation is only a potential EoD as the 14-day grace period starts running.

The borrower is due to send a utilisation request on 5 March to draw down further funds on 8 March. Both of these would occur during the 14-day grace period.

During the grace period, while there is only a ‘**potential event of default**’, Lender X *cannot* call an EoD and *cannot* use its remedies under the ‘Acceleration’ provisions of the EoD clause.

However, under clause 4.2(a), Lender X *can* exercise a drawstop of the term loan (i.e. suspend lending any further tranches) if a ‘Default’ is continuing (as explained above, ‘Default’ in the LMA includes both an EoD and a potential EoD). So for our term loan above, during the grace period while the potential EoD is continuing, the borrower cannot draw down further funds. N.B. you will see in clause 4.2 that if the loan is a rollover loan (which occurs only in RCF’s), drawstop can only be exercised if there is an actual EoD.

If the borrower rectifies the situation by quashing the petition within the grace period, then the *potential* event of default never becomes an EoD (and the drawstop would be lifted).

**Potential event of default (example)**

[Diagram Timeline]

1 December - Loan Agreement signed

2 March - 'vexatious' insolvency proceedings brought against borrower. 14-day grace period begins.

5 March – utilisation request due to be sent. Representations deemed repeated

Note that in this situation, submitting the utilisation request is likely to be within the borrower's control. However, the same problem would arise if 5 March were to be the first day of an interest period.

**Potential event of default**

A problem can arise for the borrower however (in both term loans and RCF’s) if it is deemed to repeat its representations while it is in a potential EoD situation. As previously discussed, in most loan facilities the borrower will be deemed to repeat representations on the date of each utilisation request and the first day of each interest period under clause.

One of the representations the lender will require the borrower to repeat is the representation that there is no EoD. However, the lender may also try to get the borrower to repeat a representation that there is no **potential**EoD i.e. using the LMA definitions, the lender may ask the borrower to repeat a representation that there is no ‘Default’.

**A borrower should never agree to repeat a representation that there is no ‘Default’ or should amend the representation so it refers only to an EoD** i.e. using the LMA definitions, the representation would refer to there being no ‘Event of Default’ instead of no ‘Default’. **Why?**

Using the scenario above, imagine that the loan agreement contains a representation that there is no **Default**. As we have seen, the issuing of a utilisation request to the lender will trigger deemed repetition of the representation.

On 5 March with their repeated representation that there is no **Default** the borrower would be representing both that there is no EoD (which is true as it is in the grace period for the insolvency proceedings) *and* no potential event of default (which is incorrect because the grace period has started).

So on 5 March, the borrower would be making a**misrepresentation**, and this would trigger the misrepresentation EoD. The misrepresentation EoD would entitle Lender X to accelerate the loan if it chose to (even though the potential EoD for insolvency proceedings may never become an actual EoD if the proceedings are dismissed within the grace period).

**Summary**

• A lender’s possible courses of action following an EoD include cancelling its obligation to make further loans, requiring immediate repayment of outstanding loans plus any accrued interest and fees, and placing outstanding loans on demand. This is known as 'Acceleration'.

• In a syndicated loan, the agent has certain duties on occurrence of a 'Default'. The 'Majority Lenders', will usually be consulted before the agent takes any action to accelerate the loan.

• It is important to appreciate the distinction between events of default, potential events of default and the term 'Default' in a loan agreement.

**Nature and purpose of security and quasi-security**

This element explains the nature and purpose of security and quasi-security and how it is used in debt finance transactions.

**Introduction**

Having considered the loan agreement, attention now turns to the security package the lender may require and drafting the security document.

A lender can make a loan on an unsecured basis, but that would make the lender an unsecured creditor. If the borrower defaults and becomes insolvent, the lender's claim against the borrower will rank alongside other unsecured creditors. An unsecured creditor only has a personal claim against the debtor and has no direct claim against the debtor’s assets.

Due to the statutory order of payment of creditors on the winding-up or administration of a company's assets, other types of creditors will rank ahead of unsecured creditors, meaning the lender risks losing some or all of their money.

This is why a lender will want to be a secured creditor by taking security, as they will enhance their chances of getting their money back.

Essentially, security is where the lender has a proprietary right in an asset of the borrower.

By contrast, quasi-security broadly provides a lender with a way of recovering their money, but does not create rights over an asset of the borrower.

**What is security?**

The aim of security is to protect a lender from the possible insolvency of a borrower. If a lender holds security over the assets of a borrower, then this increases the likelihood of the lender being repaid.

When a lender holds security over an asset of the borrower, if the borrower defaults, then the lender can step in and take possession of that asset or sell that asset to repay any outstanding amount that is due on its loan to the borrower.

Depending on the type of security taken, the lender may effectively 'control' the asset in that it cannot be disposed of by the borrower without the involvement of the lender.

Taking security also gives lenders certain rights under insolvency legislation, for example the right for a 'qualifying floating charge' holder to appoint its own choice of administrator using the out-of-court procedure.

Under insolvency law, the claims of secured creditors rank ahead of those of unsecured creditors and shareholders.

The right for a lender to enforce its security will be triggered when a borrower defaults under the connected loan agreement.

**Which obligations are secured?**

The proceeds of sale of the secured assets can only be applied towards repayment of the secured debt (i.e., the monies owed to the lender). This is typically defined in the security document as the ‘**Secured Liabilities**’.

Secured Liabilities is usually defined in one of two ways:

- all monies; or

- limited to amounts under a specific loan agreement.

See slides below for examples.

**Secured Liabilities- 'all monies'**

As a simple example, with 'all monies' security the Secured Liabilities may be defined as:

**'all present and future liabilities and obligations of the Borrower to the Lender which are, or may become, due owing or payable on any account whatsoever'**

'All monies' security is used where all the borrower's financing arrangements are to be secured by the security and will cover the initial borrowing as well as future financing obligations (whether known or unknown at the point the security is entered into).

**Secured Liabilities- Limited to amounts under specific loan**

The alternative, and more common, formulation is for the Secured Liabilities to be limited to amounts owed under a specific loan agreement. This may (as a simple example) be defined as follows:

**'Secured Liabilities means all present and future monies, obligations and liabilities owed by an Obligor to the Lender, whether actual or contingent and whether owed jointly or severally, as principal or surety or in any other capacity, under or in connection with the Finance Documents, together with all interest (including, without limitation, default interest) accruing in respect of those monies or liabilities.'**

'Obligor' will include the borrower and any other entity providing security and/or gurarantees to the lender; and 'Finance Documents' will include the loan agreement, any security documents/guarantees and any separate fee letters.

**What are the secured assets?**

A lender may take security over just one asset, or over all the assets of a borrower, depending on the deal.

An important point to note is that it is not uncommon for a lender to take security over assets with a value far in excess of the amount of money lent. One reason for this could be that the lender is concerned that the value of the assets may reduce over time, or it may be driven by the desire of the lender to take security over all or substantially all the assets of the borrower in order that it has a 'qualifying floating charge'.

A borrower may agree to give full security as it has an “equitable right of redemption” to compel the lender to release the security as soon as the secured debt has been repaid even if the date for repayment has passed.

**How is security documented?**

There will be a separate security document which will set out matters such as in whose favour the security is granted, the scope of the security (i.e., the definition of Secured Liabilities), the identity of the secured assets and the type of security taken over that asset and various other undertakings and boilerplate provisions.

Security will also need to be 'perfected' i.e., brought to the attention of those who need to know about it for the security to be effective. Some examples of perfection methods include (but are not limited to) registration at Companies House, notification to third parties or registration at various other registries.

**What is quasi-security?**

- Guarantees

- Indemnities

- Comfort Letters

The above instruments are sometimes discussed by lenders in the same context as security, although they are not ‘security’ in the true legal sense.

Quasi-security differs from security as quasi-security only provides the lender with a contractual claim against the guarantor or indemnity provider.

Unlike security, these do not give the lender 'proprietary' rights over the borrower's assets- i.e., the lender has no right to take possession of or sell any of the borrower's assets.

However, in some cases guarantors may be required to separately provide security for the secured liabilities owed by the borrower in which case the lender would obtain proprietary rights over the assets of the guarantor.

Lenders will frequently require a guarantee/indemnity from each member of the borrower's group in respect of the borrower's payment obligations.

**Guarantees and Indemnities**

A guarantee is a promise by one party (the guarantor) to answer for another party's liability on a default (i.e., if a borrower defaults under the loan agreement, the lender can pursue the guarantor directly for repayment).

A guarantee is a **secondary obligation** between the parties in that its validity is dependent upon the **primary obligation** (i.e., the loan agreement between the lender and the borrower) being/remaining valid.

Linked to this is the fact that if the primary obligation is void (or is discharged) the guarantee will fall away. Lenders will therefore include provisions to the effect that the guarantee will survive failure of the primary obligation (the borrower’s obligation under a loan) and add **an indemnity** which creates a separate stand-alone primary obligation on the part of the guarantor to indemnify the lender for any loss if the borrower does not satisfy its obligations.

The key point is an indemnity will survive the invalidity of the underlying loan agreement, whereas a guarantee will not.

Consequently, the guarantee provisions in the LMA Agreement include both a guarantee and an indemnity.

**Comfort letters**

Comfort letters are usually seen in the context of support being given by a parent to support the obligations of a subsidiary where it may not be possible for a lender to obtain security or a guarantee and indemnity. For example, the parent company may be constitutionally or contractually prevented from doing so.

In such circumstances the lender may agree to accept a comfort letter (also known as a support letter or letter of intent) from the parent company. Such letters are not usually intended by either party to be legally binding, however they do represent a moral obligation which will provide some reassurance to the lender that a parent will stand by its subsidiary.

Care needs to be taken when drafting comfort letters, so as to make the terms non-binding.

Usually, they include very general statements of intention and support - e.g., that the intention of comfort letter provider is to maintain investment in its subsidiary , and that it is aware of and supports its subsidiary's borrowing.

**Summary of why would a lender want security/quasi-security?**

In short, it will protect a lender and give it a better chance of getting its money back. This is particularly important if the borrower is a higher credit risk to the lender.

**If security is granted to a lender, the lender:**

has direct recourse to the asset over which the security was granted;can avoid the need for litigation if the borrower defaults;obtains better priority against other creditors on the insolvency of the borrower; andhas an increased likelihood of recovering the debt.

**If quasi-security is granted to a lender, the lender:**

can pursue a separate contractual right against the guarantor or indemnifier;can take steps to pursue a moral claim against the comfort letter provider;has an increased likelihood of recovering all or part of the debt from an alternative source to the borrower.

**Why would a borrower (or other obligor) agree to give security or quasi-security?**

**Lack of credit history:** If a borrower is a newly incorporated entity, it will not have historic financial or trading data. Without this it will be harder for the lender to assess the credit risk and the lender may require security and/or quasi-security to be given at least for an initial period of time.

**Asset specific finance:** If a borrower is raising funds to acquire a specific asset it would be usual to grant security over that asset to the provider of the finance. If the asset were later sold the proceeds realised would be applied to prepay the loan.

**Weak credit status:** If a borrower has a weak credit status, a lender may refuse to lend to it without the benefit of security and/or quasi-security.

**Cheaper borrowing:** If a borrower is able and willing to give security and/or quasi-security, this may result in cheaper borrowing costs (the credit risk being taken by the lender is less, so a lower interest rate will usually be payable).

**What is recourse?**

An important element of assessing the risk of a loan is working out where the money will come from to repay it, either from the borrower’s operations (while it is still trading) or, in the worst case, from the sale of its assets on insolvency. The term used for the lender’s claim on certain assets for repayment of the loan is “recourse”, and the lender needs to ensure it has recourse to sufficient assets.

Therefore, the scope of the security package needs to be appropriate in the context of the transaction as a whole, taking into account the credit rating of the borrower, the lender's assessment of risk, size and structure of the transaction and the borrower's key assets. This will then determine both which assets should be subject to security and what type of security interests should be taken.

If a lender lends to a borrower in a corporate group, then the borrower and its subsidiaries and/or sister companies may be required to give guarantees and indemnities and security. Together we call the borrower, and any other group company giving a security/guarantee, the 'Obligors' (and each an 'Obligor'). This will be a defined term in the loan agreement.

**Task: can you think of any situations where a borrower may be unable to give security or quasi-security?**

**Why may a borrower be unable to give security/quasi security?**

**Restrictions in an existing loan agreement.**

**Negative pledge:** As you have seen, this is one of the general undertakings usually found in a loan agreement and it prohibits the creation of further security in competition with the lender which has advanced funds under the loan agreement.

**No further financial indebtedness**: There may also be an undertaking included that restricts the total amount of financial indebtedness incurred by a borrower. As guarantees and indemnities are likely to fall within the definition of ‘Financial Indebtedness’, the giving of these may breach any such undertaking.

**Financial Assistance.** The borrower's lawyers will need to be alive to whether the giving of any security or quasi-security (such as a guarantee or indemnity) as part of the transaction would amount to unlawful financial assistance under sections 677-683 Companies Act (‘CA’) 2006.

**Articles of Association:** The Articles of Association of a borrower may restrict or prohibit it from granting security and/or quasi-security. While it may be possible to amend the borrower’s Articles in order to permit it to do so, this will depend on the entity in question, as for a public limited company with a large number of shareholders this may not be feasible.

The check of a potential borrower’s Articles of Association is something that is key at the outset of a transaction and the lender’s lawyers (particularly trainees) are often tasked with checking this information. A particular concern in certain transactions will be restrictions in the Articles of Association making enforcement of security over shares problematic, such as directors having a discretion to refuse to enter a transferee (i.e., the lender) of the shares into the register of members of the borrower. Such restrictions will need to be removed from the Articles of Association.

**Commercial contracts.** Itcould be the case that commercial contracts may contain an absolute prohibition on assignment or prohibit security being taken over the benefit of the contract without the prior consent of the contract counterparty. In either case the issue needs to be investigated as part of the due diligence and if necessary, addressed before the security is taken.

**Summary**

The aim of security is to protect a lender against possible default by the borrower under the loan agreement.

When a lender holds security over an asset of the borrower, if the borrower defaults, then the lender can step in and can have the sale proceeds of the relevant asset applied in repayment of any outstanding amount that is due on its loan to the borrower.

Quasi-security does not give a lender rights over a borrower's assets but assists a lender in recovering its debt by allowing a personal claim against a guarantor or indemnity provider.

Where an entity (e.g., a parent company) is unable to give security or a guarantee (e.g., due to undertakings in its other loan agreements), a lender may require a comfort letter as reassurance of the parent's continued support of its subsidiary (to which the lender is making the loan).

Any contractual, constitutional or other legal restrictions preventing a borrower from granting security will also need to be considered by the lender at the outset.

**Types of security**

This element explains the different types of security interest available to a lender, the assets that may be secured and some practical and commercial considerations when taking security.

**Main types of security**

* Assignment by way of security (e.g. borrower's rights against a third party)
* Taking physical possession of asset:
  + Pledges
  + Liens
* Transferring ownership in asset:
* Mortgages
* Giving rights over assets:
* Charges

**Charges**

**What is a charge?**

A charge is an equitable, proprietary interest in and to the asset.

**What does the lender achieve?**

A charge gives the lender the right to have recourse to the charged asset in order to satisfy the secured debt. There is no transfer of title to the asset itself.

The main types of charges are fixed and floating charges which we will look at in further detail on the next slide.

**Fixed Charges**

A fixed charge attaches to an asset as soon as the charge is created. It gives the lender a claim over the proceeds of sale of that asset in priority over other creditors of the borrower.

For a fixed charge to be validly and effectively created as such (so that it is not instead classed as a floating charge), the lender has to show a sufficient level of **control** over the asset. This is normally done by insisting, in the security document, that the owner of the asset (the borrower) gets the consent of the lender to deal with the asset, e.g. to sell it or to create further charges over it.

If the borrower sells an asset subject to a fixed charge, the buyer of that asset takes subject to the fixed charge as long as it has notice of the charge. Provided the fixed charge has been registered at Companies House in accordance with s. 859A-Q CA 2006, the buyer will have 'actual notice' of the fixed charge if it carries out a search of the charges register. The law is unclear as to whether registration would operate as 'constructive notice' on a buyer who has not carried out a search of the charges register, but further consideration of this point is outside the scope of this knowledge stream.

A key element of a fixed charge to consider is that it will not be suitable for every type of asset, because a fixed charge will severely limit the borrower’s ability to deal with that asset.

**Floating Charges**

There are certain types of asset which the borrower needs to be able to deal with freely as part of its business, such as stock. The value of such assets will therefore regularly fluctuate. The most appropriate form of security for fluctuating assets is a floating charge.

Under a floating charge, a borrower is able to deal with the charged assets in the ordinary course of its trade – e.g. to sell, hire or lease them without first obtaining the consent of the lender.

A floating charge ‘floats’ over the charged assets until the occurrence of certain events. On the occurrence of one or more of these events, the charge ‘crystallises’ and fixes on the charged assets. The floating charge effectively becomes a fixed charge, in that the borrower no longer has the ability to deal with the assets over which the charge has crystallised without the lender’s consent.

However, for insolvency purposes the charge itself is still treated as a floating charge for insolvency ranking. This means that the proceeds of sale of the assets subject to it will be applied in paying the fees, costs and expenses of the relevant insolvency office-holder, the debts owed to preferential creditors and in setting aside the prescribed part fund (discussed later) before being applied in satisfaction of the debt owed to the floating charge holder.

**Crystallisation of floating charges**

Crystallisation can occur as a matter of law on the following certain events:

* on the liquidation of a borrower;
* on the appointment of a receiver; or
* if the borrower ceases to carry on business.

A typical security document contains a list of additional triggers, for example an event of default under the loan agreement or any event which, in the opinion of the lender, would put the assets in jeopardy. If any of these events occurs then the floating charge would crystallise.

**How to identify a floating charge?**

**Key case: Yorkshire Woolcomber's Association Ltd [1903] ('Yorkshire Woolcombers')**

In this case the court discussed the characteristics of a floating charge. It was held that a charge would be deemed floating if:

* it is a charge on a class of assets of a company present and future;
* that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and
* by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets.

**Distinction between a fixed and floating charge**

**Key case: National Westminster Bank plc v Spectrum Plus Limited and others** **[2005] UKHL 41** (**‘Spectrum’**).

The House of Lords reviewed the distinction between fixed and floating charges in the above case. The judges generally approved the Yorkshire Woolcomber’s definition but focused particularly on the third element of that definition (i.e., until action is taken by the lender the borrowing company may carry on its business using those assets in the ordinary course of its business).

According to the leading judgement, the essential characteristic of a floating charge, which distinguishes it from a fixed charge, is that “the asset subject to the charge is not finally appropriated as security for payment of the debt until the occurrence of some future event. In the meantime, the borrower is left free to use the charged asset and to remove it from the security”. Conversely, it is an essential characteristic of a fixed charge that assets can be disposed free from the security only with the “active concurrence” of the lender.

Note that the **substance** of the charge is more important than the **label** applied by the parties. To determine whether a charge labelled as fixed by the parties is in fact floating, you need to look at the element of **control** over the asset granted by the charging document, and the nature of the charge evidenced by the terms of the security document, **not** the name which the parties have given to the charge.

**Key case: Re Avanti Communications Limited (in administration) [2023] EWHC 940 (Ch) (‘Re Avanti’).**

The recent case of Re Avanti is the first major case to have considered the Spectrum principles further in relation to the control required for a fixed charge.

In Re Avanti, the High Court held that there should be a more nuanced approach than that taken in Spectrum and that it will not always be necessary for there to be an absolute prohibition on the chargor (i.e. the party providing security) dealing with the charged assets for a fixed charge to be valid.

Instead, there should be a number of factors taken into consideration, including:

* + The nature of the assets;
  + The nature of the business of the chargor; and
  + The level of flexibility and freedom the chargor will have to deal with the charged assets.

Where the chargor agrees to ‘material and significant’ restrictions on the disposal of the assets and a prohibition on the disposal of such assets in the ordinary course of business, the charge likely take effect as a fixed charge. This is on the basis that the lender (as chargee) will be retaining ‘very significant control’ over the charged assets.

Equally, if there are some careful and considered exceptions to the prohibition on disposal, this does not always mean that the charge cannot take effect as a fixed charge.

Therefore, control remains a significant factor in the determination of the charge as a fixed charge under both Spectrum and Re Avanti.

**What are the disadvantages of a floating charge for a lender?**

The borrower is free to deal with the assets subject to a floating charge. Whilst this flexibility enables a borrower to run its business day to day, the risk for the lender is the reduction of the 'pool' of assets available to it on enforcement of its security. Although the lender will benefit from certain contractual protections to mitigate against this, the lender will nonetheless prefer to take fixed charges over important assets.

Floating charges rank behind fixed charges (even those entered into after the floating charge), preferential creditors (such as employees) and the prescribed part fund.

Administrator/liquidator fees, costs and expenses are taken out of floating charge assets (including any tax liability on capital gains arising from disposals made by the administrator in the course of administration.

It is subject to more stringent avoidance rules as in certain circumstances floating charges are void if the borrower enters into liquidation or administration.

A floating charge may not be recognised in other jurisdictions.

**What are the advantages of a floating charge for a lender?**

The lender obtains security, but the borrower retains flexibility to run its business day to day as it is able to dispose of assets subject to a floating charge in the ordinary course of its trading.

Provided the floating charge together with any other security the lender holds over the borrower's assets is over all or substantially all  of the assets of the borrower, a lender will be a holder of a '**qualifying floating charge'**giving it the right to appoint an administrator out of court - see next slide.

Historically, a lender with a floating charge could appoint an administrative receiver with wide-ranging powers to manage the borrower and sell the borrower's assets to repay the lender.

However, for floating charges **created on or after 15 September 2003**, the lender will only be able to appoint an administrative receiver if the charge falls into one of the **‘limited exceptions’**(e.g., the floating charge was created in relation to certain project financing or capital markets transactions). The detail of these exceptions is outside the scope of this knowledge stream.

Therefore, if the floating charge was created on or after 15 September 2003 and **does not fall within one of the ‘limited exceptions’**, the lender can **no longer** appoint an administrative receiver, but as a holder of a ‘**qualifying floating charge’** (as defined below) such a lender has the power to appoint its own choice of administrator by using an out-of-court procedure, which is quicker and cheaper than the court-based process of appointing an administrator.

A ‘**qualifying floating charge**’ is one which fulfils the requirements of paragraph 14 of Schedule B1 to the Insolvency Act 1986.

Essentially, this means that (i) a floating charge, which together with any other security the lender holds over the company's assets is over the whole or substantially the whole of the company’s assets and (ii) the document creating the floating charge must state that paragraph 14 applies or purport to grant to the lender the power to appoint an administrator.

**Mortgages**

**What is a mortgage?**

A mortgage is a transfer of ownership of an asset to the lender.

In the case of a legal mortgage, it involves the transfer of legal ownership. In the case of an equitable mortgage, it involves the transfer of beneficial ownership.

With a legal mortgage the lender then becomes the owner of the asset, subject to a right of redemption following repayment by the borrower.

[Diagram:

“Legal mortgage” arrow to “Legal Ownership”

Equitable Mortgage “arrow to” Beneficial Ownership]

**Legal mortgage**

A legal mortgage involves a transfer of legal title to an asset to the lender, subject to:

* an obligation on the lender to transfer the asset back to the borrower on repayment of the loan (known as the ‘equity of redemption’); and
* a right to take possession of and sell the asset on default.

Assets which may be subject to a legal mortgage include ships and aircraft. Provided the mortgage is created by deed, the lender will enjoy a power of sale pursuant to s. 101 Law of Property Act 1925 (the **'LPA 1925’**).

A transfer of legal title to certain assets (such as shares) bring greater administrative burdens and potential liabilities, so an equitable mortgage or fixed charge may be preferable, as there is no transfer of legal title on their creation. Taking security over shares is considered further later on in these slides.

Legal mortgages cannot be taken over future property- the asset must be owned by the chargor when the security is created. Also, legal mortgages can only be created over legal interests in assets (not equitable interests).

**Mortgages over land**

Under the LPA 1925, a legal mortgage over land can only be created by way of a “charge by deed expressed to be by way of legal mortgage” (s. 87 LPA 1925). It does not transfer legal title to the asset but gives the secured creditor similar rights. Crucially, the lender benefits from a power of sale over the land.

In practice this may be referred to as ‘a charge by way of legal mortgage’, ‘legal mortgage’ or a ‘first legal mortgage’. In addition to registration at Companies House, charges by way of legal mortgage should also be perfected by registering at the Land Registry in order to obtain priority over subsequently created security interest.

As it is not possible to create a charge by way of legal mortgage over land acquired after the date of the security document (a debenture) then a lender will usually take an equitable mortgage over any future land with an assurance from the borrower that they will ‘upgrade’ the fixed charge over such land to a charge by way of legal mortgage as and when the lender requires it. This ‘upgrade’ will occur by the borrower executing a short supplemental mortgage and registering it at Companies House and the Land Registry.

**Equitable mortgages**

Equitable mortgages do not involve a transfer of legal ownership but a transfer of the beneficial interest in an asset. An equitable mortgage is created with less formality than a legal mortgage. There is no practical difference between an equitable mortgage and a fixed charge – both will give the lender a proprietary interest in the asset concerned.

A ‘bona fide’ purchaser for value without notice of an equitable mortgage would buy the asset free of the mortgage. Registration of the equitable mortgage at Companies House is therefore very important (and is a requirement pursuant to s.859A CA 2006 in any event).

This will ensure a purchaser has 'actual notice' of the equitable mortgage by searching the charges register. The law is unclear as to whether registration itself would operate as 'constructive notice' on a purchaser who hasn't carried out a search of the charges register, but further consideration of this is point outside the scope of this knowledge stream.

**The differences between mortgages, charges and charges by way of legal mortgage:**

The theoretical difference between these three types of security is that:

* a **mortgage** is the conveyance of an asset to the lender - i.e., the transfer of title (either legal or beneficial) to the asset. The lender becomes the owner of the asset subject to a right of redemption – i.e., the lender has to transfer it back to the borrower following repayment of the underlying loan.
* a **charge** gives the lender proprietary rights in the asset, but there is no transfer of title to the asset itself.
* a **charge by way of legal mortgage (applies to land only)** does not transfer title to the asset. Instead, it grants the lender the same powers, protection and remedies as if the mortgage had been created by way of a lease for a term of 3,000 years.

**Security by taking physical possession of an asset**

**(Note: these are not commonly used in debt finance transactions)**

**Pledge**

A pledge arises where a lender takes actual or constructive delivery of an asset until repayment of a debt. An example of constructive delivery is where the lender receives the keys to a safe deposit box which contains the relevant asset. No other formalities are required, but to avoid any argument that an item has merely been deposited for safekeeping, a letter of pledge or a memorandum of deposit is usually provided. There is an implied power to sell the asset if the debt is not repaid.

To be valid, the pledge must provide the lender with control of the asset. The lender taking a pledge has liability as bailee and it must keep safe custody of the asset alongside ensuring that the asset is insured.

The borrower loses possession of the asset for income-generating purposes.

**Lien**

A lien is a right to retain another’s property until that person meets an obligation such as payment for services. This is different from a pledge where an asset is delivered to and retained by a lender until a debt is repaid. The right arises automatically by operation of law and typically (although not always) involves possession of the property.

For example, where a mechanic is in possession of a car for repair they are able to retain the car until the owner has paid the repair bill.

**Assignment by way of security**

The borrower’s rights under a contract (also referred to as a ‘chose in action’) can be a valuable asset over which the lender may wish to take security. Examples of a borrower’s contractual rights against a third party include where a borrower has (i) the benefit of an insurance policy with an insurance company, or (ii) is owed interest and principal under a loan it has made, or (iii) has a valuable income-stream under a supply contract with a third-party (the contract counterparty).

The borrower can create security over the benefit of each of these arrangements in favour of a lender.

This is subject to checking first whether the consent of the counterparty is required for an assignment, or whether a contract contains a prohibition on assignment. This issue needs to be addressed before security is taken. If consent cannot be obtained, there is little point in taking the security in the first place.

Security over contractual rights is usually taken in the form of an assignment by way of security or a fixed charge – this will generally be a matter of preference for the lender.

An assignment will either be legal or equitable depending on how it is created, as discussed below.

**Difference between legal and equitable assignment**

**Legal Assignment**

If the assignment satisfies the criteria set out in s. 136 LPA 1925, it will be a **legal** assignment (or a ‘statutory assignment’) and will be equivalent to a legal mortgage in that the ownership of that right passes to the lender. However, because the assignment is only intended to serve as security, the security document will also contain a proviso for re-assignment on satisfaction of the secured obligation by the borrower.

Section 136 LPA 1925 sets out the requirements for a legal assignment. It must be:

* in writing;
* an absolute assignment (subject to a proviso to re-assign) in that the **whole** of the asset must be assigned, not just part of it;
* signed by the assignor; and
* **notified** to the original debtor/contract counterparty.

**Equitable Assignment**

An **equitable** assignment will arise if the parties intend to create an assignment, but one or more of the elements of s. 136 LPA 1925 are not satisfied. The element most likely to be missing in an assignment by way of security is notice to the original third party involved in the arrangement.  For practical purposes, it is less important whether an assignment is legal or equitable and more **important whether notice has been given.**

**Practical and commercial considerations when taking security**

The key point to bear in mind when considering the adequacy of a security package is that it is not its value at the time the security is taken which matters, but what its value would be in an enforcement situation – particularly in the event of the borrower’s insolvency. So, in considering what security to take and which other matters to consider, it is the enforcement of the security which must be uppermost in a lawyer’s mind.

**Consequently, the lender and its lawyers must consider various issues, such as:**

* if the consent of the contract counterparty is required for the assignment of a key contract, that issue needs to be addressed before the security is taken. If consent cannot be obtained, there is little point in taking the security in the first place;
* will the lender enforce security over the whole of a business by way of a share sale or an asset sale, or will the lender want the option of being able to do either - i.e., should the lender consider taking a charge over the shares of the borrower in addition to charges over the assets owned by the borrower?

Continued

**Practical and commercial considerations when taking security**

* will each secured asset retain its value? Is it a perishable item or an item which could quickly become obsolete? A lender needs to be aware of the risk of depreciation of certain assets (e.g. plant and machinery), although this in itself will not prevent a lender taking security over such assets;
* is there existing security over any asset(s)? If so, assess whether it will be possible for the borrower to grant further security over such asset(s) - i.e. will any negative pledges be triggered? Also, even if it is possible to grant further security, consider the implications of having more than one competing security over the same asset (i.e. a subsequent lender will rank below an original lender with prior security correctly created and registered);
* can the asset be sold easily? Is there a ready market for it? Can its value be ascertained? For instance, there may be no ready market for shares in a small private limited company; and

For certain assets there are further issues which need to be considered when contemplating taking security, which are discussed in the next few slides.

**Fixed charge over book debts**: It is not sufficient for the security document to describe the charge as ‘fixed’. The judgement in *Spectrum* stated  that the categorisation of whether a charge is fixed or floating depends upon the commercial nature and substance of the arrangement, not what the parties have called the charge in the security document.

* The label that the parties have given to the security may indicate the parties’ intention in this respect, but it is not conclusive. It is a question of substance over form.
* The lender needs to demonstrate sufficient control over book debts and the proceeds of their collection for there to be a fixed charge. If control is lacking, it may be re-characterised as a floating charge.
* If a fixed charge is to be taken over book debts, some controls will usually be documented in the security document. It is common for a floating charge to be taken in respect of book debts arising from the sale of goods and services.

**Security over shares:** Practical steps to take when taking security over shares include checking that:

* the directors do not have the right to refuse to register a transferee (i.e., the lender or a buyer of the shares following enforcement) in the register of members of the company; and
* pre-emption rights do not apply to a transfer of the shares on enforcement.
  + If there is a right to refuse a transfer or pre-emption rights do apply, the Articles of Association of the relevant company must be amended **before** the relevant security is granted. This type of check is done at the outset of the deal through due diligence and can be a common trainee task. The Articles of Association (with any amendments) will be one of the conditions precedent documents.

Practical steps to take when taking security over shares include checking that:

* Will the lender become a person of significant control ('PSC') (as covered in Business Law on the SQE 1 preparation course), giving rise to a registration requirement on the borrowing company's PSC Register. A company is required to request information from any legal entity it knows or reasonably believes to be a PSC required to be registered on its PSC register. If a legal entity with a relevant interest in the company (i.e. shares) fails to respond to the request, the company may issue a restrictions notice freezing the relevant interest. From a debt finance perspective, this is relevant in the context of taking security over shares. If a restrictions notice is issued, it could affect whether the security over shares can be taken, enforced or whether voting rights can be exercised.
* Will the grant of security over shares trigger a mandatory notification requirement to the Secretary of State for Business, Energy and Industrial Strategy under the National Security and Investment Act 2021.

Further checks to make include:

* Are the shares in an **un**limited liability company? In this situation, the liability of the shareholder is not limited to the nominal value of the shares but is unlimited.
* Is there any amount unpaid on the shares?
* Are there any liens over the shares?
* Does the company whose shares are mortgaged or any of its subsidiaries operate a defined benefit pension scheme? If so, the lender needs to be advised that, should the scheme be in deficit at the time, or after enforcement, of the legal mortgage, the lender may be liable for that deficit if it is ‘associated’ or ‘connected’ with the company (see below). This can be the case even if the liability is in a subsidiary of the company whose shares are mortgaged.

The strongest form of security which can be taken over shares is a **legal mortgage**.

* In order to perfect a legal mortgage over shares, the borrower will execute a stock transfer form in favour of the lender and the lender will then be registered in the register of members of the company whose shares are being charged.
* The lender will also receive share certificates in its name – in other words, the lender becomes the legal owner of those shares, subject only to the right of redemption.
* This means the lender has the right to receive notices to vote, to receive dividends, to receive bonus shares, is treated as a member of the company and can more easily, effect a quick sale of the company.

However, there are disadvantages to a lender in taking a legal mortgage of shares, namely:

* being a member of the company will involve a degree of administrative duties such as attending meetings and voting. A lender may appoint a nominee for this purpose;
* if the shares are partly paid, the lender (as new owner) will be liable for the uncalled amount;
* there is a risk to the lender of the company whose shares have been mortgaged to it becoming a subsidiary for the purposes of the CA 2006, or an associate company of the lender for the purposes of the Insolvency Act 1986;
* the risk to the lender that it becomes liable for a deficit in a defined benefit pension scheme or for environmental issues; and
* the risk to the lender that it becomes subject to the PSC regime (under Part 21A CA 2006).

Because of the disadvantages of taking a legal mortgage discussed above, a lender may choose to take an **equitable** **mortgage** or **fixed charge** over shares instead.

* In order to perfect an equitable mortgage/fixed charge, the lender will usually require the company creating the security to provide it with a signed, but undated, stock transfer form as well as the relevant share certificates.
* The charging document will generally also contain a security power of attorney. The intention is that the lender is able to date the stock transfer form and present it to the company whose shares are secured at such time as the lender wishes to become the registered holder of those shares on enforcement of the security.

**Assignment by way of security/fixed charge over contractual rights:**Where rights under a contract has been assigned, it may provide for payments to be redirected so that they are paid by the contract counterparty directly to the lender from the date of the assignment in which case clearly notice of the assignment will need to be given to the contract counterparty.

* Alternatively, the lender may be happy for payments under the contract to continue to be made to the borrower until an Event of Default or other trigger has occurred at which point notice will be served on the contract counterparty requiring payments to be re-directed to the lender.
* An unnotified assignment is not capable of being a legal assignment because it does not comply with the requirements of s. 136 LPA 1925 (mentioned  above) but more importantly not giving notice will mean that the counterparty will be entitled to: (1) make payments under the contract to the borrower; (2) set off amounts owed to it by the borrower against the payments which it owes under the contract; and (3) amend the terms of the contract by agreement with the borrower, without requiring the lender’s consent.

**Security over insurance contracts:**The lender may wish to take security over rights under insurance contracts by way of an assignment by way of security or a fixed charge. The main types of insurance contract over which a lender will take security are:

* ‘Keyman’ insurance (this covers the risk to the borrower of something happening to an individual who is key to the business); and
* buildings insurance.
* Insurance contracts are entered into on the basis of utmost good faith. If the insured misrepresented facts when entering into the contract, the policy will be void. Non-payment of premium will also invalidate the policy.
* Lenders may try to overcome these two issues with a clause in the security document and a specific agreement with the insurer that states that misrepresentation or non-payment will not invalidate the insurance policy. This is normally strongly resisted by insurers.
* Lenders will generally not want to be ‘**jointly insured**’ with the borrower, as this may increase their potential liability (e.g. they may be liable to pay the premium, and there is the risk that the lender may do something which invalidates the policy).
* Equally, being ‘**noted**’ on the insurance policy is not sufficient protection for the lender, as it will not be a party to the insurance policy and will not be able to enforce the policy directly. The best position for the lender is for it to be referred to as **“co-insured in respect of its separate rights and interests”**.This means that the cover provided is ‘composite’ (i.e., the policy contains two contracts of insurance (1) between the insurers and the borrower and (2) the insurers and the lender). If the borrower’s interest falls away – for instance as a result of the borrower having failed to disclose something relevant or in the event of the borrower’s insolvency – then the lender’s interest should still stand.
* As an absolute minimum, the lender will want to ensure that its interest is noted on the insurance policy so that the bank is notified if the policy is varied in a material way, cancelled or not renewed and the insurers are aware that the bank may be able to claim the charged insurance monies directly or that they may be held by the borrower on trust.

**Summary**

* The main types of security explored on this workstream are:
* Charges (fixed and floating)
* Mortgages (legal mortgages, equitable mortgages and mortgages over land)
* Taking physical possession of an asset (pledges and liens)
* Assignment by way of security
* Certain practical and commercial issues (applicable to all assets and specific to particular assets) also need to be considered when determining the security package for a transaction.
* Broadly, lenders are more concerned about enforceability of security rather than the value of security on creation.

**Perfection and registration of security**

This element explains how you perfect security (including the process of registering security at Companies House) and why this is important. It also addresses priority between competing security and some other legal issues to consider when taking security.

**What is perfection of security?**

Where the lender has physical control of the secured assets, it is usually impossible for third parties to acquire rights over those assets without the lender’s knowledge. Accordingly, it is generally held that the best way to secure an asset is to take possession of it (e.g., to take security by way of pledge).

Where a borrower is still in possession of the secured assets, the borrower may try (fraudulently) to sell them – to help protect a lender from such a scenario there is the process of ‘perfecting’ the security.

This is done so by bringing the security interest to the notice of third parties and helps to overcome the problem that equitable security interests (which will include all fixed charges) can be ignored by a bona fide purchaser (including a subsequent lender) for value without notice.

The manner and method of perfecting security will vary depending on the nature of the security interest taken over the asset and the type of asset.

**What is perfection of security?**

**Perfection methods include:**

- physical possession (as with a pledge);

- transfer of legal or beneficial title to the security holder (as with mortgages);

- notice to a relevant third party (such as to a contract counterparty in the case of assignments by way of security/fixed charges over contractual rights);

- registration at Companies House (in practice this will relate to **all** security); and

- registration with central registries relating to specific assets (such as the Land Registry for charges by way of legal mortgage over land).

We will firstly consider the formalities for registration at Companies House. The main aim of which is to give third parties notice of security and thereby make it valid against their claims.

**Registering security at Companies House**

The Registrar of Companies shall register any security created by a company (or an LLP) at Companies House, provided the requisite statement of particulars of the charge have been delivered to it **within 21 days beginning with the day after the day on which the charge is created** (s. 859A(4) CA 2006).

To register the security, the company or any person interested in the charge (such as the lender) must deliver to Companies House (either electronically or by paper filing, though now mostly electronically) the following:

- a section 859D statement of particulars in relation to the security. This will be set out on **Form MR01** available on the Companies House website;

- a certified copy of the security document (s. 859A(3) CA 2006); and

- the relevant fee.

This is a common trainee and/or junior associate task following the completion of the relevant financing. It is vitally important to attend to registration as soon as possible after the creation of the charge, in case of rejections for minor errors or other mistakes, so as to ensure sufficient time to re-submit documents if necessary.

On receipt of the relevant documents, the Registrar will allocate to the security a **unique reference code** and will include on the register (i) a note of the unique reference code and (ii) the **certified copy of the security document** (s. 859I(2) CA 2006). The Registrar will issue a **‘certificate of registration’** stating the name and number of the company in respect of which the security has been registered and the unique reference number allocated to the security (s. 859I(3)(4) and (5) CA 2006).

This is conclusive evidence that the security has been correctly registered.

Form MR01 is a relatively simple form. As well as including details of the company creating the charge, charge creation date and names of persons entitled to the charge, the Form MR01 only requires a short description of any land, ships, aircraft or intellectual property registered (or required to be registered) in the UK which is subject to a fixed charge.

The rest of the form involves ticking appropriate boxes, including a signature and details of the presenter of the form (this will usually be the lender’s lawyers).

**Consequences of failure to register security**

Under s. 859H CA 2006, if the charge is not registered at all, or is not registered within the 21 day period:

the security is void against the liquidator, administrator and any creditor of the company; andthe debt becomes immediately payable.

As a result of these consequences, registration of security will always be carried out in respect of all types of security created by a company.

In the absence of a priority agreement between creditors, priority between most competing charges of the same type (such as between two fixed charges) is determined by the date of creation, subject to correct registration within the 21-day time period. Accordingly, registration pursuant to s. 859A CA 2006 is very important to retain priority, as well as to prevent the charge being void against other creditors of the company.

Lenders may include a completed Form MR01 as a condition precedent in the loan agreement to which the security relates so that registration of the security document at Companies House can take place immediately after signing.

**How is security released?**

The security document will provide for the release of the security once the secured debt is repaid. There are no strict formalities for the release of security, except for security over registered land for which the requisite form needs to be filed at the Land Registry (see below).

However, it is in a company’s interest to inform Companies House that a secured debt has been repaid and request for the register to be amended to show that the security has been released.

This is so that third parties (such as potential new lenders) searching the register have notice that a prior debt has been satisfied and the relevant security has been released.

To register a release of security, the following steps need to be completed:

- the chargeholder (the lender) should execute a ‘Deed of Release’ and execute any other documents required to release security over specific assets (such as a Form DS1 to release a charge by way of legal mortgage over registered land, which should be registered at the Land Registry);

- the company must deliver to the Registrar, with respect to the registered charge, one of the statements set out in s. 859L(2) CA 2006, being (i) a statement that the debt secured by the charge has been paid or satisfied in whole or in part (using Form MR04) or (ii) a statement that all or part of the property or undertaking charged has been released from the charge or ceased to form part of the company’s property and undertaking (using Form MR05). In addition, the company must include in the relevant form the particulars listed in s. 859L(4); and

- the Registrar, following receipt of either Form MR04 or Form MR05, must include in the register in relation to the released charge (i) a statement of satisfaction in whole or in part; or (ii) a statement of the fact that all or part of the property or undertaking has been released from the charge or has ceased to form part of the company’s property or undertaking (as the case may be) (s. 859L(5) CA 2006).

**Registration requirements for specific assets**

Security over certain assets will need to be registered in other registers **as well as** **being registered at Companies House.**

This relates to the following assets:

- **Land**

- **Shares**

- **Aircraft**

- **Ships**

- **Intellectual property**

**Unregistered Land**

Charges by way of legal mortgage now created over unregistered land trigger compulsory first registration of the land (and mortgage) and will be entered on the Charges Register of the relevant property at the Land Registry (once first registration of the relevant title has been completed).

Charges by way of legal mortgage over unregistered land created **before** compulsory registration will have been created by the deposit of the title deeds and the executed mortgage deed with the lender. They were not registrable at the Central Land Charges Register, but, because the lender had control of the title deeds, the borrower could not deal with the land without the lender’s knowledge. Subsequent (puisne) mortgages of unregistered land should have been registered as Class C(i) Land Charges on the Central Land Charges Register.

**Registered Land**

Charges by way of legal mortgage over registered land should be registered against the title number of the relevant property at the Land Registry (the entry will appear in the Charges Register). Priority is by **date of registration**, regardless of when the security was created (hence the importance of carrying out a priority search and submitting the application for registration of the charge within the 30 working day priority period).

**The Register of Overseas Entities**

Although not strictly related to registration of security, there is a further issue lenders need to be aware of when taking security over a borrower's assets if the borrower is an 'overseas entity'.

Under the Economic Crime (Transparency and Enforcement Act) 2022, an 'overseas entity' (which includes a body corporate, partnership, or other entity that is a legal person governed by the law of a country or territory outside of the UK) that wishes to become the owner of a 'qualifying estate' (which would broadly include UK freehold or leasehold property) must register on the Register of Overseas Entities (the 'Register').

Of particular relevance to debt finance transactions is the restriction on the creation of charges by way of legal mortgage in respect of property where the overseas entity is not correctly registered. Any charge by way of legal mortgage created after 1 August 2022 (subject to certain exemptions) would take effect as an equitable mortgage until such time as the overseas entity is registered on the Register (and receives its unique overseas entity ID).

**Shares**

As a legal mortgage transfers legal title to the shares to the mortgagee, this transfer must be registered in the **register of members** of the company whose shares have been mortgaged (N.B. **not** the register of shareholders of the company **creating** the security over those shares). In other words, the lender (or its nominee) will appear in the register of shareholders as the owner of the legal title to the shares. Note that beneficial interests cannot be noted on the register so no such registration is required for an equitable mortgage or fixed charge over shares.

**Intellectual Property**

The following registers will be relevant:

- **Patents -** Register of patents at the Intellectual Property Office.

- **Registered designs -** Register of designs at the Intellectual Property Office.

- **Registered trademarks -** Register of trademarks at the Intellectual Property Office.

Actual knowledge of an earlier registered charge in the Charges Register at Companies House will prevent a subsequent lender from taking priority, even if the subsequent lender’s charge is registered at the Intellectual Property Office before that of the earlier created charge.

**Aircraft**

Mortgages over aircraft should be registered in the Register of Aircraft Mortgages with the Civil Aviation Authority.

Priority is by date of registration, regardless of when the mortgage was created.

**Ships**

Under the Merchant Shipping Act 1995, mortgages over ships are registered with the Registry of Shipping and Seamen in Cardiff.

Priority is by date of registration, regardless of when the mortgage was created.

**Perfection of assignments by way of security/fixed charge over contractual rights**

Assignments by way of security over contractual rights are perfected by giving notice to the contract counterparty/debtor in accordance with s. 136 LPA 1925. Under the **Dearle v Hall** **rule**, the priority of assignments by way of security is generally determined by the date upon which notice is given to the contract counterparty. A notice to the counterparty/debtor will often also be given in relation to a fixed charge over contractual rights.

However, the requirement to serve notice on all the contract counterparties could be administratively difficult. Accordingly, a lender may have to accept that a notified assignment is commercially impracticable. A compromise position may be for the borrower to sign the notices and to deliver them to the lender at the time the security is granted but for the lender to agree only to deliver the notices to the contract counterparty following an Event of Default under the terms of the finance documents.

**Priority between competing security over same asset**

If a borrower enters into a liquidation or an administration , assets will be sold and the proceeds of sale divided up among the creditors in accordance with the rules of priority.

In general, secured creditors will rank ahead of unsecured creditors. As between different secured creditors holding fixed or floating charges over the same asset which have been registered at Companies House, priority is, subject to some caveats, as follows (on the assumption that each security interest has been registered within the prescribed time and in the prescribed manner):

- fixed charges will have priority over floating charges (even if the fixed charge is created AFTER the floating charge);

- fixed charges (and mortgages) will as between themselves rank in priority according to their date of creation; and

- floating charges will as between themselves rank in priority according to their date of creation.

However, the following exceptions may apply:

- for security over assets requiring registration in a specialist registry (e.g. registered land at the Land Registry), this must be done in addition to registration at Companies House. In this case, it is usually the date of registration in the specialist registry which determines priority;

- a lender taking a floating charge can avoid losing priority to a later fixed charge holder by including a negative pledge in the security document containing the floating charge. The Form MR01 includes a box to tick ‘Yes’ or ‘No’ to indicate whether or not the terms of the security include a negative pledge. There is an argument that any new lender which carried out a search at Companies House would have actual notice of the negative pledge and hence any new security granted to them (in breach of the negative pledge) would not have priority over the prior floating charge;

- creditors may enter into contractual arrangements to change the order of priority the law would otherwise impose (e.g. an intercreditor agreement/deed of priority); and

- in the case of assignments over chose in action, e.g. contract rights, priority is dictated by the date on which notice is given to the relevant counterparty, rather than the date of creation – this is the rule in **Dearle v Hall**.

**Other points to consider when taking security**

**Financial assistance**

**Corporate benefit**

**Corporate power and authority**

**Maintenance of capital**

**Financial Assistance** - where a loan is being provided to finance an acquisition of shares, depending on the nature of the proposed security and/or quasi-security and the details of the overall transaction being contemplated, there could be financial assistance issues arising for public companies and private companies that are subsidiaries of public companies.

Please refer back to the materials and examples of financial assistance considered on the SQE Business Law Preparation course.

**Corporate power and authority** – additional questions should be asked relating to the company’s power to enter into any security, such as does the company have the corporate power to enter into the security and/or quasi-security document? Before taking any security, you need to check for any restrictions in the company’s Articles of Association. If there are any such restrictions, a **special resolution** will be needed to amend the company’s Articles of Association in order to permit it to do so, before the security is granted. The bank will also want to see copies of any such resolutions and any amended Articles of Association, as well as board minutes approving the execution of the security document. These will be required as conditions precedent in the loan agreement.

**Corporate benefit** - the lender should ensure the company granting the security (and/or quasi-security) derives some corporate benefit for the purposes of s.172(1) CA 2006 (the duty to promote the success of the company). This is particularly important where the company is not the borrower, for example where the security is being given by a subsidiary in respect of its' parent's obligations (‘upstream’) or in respect of the obligations of another company at the same level in the group (‘cross-stream’). Common conditions precedent to the financing are board minutes and resolutions confirming that the directors of the company have considered this issue.

**Maintenance of capita**l - if a subsidiary gives an upstream guarantee or security to guarantee or secure a loan made to its parent, then this will not result in a breach of the capital maintenance rules if the directors of the subsidiary consider in good faith and on reasonable grounds that the parent is likely to be able to repay or refinance the loan when it falls due for repayment (and so the guarantee or security is not likely to be enforced). If this is not the case, then the guarantee or security may be treated as a distribution for which the company must have sufficient distributable profits so that there will be no unlawful reduction in its capital. A lender will want to see evidence that the directors of the subsidiary giving an upstream guarantee or security have considered capital maintenance issues and concluded that the guarantee or security is not likely to be enforced and, therefore, no provision need be made in the subsidiary’s balance sheet. Usually, a lender will want to see a certified copy of the board minutes or written resolutions of the directors and a certificate addressed to the lenders/agent, or a representation in the loan agreement, that the guarantee or security will not reduce the subsidiary’s net assets by more than its distributable profits.

You will have looked at the doctrine of maintenance of capital on the SQE Business Law Preparation course.

**Summary**

• Perfection of security is vital in protecting a lender’s interests as it ensures third parties are aware of the lender's security interest.

• Methods of perfection will depend on the nature of the asset and the security interest being created.

• Certain charges must be registered at Companies House, though in practice all security will be registered at Companies House. This is essential as correct registration will determine priority between competing creditors (in the absence of a priority agreement between the creditors).

• Other points which need to be considered when taking security include financial assistance, corporate power and authority, corporate benefit and maintenance of capital.

**Subordination**

• We have now considered the key clauses in a loan agreement.

• The remaining slides focus on a problem that arises when there is a group of companies and there are loans at different levels of the group.

• This is known as **structural subordination.**

**Structural Subordination**

• It is very common for companies to operate under a group structure where a holding company has 100% shareholdings in subsidiaries. These subsidiaries may be operating companies, running businesses and owning assets or themselves intermediate holding companies of operating companies. Lenders may lend to the holding company which then filters the money down to the subsidiary(y/ies).

• This can cause problems for the lender which lends to the holding company if the subsidiaries have existing loans or later take out loans. This is because of the statutory order of repayment of creditors on the winding-up of a company.

**The repayment of creditors on a winding-up is made in the following order (note: this is a deliberately simplified list):**

• fixed chargeholders;

• preferential creditors;

• payments out of the ring-fenced fund;

• floating chargeholders;

• unsecured creditors; and finally

• shareholders.

**Subordination**

**Example:**

[Diagram: Bank X arrow under box “Lends” to Hold Co ; line from Hold Co to Company A and line from Hold Co Company B (under box “100% subsidiaries”) ; Arrow from Bank Y to Company B under box “Lends 18 months later”].

**Structural Subordination**

**Example:**

• Companies A and B are wholly-owned subsidiaries of HoldCo. Companies A and B are the operating companies owning the majority of the group’s assets and generating the income for the group. HoldCo’s only assets of value are the shares in its subsidiaries and it does not generate any of its own income.

• Bank X lends money to HoldCo. 18 months later, Bank Y lends money to Company B.

• On a winding up of the group, the assets of Company B will not be available to satisfy the debt owed by HoldCo to Bank X until Bank Y (and any other creditors of Company B) has been paid in full. This is because HoldCo only has a claim to the assets of Companies A and B as a shareholder – and, as can be seen from the above list, shareholders are the last to be paid on a winding up.

• Note that the issue is the existence of the **loan** to Bank Y. **It does not matter if this loan between Company B and Bank Y is secured or not** because Bank Y, whether as a fixed chargeholder (if the loan is secured) or an unsecured creditor (if the loan is unsecured), will still rank above Holdco as shareholder.

• Because of the group structure, and the order of claims imposed by the statutory order of payments on a winding up, **Bank X is said to be ‘structurally subordinated’ to Bank Y**.

**Structural Subordination- solutions**

**Unsurprisingly, this situation is unsatisfactory to Bank X. To reduce the effect of a situation like the one in the example, Bank X can:**

• Insist on HoldCo giving (1) no financial indebtedness, (2) negative pledge and (3) no disposals undertakings to Bank X in the loan agreement. These would restrict HoldCo and HoldCo’s subsidiaries from (1) creating more than a certain amount of debt; (2) granting security over their assets; and (3) selling any of their assets. The aim is to limit the amount owed to creditors that would rank ahead of Bank X on a winding up of the group and to retain as many assets as possible in the group which are unsecured and available to pay off creditors. These would also ensure that no further debt could be taken on at Company B level, meaning that Bank X is not further structurally subordinated in respect of additional lenders to Company B.

• Take a guarantee and/or take security from Company B so Bank X has a direct claim against Company B or its assets.

• Require a subordination agreement between the respective lenders (i.e., contractual subordination) (see slides below).

**Contractual Subordination**

• Where there are different lenders either in a group structure (as above) or within a transaction (e.g. there may be a loan from a syndicate as well as a separate loan being given by a shareholder or the directors) then these lenders can decide amongst themselves the order in which they will be paid by a defaulting borrower.

• The document which governs this arrangement is invariably either called a subordination agreement, an intercreditor deed or a deed of priorities.

• There are various ways that contractual subordination can be structured but the most common is when the junior lender agrees that it will not demand the junior debt from the borrower until such time as the senior lender has been paid in full.

• This might be drafted to include all monies owed to the junior lender or just the amount of principal owed (so the junior lender is able to receive any fees or interest owed to it).

• Only when the senior lender has been paid in full will all amounts outstanding to the junior lender be paid in the agreed contractual order of priority.

• If the junior lender receives money from the borrower before the senior lender has been paid in full the agreement usually provides that the junior lender will hold this money on trust for the senior lender.

• It is sometimes the case that all of the lenders who have entered into a contractual subordination agreement have taken security for their loans. In this instance, the senior lender will not want a junior lender being able to enforce its security (and thereby forcing the senior lender’s hand) so the agreement will also include a provision restricting when the junior lender can enforce its security.

• Enforcement of security is often only allowed with the consent of the senior lender.

• The agreement should also provide that all parties are restricted from amending the loan agreement in specified ways without the other lenders’ consent. This will primarily relate to changes such as increasing amounts due under the respective loan agreement (interest and principal) or making the terms of the loan agreement materially more onerous for the borrower.

• This will help to maintain the level of indebtedness due to any party and the terms with which the borrower has to comply.

• You might be wondering why a junior lender would agree to these terms which, in effect, means they are more exposed to potentially not having their debt repaid in full or even at all. However, to reflect this increased risk of non-payment a junior lender will be able to charge the borrower higher fees and/or margin.

• The order of priority under a subordination agreement will only be relevant if the borrower becomes insolvent or enters into financial difficulty. Most of the time, the borrower will be able to pay both the senior and junior lenders in accordance with the repayment schedule in their respective loan agreements.

• Another reason why a junior lender might agree to entering into a subordination agreement is if there is a need for a cash injection into the borrower/group. Agreeing to be subordinated to another lender might be the only way to attract a new lender. This is one of the reasons why a lender to a subsidiary might agree to give up their priority in a structural subordination situation (as in the example above).

**BRIERLEY KHAN**

**EMAIL**

**From:** Thomas Weinhart

**Sent:** [date of session]

**To:** Brierley Khan Trainee

**Subject:** Project Emerald Facility Agreement

Thanks for your initial research on the above deal.

You will see that Michelle has now forwarded us the draft mandate letter together with the draft term sheet attached for this deal. Please review these drafts. Michelle raises a few questions in her e-mail, but before you address those, could you consider the following:

1. Why is it important the term sheet is expressed ‘subject to contract’?
2. The term sheet mentions underwriters. Why is it important the loan for this transaction is underwritten?
3. Why are there two separate facilities?
4. What is the significance of this loan being classified as a green loan?
5. Do you have any concerns about the ‘Availability Period’ for Facility A being one month? Why is there no cap for Facility B?
6. What type of repayment schedule has been agreed for this transaction? In what alternative ways could repayments be scheduled?
7. Why are the fees set out in separate fee letters?
8. Which entities are giving guarantees and security in respect of the loan?
9. Why are the ‘Conditions Precedent’ important for the Borrower? Should the Borrower be concerned about agreeing to any of these ‘Conditions Precedent’?
10. Why have only items (a)-(c) been included in ‘Representations and Warranties’, and not more?
11. Which of the ‘Undertakings’ have been included to comply with Green Loan Principles?
12. What is the significance of the ‘Costs’ provision?
13. What is the function of the ‘Majority Lenders’ in a syndicated loan?
14. Why do the Lenders impose time-limits in the ‘Acceptance’ provision?
15. Why will the Borrower be concerned about its’ confidential information in this transaction and how will it ensure a lender is restricted from disclosing confidential information?

Please make a note of your responses to these points and also prepare a response to the specific points Michelle raises in her e-mail.

Can we speak first thing tomorrow on this? I’ll set up a call with Michelle tomorrow afternoon.

Thomas

Thomas Weinhart

Partner

Brierley Khan LLP

**From**: Michelle Harris <Michelleharris@infinity.com>

**To**: Thomas Weinhart <[ThomasWeinhart@brierley.com](mailto:ThomasWeinhart@brierley.com)

Cc: Max Henderson [maxhenderson@infinity.com](mailto:maxhendersona@infinity.com)

**Subject**: Project Emerald Facility Agreement

Hi Thomas

It was great to see you yesterday and thanks for your advice in relation to the LMA Green Loan Principles which was helpful. EniBank have sent over a first draft of the mandate letter and an amended term sheet; the term sheet now reflects the points we discussed in order that the loan be classified as green so that’s great. Hopefully we can get it signed and start drafting the loan agreement.

I had a couple of points to check with you.

1. The term sheet refers to EniBank taking the roles of Arranger, Agent and Security Trustee. What do these roles involve?
2. The mandate letter mentions that we will prepare the Information Memorandum in conjunction with EniBank. What is the purpose of this document and what information will it need to contain?

Could we have a call tomorrow to discuss these points? I’m free in the afternoon.

Kind regards

Michelle

**Draft (1): [date]**

**EniBank Plc**

Infinity Manufacturing Limited

2 Albert Street

Birmingham

B5 8HP

For the attention of Ms Michelle Harris

[date]

Dear Ms Harris

**Mandate Letter**

We, EniBank Plc as arranger, and [ ] as underwriters (the ‘**Underwriters**’), have pleasure in setting out the terms on which you have mandated EniBank Plc to arrange, and [ ] have agreed to underwrite, the provision of credit facilities (the ‘**Facilities**’) of £450,000,000 to be made subject to the terms of a facilities agreement (the ‘**Facilities Agreement**’) and to the terms set out below.

EniBank Plc commits to arrange and the Underwriters commit to underwrite, subject as described below, the Facilities on the terms set out in the summary terms and conditions enclosed with this letter (the ‘**Term Sheet**’). Terms defined in the Term Sheet and not otherwise defined in this letter shall have the meaning given to them in the Term Sheet.

This proposal is subject to:

(a) the negotiation, execution and delivery of the Facilities Agreement and other related documentation in form and substance satisfactory to the Underwriters and their counsel (the ‘**Facility Documents**’);

(b) there not occurring or becoming known to the Underwriters a material adverse change (or event which, in the opinion of the Underwriters, is likely to result in a material adverse change) in:

(i) the business, assets, operations, financial condition or prospects of the Borrower or any of the Guarantors (the ‘**Obligors**’) taken as a whole since that represented in the Borrower’s or any Guarantor’s latest published audited accounts; or

(ii) the international or domestic money, debt, bank or capital markets during the period from the date of this letter until the date of signature of the Facility Documents,

and the Underwriters not becoming aware of any materially adverse information affecting the Borrower or the Group taken as a whole during the period from the date of this letter until the date of signature of the Facility Documents, in each case as would be likely, in the opinion of the Underwriters, to prejudice syndication of the Facilities; and

(c) payment of the arrangement and underwriting and fees as set out in the Term Sheet.

**1. Syndication:**  You acknowledge our intention, either prior to or after the execution of the Facility Documents, to syndicate participations in the Facilities. We agree to co-operate and to work together with a view to discussing and agreeing any steps which may be necessary to achieve a successful syndication. Within the syndication timetable to be established by us after consultation with you, you will provide us with such information (including but not limited to the information referred to in paragraph 3 (Information Memorandum)) and make available such management, personnel and materials, in each case as are of a type customarily provided or made available for a syndication of this nature (including but not limited to the attendance of senior management for bank presentations at such times as may be mutually agreed). We will manage all aspects of the syndication in consultation with you including the timing of all offers to prospective participants, the acceptance of commitments and the determination of the amounts offered.

**2. Clear Market:** To ensure an orderly and effective syndication of the Facilities, you agree that until the date on which we confirm that general syndication has been completed, you will not, and you will procure that none of your affiliates or subsidiaries will, establish, arrange or syndicate (or attempt to establish, arrange or syndicate) any other facility in the international or domestic bank debt markets except with our prior written consent.

**3. Information Memorandum:** You, in conjunction with EniBank Plc, will prepare the Information Memorandum that will be required to be provided by you to potential lenders in general syndication in consultation with us. You will be responsible for the accuracy of the contents of the Information Memorandum and will warrant the accuracy of the contents in the Facility Documents.

**4. Indemnity:** Whether or not the Facilities are completed or any further documentation relating to the Facilities is signed, you will indemnify and hold us harmless and each of our affiliates and subsidiaries and each of our directors, officers and employees (each an ‘**Indemnified Person**’) from and against any claims, charges, losses, liabilities and expenses which may be incurred by or asserted or awarded against any Indemnified Person (except to the extent that the same arises from the wilful misconduct or gross negligence of such Indemnified Person) as a result of the arranging or syndicating of the Facilities or as a result of any information which is received from or approved by you or any of your affiliates proving to be untrue, inaccurate and/or misleading in any material respect as at the date of issue.

**5.** **Expenses:** You will reimburse us all our reasonable out of pocket expenses (to include the expenses and charges of our affiliates or subsidiaries involved in the Facilities) the fees and disbursements of our advisers and any other fees and expenses payable in connection with the Facilities.

You shall reimburse, or procure the reimbursement of, such expenses in all circumstances and irrespective of whether or not the Facility Documents are signed.

**6.** **Payments:** Each amount payable under this letter shall be payable with all applicable VAT or other applicable taxes and shall be paid free and clear of any set-off or withholding tax of any nature. If any deduction is required to be made in respect of the payment of any sum under this letter, you shall pay such amount as will result after any such deduction in the full amount being paid to us.

All amounts due to us are payable no later than 30 days after the date of receipt of the relevant invoice.

**7. Confidentiality:** This letter is intended for your exclusive use and is provided on the express understanding that you shall treat this letter as strictly confidential except to the extent you are required to make disclosure(s) under any applicable law, rule or regulation.

**8. Market flex:** If at any time before the date of close of general syndication, we notify you that, in our opinion, there has been, since [today’s date], a material increase in the pricing of corporate debt in the London syndicated lending market, we reserve the right to adjust the structure, terms and pricing of the Facilities in order to ensure a successful syndication. Our commitment to underwrite the Facilities under this letter and the Facility Documents is subject to appropriate amendments being made to the Facility Documents.

**9. Announcements:**  You and we each agree that no announcements regarding our respective roles as borrower, underwriter or arranger of the Facilities will be made without each other's prior written consent (such consent not to be unreasonably withheld or delayed) or except to the extent that any such announcement is required under any applicable law, rule or regulation.

**10. Warranty:** You warrant that all information or documentation supplied by you or on your behalf to us for the purposes of the Facilities is true and accurate in all material respects and not misleading.

**11. Period of Offer:** This offer shall remain in effect until the close of business, in London, on [date] at which time it will expire unless we receive your written acceptance of this letter. Following acceptance of this letter our obligations will terminate unless the Facility Documents are signed on or before [date]. Your obligations under paragraphs 4 (Indemnity), 5 (Expenses), 6 (Payments), 7 (Confidentiality) and 12 (Law) shall continue notwithstanding the termination of this letter.

**12. Law:** This letter will be governed by English law.

If you agree to the above please sign and return the attached copy to us.

Yours faithfully,

|  |  |  |
| --- | --- | --- |
| ……………………….  For and on behalf of  **EniBank plc**  We accept the terms set out above. | ……………………………  For and on behalf of  **[*underwriter*]**  We accept the terms set out above. | ………………………………  For and on behalf of  **[*underwriter*]**  We accept the terms set out above. |

………………………..

For and on behalf of

**Infinity Manufacturing Limited** [date]

**ENIBANK PLC**

[address]

To: INFINITY MANUFACTURING LiMITED

2 Albert Street

Birmingham B5 8HP

[date]

**Subject to contract**

Dear MS HARRIS,

**Term Sheet: £400,000,000 Term Loan Facility and £50,000,000 Revolving Credit Facility**

We are pleased to offer you financing on the following terms:

**Lenders:** A syndicate of financial institutions to be selected by the Arranger in consultation with the Borrower.

**Underwriters:** EniBank Plc and [insert names of other underwriters]].

**Arranger:** EniBank Plc.

**Agent:** EniBank Plc.

**Security Trustee:** EniBank Plc.

**Borrower:** Infinity Manufacturing Limited

**Guarantors:** Infinity Group plc; Infinity Jersey Limited; Infinity Technical Investments Limited, and following the Acquisition, T-Craft Motor Company Limited (the ‘Target’)(together the ‘Guarantors’).

**Facilities:** The facilities will be made available in two facilities. Facility A shall be a £400,000,000 term loan facility. Facility B shall be a £50,000,000 revolving credit facility. The facilities shall be underwritten in full by the Underwriters in the proportion of their commitment.

**Total Facilities Amount:** £450,000,000

**Purpose:** The Borrower shall apply the proceeds of Facility A towards the cost of acquisition by the Borrower of the entire issued share capital of T-Craft Motor Company Limited (the ‘Target’). Facility A will be classified as having green purposes in line with the Green Loan Principles published by the LMA, LSTA and APLMA in February 2021 (the ‘Green Loan Principles’).

The Borrower shall apply the proceeds of Facility B to finance costs and expenses in connection with the acquisition, and for general corporate purposes.

**Availability Period:** Facility A: until the date falling one month after execution of the Facilities Agreement.

Facility B: Utilisation Requests can be submitted up until one month before the Repayment Date.

**Utilisation:** Facility A: one Utilisation.

Facility B: each Utilisation in a minimum amount of £500,000.

**Repayment Date:** The facilities will be repaid in full on the fifth anniversary of the date of the Facilities Agreement.

**Voluntary**

**Prepayments:** Permitted on 30 days’ notice. Prepayment amounts to be no less than £5,000,000. Prepayments made under Facility A may not be redrawn.

**Interest Rate:** Facility A: the sum of: (a) SONIA and (b) a margin of 2.5%

Facility B: the sum of: (a) SONIA and (b) a margin of 2.65%

**Interest Periods:** One, two, three or six months at the option of the Borrower.

**Fees:** The following fees will be payable:

1. Arrangement fee as set out in the fee letter;
2. Agency fee as set out in the fee letter;
3. Security Trustee fee as set out in the fee letter; and
4. Commitment fee at 0.5% p.a. on daily undrawn amount (payable monthly) in arrears.

**Guarantees:** The facilities shall benefit from joint and several guarantees from each of the Guarantors.

**Security:** The Lenders will be granted:

(a) Charge by way of legal mortgage over the Target’s plant in Derby and charge over shares in the Target;

(b) Fixed and floating charges over all current and future assets of the Borrower way of a debenture (the ‘Debenture’);

(c) Fixed charge over the shares held by Infinity Group plc in its material subsidiaries;

(d) Fixed and floating charges over all current and future assets of Infinity Technical Investments Limited;

(e) Fixed and floating charges over all current and future assets of the Target;

(f) Fixed charges over intellectual property owned by Infinity Group plc; and

(g) The Lenders (at the Borrower’s cost) to be entitled to conduct annual security reviews and valuations.

**Conditions Precedent:** Standard conditions precedent for a transaction of this type, in a form and substance satisfactory to the Agent (acting reasonably), including but not limited to:

1. Board and shareholder resolutions (where required) of the Borrower and each of the Guarantors;
2. Formalities Certificate from Borrower and each of the Guarantors with constitutional documents of the Borrower and each of the Guarantors attached;
3. satisfactory evidence of the Borrower’s contribution of £100,000,000;
4. Legal opinion from the Lenders’ solicitors (in a form to be agreed by the Agent acting reasonably and to include confirmation that the loan and security documents are legal, valid, binding and enforceable and the security is effective);
5. Accountant’s report (in a form to be agreed between the parties) from the Lenders’ accountants confirming completion of and satisfaction with financial due diligence;
6. The Hedging Agreement, duly executed by the Borrower and the Hedging Counterparty;
7. Valuations and surveys for the plant in Derby;
8. Evidence of necessary planning, consents and permissions to operate the plant in Derby;
9. Confirmation of satisfactory insurance over the plant in Derby; and
10. Compliance with the Lenders’ KYC requirements**. FOR YOUR INFORMATION**: Banks in the UK are required by law to comply with anti-money laundering (AML) laws and Know your Customer (KYC) requirements to prevent criminals and terrorists from using financial products or services to store and move around their money. In the UK these requirements come mainly from the Terrorism Act 2000 (as amended), the Proceeds of Crime Act 2002, the Money Laundering Regulations Act 2007, the Money Laundering, Terrorist and Financing and Transfer of Funds Regulations 2017 and the Sanctions and the Anti-Money Laundering Act 2018 which apply across a range of sectors and institutions. KYC information that is gathered is also used to help banks adhere to the strict financial sanctions regimes that are in place across the globe.

**Representations and**

**Warranties:** Usual and customary for facilities of this type, including but not limited to:

1. Accurate valuation of Target and the plant in Derby;
2. Facility A to be used for an electric car production plant project which is in line with the Green Loan Principles;
3. Accuracy of annual reporting on environmental benefits.

**Undertakings:** Usual and customary for facilities of this type, including but not limited to:

1. Negative pledge (with exceptions to be agreed);
2. No material change of business;
3. Restrictions on disposals (with exceptions to be agreed);
4. Proceeds of Facility A to be credited to a dedicated loan account or otherwise tracked in accordance with the Green Loan Principles;
5. Annual reporting on environmental benefits resulting from use of Facility A;
6. Annual external reviewer to assess use of Facility A in line with the Green Loan Principles;
7. Maintenance and insurance of the plant in Derby; and
8. No payment of dividends by the Borrower.

**Financial** [Not relevant for teaching purposes]

**Covenants:**

**Events of Default:** Usual and customary for facilities of this type, including but not limited to:

(a) Cross default in respect of any material financial indebtedness of the Obligors (with exceptions to be agreed);

(b) Material adverse change;

(c) Substantial damage to the plant in Derby;

(d) Failure to apply Facility A in line with the Green Loan Principles; and

(d) Insolvency.

**Taxes:** All payments to be free of withholding and other taxes.

**Costs:** All reasonable expenses incurred in the preparation, negotiation, execution and delivery of the Facilities, including but not limited to reasonable legal fees, to be paid by the Borrower whether or not the Facilities are put in place.

**Majority Lenders:** 66⅔ % of the Total Commitments.

**Assignment:** Any Lender may transfer or assign all or part of the Facilities to another syndicate lender or an affiliate of a syndicate lender without the Borrower’s consent.

**Other:** All other standard terms for documents of this nature to be included.

**Acceptance:** These terms will be available for 30 days from the date of this Term Sheet. If the loan agreement in respect of the Facilities is not executed within three months of acceptance of this offer, the Arranger reserves the right to renegotiate the Term Sheet or withdraw the offer.

**Confidentiality**: This Term Sheet and its contents are intended for the exclusive use of the Borrower and shall not be disclosed by the Borrower to any person other than the Borrower’s legal and financial advisors for the purposes of the proposed transaction, unless the prior written consent of the Arranger is obtained.

**Law:** English law.

**Jurisdiction:** Courts of England.

***s.859A(1)-(5) and s. 859H of the Companies Act 2006.***

**859A Charges created by a company**

(1)  Subject to subsection (6), this section applies where a company creates a charge.

(2)  The registrar must register the charge if, before the end of the period allowed for delivery, the company or any person interested in the charge delivers to the registrar for registration a [section 859D](https://uk.westlaw.com/Document/IDB721A9191E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=52acdae7d96a4f889e1132cfd2c04752&contextData=(sc.DocLink)) statement of particulars.

(3)  Where the charge is created or evidenced by an instrument, the registrar is required to register it only if a certified copy of the instrument is delivered to the registrar with the statement of particulars.

(4)  *“The period allowed for delivery”*is 21 days beginning with the day after the date of creation of the charge (see [section 859E](https://uk.westlaw.com/Document/IDB7241A191E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=52acdae7d96a4f889e1132cfd2c04752&contextData=(sc.DocLink))), unless an order allowing an extended period is made under [section 859F(3)](https://uk.westlaw.com/Document/IDB7268B191E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=52acdae7d96a4f889e1132cfd2c04752&contextData=(sc.DocLink)).

(5)  Where an order is made under [section 859F(3)](https://uk.westlaw.com/Document/IDB7268B191E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=52acdae7d96a4f889e1132cfd2c04752&contextData=(sc.DocLink)) a copy of the order must be delivered to the registrar with the statement of particulars.

#### 859H Consequence of failure to deliver charges

(1)  This section applies if—

(a)  a company creates a charge to which [section 859A or 859B](https://uk.westlaw.com/Document/IDB71303091E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=16149a599a7249c0a953bd354fc1825a&contextData=(sc.DocLink)) applies, and

(b)  the documents required by [section 859A](https://uk.westlaw.com/Document/IDB71303091E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=16149a599a7249c0a953bd354fc1825a&contextData=(sc.DocLink)) or (as the case may be) [859B](https://uk.westlaw.com/Document/IDB71F38091E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=16149a599a7249c0a953bd354fc1825a&contextData=(sc.DocLink)) are not delivered to the registrar by the company or another person interested in the charge before the end of the relevant period allowed for delivery.

(2)  *“The relevant period allowed for delivery”*is—

(a)  the period allowed for delivery under the section in question, or

(b)  if an order under [section 859F(3)](https://uk.westlaw.com/Document/IDB7268B191E611E299FE89618584BA63/View/FullText.html?originationContext=document&transitionType=DocumentItem&ppcid=16149a599a7249c0a953bd354fc1825a&contextData=(sc.DocLink)) has been made, the period allowed by the order.

(3)  Where this section applies, the charge is void (so far as any security on the company's property or undertaking is conferred by it) against—

(a)  a liquidator of the company,

(b)  an administrator of the company, and

(c)  a creditor of the company.

(4)  Subsection (3) is without prejudice to any contract or obligation for repayment of the money secured by the charge; and when a charge becomes void under this section, the money secured by it immediately becomes payable.

**Documenting security**

This element explains how the security package will be documented and explores some key clauses found in a security document.

**Introduction**

· Straight-forward secured loans will often be documented with the bank’s standard form security document. However, more complex secured loan facilities require more sophisticated security documents.

· Such documents not only describe the security being taken (in what is known as the **'charging clause’**), but also contain provisions aimed at protecting the secured assets and the position of the lender against certain risks.

· The provisions incorporated into security documents will also depend on the type of underlying loan facility (i.e. a term loan or a revolving credit facility) and whether it is a bilateral or a syndicated facility.

· Terms defined in the underlying loan agreement will usually have the same meanings in the security document, to avoid having to repeat all defined terms in the security document.

· There will be wording in the security document to the effect that terms defined in the loan agreement (itself defined in the security document) will have the same meaning when used in the security document, unless expressly defined in the security document.

· Also, a number of provisions in the loan agreement such as the representations and undertakings will (where appropriate) be made in relation to the ‘Finance Documents’. As you have already seen, the definition of Finance Documents will also encompass any security document.

**How is security documented?**

· There are a variety of terms used in the market for describing security documents. For example, the term **‘Debenture’** is often used for security documents containing a comprehensive package of mortgages, fixed and floating charges and assignments. Other terms you may come across include ‘Mortgage Debenture’, ‘Charge’, ‘Security Agreement’ etc.

· You will see a Debenture document (adapted from the LMA form of debenture for teaching purposes) and consider some of its key clauses. The clause references below refer to the clauses in the Debenture.

· For the remainder of these slides, we will be referring to a Debenture.

· In a **bilateral loan** the Debenture will be executed by the borrower in favour of the lender (often referred to as the ‘**Secured Party**’).

· In a **syndicated loan** the Debenture will usually be executed by the borrower in favour of the **security trustee** (who may be labelled the 'Security Agent') for the Secured Parties(which will include all the lenders in the syndicate from time to time).

· This security trustee arrangement will create security for the syndicate as a whole, notwithstanding the identity of the lenders may change during the life of the loan.

**Structure of a Debenture document**

**Broadly speaking, the clauses in a typical Debenture can be categorised as follows:**

· scope of security and creation of security;

· perfection of security;

· protection of secured assets;

· enforcement of security; and

· boilerplate clauses.

**Scope of security and creation of security**

**The following definitions and clauses address the scope of the security a lender is taking and describes the actual security package:**

· **Definition of 'Secured Liabilities**' **(clause 1**): This defines the secured debt (i.e. the monies owed to the lender). The proceeds of sale of the secured assets can only be applied towards repayment of the secured debt plus certain costs associated with the sale of the secured assets. This was considered in Workshop 4 Element 1.

· **Creation of Security (clause 2)**: This clause is known as the 'charging clause' and it sets-out which of the assets of the borrower are being charged and, how each asset will be secured.

**Perfection of security**

**The following provisions assist with enhancing and perfecting a lender's security (as created by the charging clause) over specific assets, by requiring relevant registrations, notices to third parties and deposit of any documents to be carried out:**

· **Land (clause 4):** in particular, in relation to future property (over which there is a fixed charge) an obligation to 'upgrade' this to a charge by way of legal mortgage to be registered at the Land Registry.

· **Investments (clause 5):** in particular, depositing with the Secured Party documents of title relating to any investments (i.e., share certificates) and blank stock transfer forms required to create an equitable mortgage over investments (i.e., shares).

· **Accounts (clause 6):** in particular, how book debts should be dealt with to ensure sufficient 'control' required for a fixed charge and provides for forms of notice to be sent to banks where fixed charges are taken over bank accounts.

· **Insurance policies (clause 7) and Contracts (clause 8):** in particular, forms of notice to be sent to counterparties (insurance company and other contract counterparties) giving notice of assignment/fixed charge of insurance policy/contract to the Secured Party.

· **In addition, the following provisions assist with enhancing and perfecting a lender's security:**

· **Further assurances (clause 16)**: The Debenture will include an undertaking from the Chargor to generally take any steps and execute any documents the Secured Party may require to create, perfect and protect any security. This means the Secured Party could potentially ask for further security beyond the initially agreed package.

· The further assurances clause is backed up by the **power of attorney (clause 17)** which enables the lender to complete the upgrade if the borrower does not cooperate, by signing documents as attorney for the Chargor to take any action which the Chargor is obliged to take but has failed to do so either following that failure or following the occurrenc eof an Event of Default.

· **The following provisions assist with enhancing and perfecting a lender's security:**

· **Notices to third parties (e.g. notices to banks relating to blocked accounts and notices to contract counterparties)(clause 6.3-6.5, 7 & 8)**: Where security is being taken over bank account balances, the secured creditor will usually require the borrower to serve notice to the bank with which the borrower holds the account notifying it of the secured creditor's interest.

· Giving notice to a counterparty is a statutory requirement for a legal assignment of rights by way of security (creating a 'legal' assignment).

· No such statutory requirement exists for a fixed charge over rights, but in practice, a secured creditor would ensure this is done.

**Protection of secured assets**

**The following provisions assist in protecting the secured assets**

· **Undertakings (e.g. negative pledge and no disposals) (clause 3):** The Debenture will contain a negative pledge (even if the facility agreement includes one) to help ensure notice of the negative pledge is given to anyone searching the Companies Registry.

· The form MR01 used to register security and Companies House requires a box to be ticked if the Debenture contains a negative pledge.

· This ensures third parties (including other potential creditors) are notified of its existence and reduces the risk of the lender losing priority to other secured creditors.

· You would also expect to see undertakings protecting secured assets such as no disposals and to maintain and insure the secured assets.

**The following provisions assist in protecting the secured assets**

· **Collection of receivables/blocked accounts (clause 6.1 and 6.2):** To demonstrate sufficient control to constitute a fixed charge over receivables in line with the principles in the **Spectrum** case and the **Re Avanti** case(see Workshop 4 Element 2) a Debenture will usually require the Chargor to collect any book debts arising in the ordinary course of business and pay them into a specified account, which may be a blocked account.

**Enforcement of security**

**Enforcement of security (clause 9):** Although common law and statute provide the lender with implied rights of enforcement, the Debenture will expressly specify when and how the lender's right to enforce security arises, namely following an Event of Default.

The Debenture will give the lender a right to appoint a receiver of the secured assets, an administrator, or (if permitted) an administrative receiver.

By way of summary, a lender's options will be:

· appoint a receiver over the property and assets charged by its security document;

· place the borrower into administration under Schedule B1 IA 1986 (remember that if the lender has a qualifying floating charge, it will be able to appoint its own choice of administrator using the out of court procedure);

· if the lender has a 'grandfathered' floating charge or falls under one of the limited exceptions, it can appoint an administrative receiver; or

· petition for the borrower to be wound up (i.e. liquidation ss. 73-229 IA 1986).

**Boilerplate provisions**

As in any commercial contract, a Debenture will contain a number of boilerplate provisions dealing with administrative matters (e.g. notices, governing law, etc.). We are going to focus on certain boilerplate clauses which also help overcome certain problems posed by common law when taking security.

Creating and perfecting security is not always enough to protect a lender, especially in relation to an overdraft facility or revolving credit facility (“**RCF**”). The consequences of the three following common law rules play a role in how lenders draft security documents:

· the rule in **Clayton's Case** (presumption that money paid into a running account repays the earliest debt first);

· presumed discharge (repayment releases security); and

· the rule in **Hopkinson v Rolt** (loss of priority of further advances made by a lender to a subsequent lender).

Further explanation of these problems and the clauses a Debenture should include to 'overcome' these problems is covered below.

**How does common law affect the drafting of security?**

**‘Repay/release problem’** - at common law, if a borrower repays a sum of money for which it gave security, when it repays that sum, the security will be released. This rule also operates in relation to guarantees.

**‘Clayton's Case problem’** - The rule in **Clayton’s Case** (Devaynes v Noble (1816) 8 LJ Ch 256) says that, in the absence of an agreement to the contrary between the creditor and the debtor, repayments by the debtor will be used to repay loans in the order in which they arose - i.e. the oldest debt will be paid off first.

**‘Loss of priority problem’** - Under the rule in **Hopkinson v Rolt** (1861) HL Cas 514, where a borrower has granted security over its assets to two different lenders (firstly to lender X and subsequently to lender Y), the first priority of lender X in respect of any new advances made under its loan will be lost to lender Y once lender X has notice of lender Y’s security. This is particularly relevant in the case of an RCF where amounts are being continuously re-paid and re-lent during the term of the facility.

**Boiler plate provisions addressing common law issues**

**Boilerplate provisions (which also address issues posed by common law):**

A standard Debenture should include the following boiler plate clauses to deal with the common law rules mentioned above. These clauses should not be deleted:

· **a continuing security clause (clause 2.1)**

· **a ruling off clause (clause 18.2)**

· defining 'Secured Liabilities' as**'all monies'**, but only if this is part of the agreed deal.

**How are these issues dealt with in a Debenture?**

**Clayton's Case problem and repay/release problem**

· **Problem 1**: A bank lends a borrower £10,000,000 under an RCF. The borrower grants a fixed charge over its most valuable assets in favour of the bank to secure this loan. Subsequent to this secured loan, the bank offers the borrower a £500,000 overdraft without taking further security. The borrower utilises the whole £500,000 facility shortly after it is created to pay the salary of its staff. A week after utilising the overdraft, the borrower repays £300,000 to the bank. There is no agreement as to which facility (secured loan or unsecured overdraft) will be repaid.

· As per the rule in Clayton’s Case, the £300,000 will go towards repayment of the oldest debt first – i.e., part repayment of the secured loan. As a result, of the £10,200,000 now outstanding, only £9,700,000 is secured. Clearly the bank would prefer to use the repayment to pay off the unsecured overdraft first, so that it would have £200,000 unsecured and the whole £10,000,000 secured.

· A further complication arises as and when a total of £10,000,000 (i.e., the amount originally borrowed under the RCF) has been repaid - which may be sooner rather than later if the rule in Clayton’s Case is applied.

· This is because of the related common law rule that security will be released as soon as the secured debt has been repaid. If the borrower subsequently redraws the £10,000,000 under the RCF, it will be unsecured.

· The same principles will apply in relation to a term loan available in a succession of tranches – once the first advance (technically an individual loan) is repaid, the position at common law is that the security will be released. This is a risk for the lender.

**Clayton's Case problem and repay/release problem – solutions**

· A lender may seek to ensure that **‘all monies’** ever owed by the borrower to it fall within the ambit of the security – often this is done by expressing that the security is **‘all monies’**, in the definition of Secured Liabilities. Doing so will ensure that an original loan between the lender and the borrower will be secured alongside any additional arrangements entered into such as an overdraft. This makes the rule in Clayton’s Case less of an issue.

· A lender will also want to ensure that its security is described as **'continuing'** - this will mean that the security will not be discharged by repayment of the initial loan advance (such as when the initial amount of any loan agreement is paid). It will instead continue for the entire term of the loan regardless of any intermediate repayment and re-borrowing.

· It will be apparent why this wording is especially important in relation to a secured RCF, as this can involve the whole of the loan being repaid before being re-borrowed. The use of the word 'continuing' to describe the security effectively overrides the repay/release problem.

**Loss of priority to subsequent mortgagees**

· **Problem 2:** Bank X lends a borrower £100,000,000 under a secured RCF (with no negative pledge). A month later, Bank X receives notice of a subsequent charge created in favour of Bank Y, who has lent £50,000,000 to the borrower. The borrower then repays £50,000,000 to Bank X and re-borrows it under the terms of the RCF.

· The rule in Clayton's Case means that the repayment of the £50,000,000 to Bank X (after Bank X has received notice of Bank Y's charge) has the effect of discharging the debt owed to Bank X by that amount. This means Bank X now has first ranking for the remaining £50,000,000 of its loan.

· The re-drawn £50,000,000 ranks behind Y's loan.

· The solution is for the lender to 'rule off' the customer's account in the lender's books when it receives notice of the subsequent charge and open a new account to which all subsequent payments are credited. It is common for a Debenture to provide that this shall be deemed to have been done even if, in practice, the lender does not get round to doing it.

· By opening this 'new account', the whole of the debt on the date when bank X receives notice of Bank Y's security, remains secured and keeps its first ranking priority.

**Loss of priority to subsequent mortgagees – ‘tacking’**

· Tacking allows a lender to secure further advances under existing security which will rank in priority to any subsequent security created in favour of another lender.

· It relates to security over**registered land only.** Under s.49(3) Land Registration Act 2002, a lender is permitted to ‘tack’ where a lender is obliged to make further advances under a loan facility (as would be the case under an RCF or a term loan with outstanding tranches to be drawn). This will be called a 'further advances' clause in the loan agreement.

· This is provided the obligation to make further advances to the borrower is noted on the Charges Register at the Land Registry. In addition, in an RCF the security would need to be described in the Debenture as **'continuing'** (as explained previously) to ensure the security is not discharged when repayments under the RCF are made.

· Applying this to the previous example, assume Bank X is only taking security over registered land and that at the time of registration of the security at the Land Registry, Bank X had noted on the Charges Register its obligation to make further advances up to £100,000,000 pursuant to the RCF. Subsequently, Bank Y notifies Bank X of its security over registered land for £50,000,000 lent by Bank Y to the borrower.

· Because Bank X ‘tacked on’ further advances under the RCF on the Charges Register at the time of registering its security, the new advance of £50,000,000 by Bank X (the borrower having repaid and asked to re-borrow the same amount in accordance with the RCF) will not rank below Bank Y’s security (as would be the case on application of the rule in Hopkinson v Rolt). Consequently, Bank X preserves its first priority for the full £100,000,000, so ‘tacking’ has defeated the rule in Hopkinson v Rolt.

· The concept of tacking also exists in respect of unregistered land, but further consideration of this is outside the scope of the knowledge stream.

**Consecutive secured loans**

· **Problem 3:** Three years ago, Bank A took security over the borrower’s food factory for a £40,000,000 loan. One month ago, the same bank took security over the borrower’s warehouse for a £55,000,000 loan. Shortly after taking out the second loan, the borrower repaid £15,000,000 to Bank A, with no indication as to which loan was to be repaid.

· Under the rule in **Clayton’s Case**, in the absence of agreement to the contrary, the **earlier** loan will have been paid off first. Since the ‘**hardening periods**’(see below)for the security granted in respect of this loan had expired, whereas those for the security granted in respect of the later loan had not, this would have left the bank unnecessarily exposed to the risk of the security granted in respect of the later loan being disapplied.

· **Solution:** The bank can draft the security document to permit it to appropriate sums in any way it wants. This allows it to override the rule in Clayton’s Case and to apply repayments to the more recent loan first.

**Hardening Periods**

Security granted by a company which enters an administration or liquidation shortly afterwards may be challenged or avoided in certain circumstances under the Insolvency Act 1986:

· as a transaction at an undervalue if the consideration received by the company in exchange for granting the security is significantly less than the value of the security (any transaction in the two-year period before the onset of insolvency can be challenged) (s.238);

· as a preference if the granting of the security placed the lender in a better position in the subsequent insolvent liquidation of the company (any transaction during the six-month period before the onset of insolvency, or any transaction with a ‘connected person’ in the two years before the onset of insolvency can be challenged) (s.239); or

· by floating charge avoidance (any floating charge not granted for valuable consideration created in the 12 months before the onset of insolvency and any floating charge created in favour of a ‘connected person’ in the two years before the onset of insolvency is void) (s.245).

For ss.238, 239 and 245 to apply, the company must be “insolvent” at the time it grants the security or become insolvent as result of entering into it. ‘Insolvent’ for these purposes means cash flow or balance sheet insolvent.

The periods of time in which these transactions can be challenged are referred to as **‘hardening periods’**. One of the reasons that a lender will seek a directors’ certificate as a condition precedent to the initial drawdown of a loan is to get the directors of a company to confirm its current solvency. In this way, the lender seeks to reduce the risk of a subsequent attack of its security package by an administrator or liquidator.

**Summary**

· There will be a separate security document in a secured loan transaction. A security document containing a comprehensive package of mortgages, charges and assignments is known as a Debenture.

· A typical Debenture will set out the parties, the borrowings the security relates to (secured liabilities), the assets secured by the Debenture with security interest (charging clause) and various boilerplate provisions, including enforcement provisions and provisions relating to the perfection of the security and protection of the secured assets.

· Certain boilerplate clauses in a Debenture help overcome problems created by common law when taking security, such as release of security on repayment or loss of priority to a subsequent secured creditor.

LMA Leveraged Facilities Agreement Compounded Rate and Term Date

28.16 Negative pledge

In this Clause 28.16, "Quasi-Security" means an arrangement or transaction described in paragraph (b) below. Except as permitted under paragraph (c) below:

(a) No Obligor shall (and the Parent shall ensure that no other member of the Group will) create or permit to subsist any Security over any of its assets.

(b) No Obligor shall (and the Parent shall ensure that no other member of the Group will):

1. sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an Obligor [or any other member of the Group];
2. Sell, transfer or otherwise dispose of any of its receivables on recourse terms;
3. enter into any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or
4. enter into any other preferential arrangement having a similar effect, in circumstances where the arrangement or transaction is entered into primarily as a method of raising Financial Indebtedness or of financing the acquisition of an asset.

(c) Paragraphs (a) and (b) above do not apply to any Security or (as the case may be) Quasi-Security, which is:

1. Permitted Security; or
2. a Permitted Transaction.