An introduction to loan finance

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Although reliance on loan finance has to an extent been reduced by the growth of the capital markets, loan finance remains a key component of corporate finance in most countries. This can be provided either intra-group from related trading or finance companies or from external financing vehicles, whether or not they are connected to the borrower. This section gives an overview of (i) the types of loan finance available and (ii) loan documentation. It is not specific to UK companies, however, and sections specify whether they relate to UK matters. Also see the United Kingdom Country Guide and related articles.

Types of loan finance

Uncommitted facilities

Uncommitted facilities are cheaper to arrange than committed facilities since a number of formalities associated with negotiating and documenting committed facilities are omitted and, of course, because the lender is under no obligation to make any finance available.

The lender therefore needs fewer protection provisions. In addition, where the lender does make finance available, it will usually only be for a short period (less than one year) and the credit risk will, therefore, be relatively small.

Short-term uncommitted facilities are often used to finance temporary or seasonal needs such as:

- paying trade creditors during a peak period or to earn any trade discounts;
- one-off transactions, e.g. a small acquisition for cash or payment of tax;
- meeting salary payments when the collection of trade receivables is slow; and
- the annual business cycle experienced by any seasonal business as working capital requirements fluctuate.

Repayment of short-term credits depends on sources that can generate cash quickly during a single operating cycle. This will usually mean looking to liquid or current assets for repayment. The company should, therefore, when appropriate, try to ensure that the maturity of a loan is matched to the realisation of such assets.

Examples of uncommitted facilities include:

- *money market line* – a company of reasonable size may have a line with its bank under which it can borrow up to a certain limit each day in the money markets on a short-term basis (frequently overnight to a month);
- *foreign exchange line* – this line will be made available from a dealing room and will be utilised by companies with frequent foreign exchange needs and which might need to take out forward contracts to hedge against exchange risks;
- *receivables financing line* – this line will usually be made available by the factoring arm of a bank – the amount which will be made available will be determined by reference to a percentage of eligible receivables and to the strength of the company's customers; and
- *overdraft* – the overdraft is a highly flexible borrowing tool and provides the basis on which all companies undertake their day-to-day transactions, allowing both payments to be made and receipts to be banked. While strictly it need not be uncommitted, the fact that it is repayable on demand gives it a similar status. It will be subject to a limit and interest will be calculated on a daily basis on the amount outstanding, usually at a margin over base rate.

Committed facilities

Committed facilities are generally available for a longer period than uncommitted facilities. Five years is a common period but periods spanning the range from one to seven years are encountered. Because of their committed nature and their longer duration, committed facilities are subject to greater documentation requirements and are more expensive to arrange.

However, this higher cost is often justified in order to assure the company of funds for the duration of a foreseen need. Attempts to finance medium-term requirements by short-term methods run the risk that it may not be possible to refinance at the time a short-term borrowing matures and this could, for example, necessitate the sale of a section of business to fund the repayment.

Medium-term committed loans are often used to finance:

- the purchase or construction of fixed assets;
- expansion;
- refinancing of long-term debt or replacing equity with debt; and
- working capital purposes while the company is growing.

There are a number of options as to how any loan may be structured. Basic amongst these is whether the loan is to be bilateral or syndicated (or club) and term or revolver. In any case, the lender will only be required to advance the loan after certain conditions set out in the agreement have been satisfied (the 'conditions precedent'). In addition, the loan will become repayable (and new advances need not be made) if one of a number of specified events occurs (the 'events of default').

Bilateral/syndicated/club

The choice between a bilateral loan and a syndicated loan is driven mainly by how large the loan will be. However, another factor to consider is whether it is important for the company to keep the identity of the lender the same throughout the course of an agreement. For example, this would be true if the company envisaged the need to seek waivers from covenants (undertakings) or events of default in the future. A lender with whom it has a relationship and with whom it does more business is likely to be more willing to sit down and negotiate waivers and even a refinancing than a non-relationship lender. If the company wants to keep a relationship with its lender, the facility is more likely to be bilateral (rather than syndicated) and provision would be made in the agreement to restrict the lender's right to assign or transfer.

If it is necessary for the loan to be syndicated (e.g. because of its size) the documentation would, ordinarily, expressly permit the lenders to sell their share of the loan in the secondary market. If this is unacceptable to the company then it can seek to negotiate suitable restrictions to the rights of the syndicate to transfer. This may require payment of additional fees by the company in order to persuade lenders to become syndicate members.

Term loans and revolving loans (see this page) re often treated differently from a transferability perspective. This is because in a term loan, once it is drawn down (utilised) in full, the borrower is not at risk of the lenders refusing, or being unable, to advance further funds. As drawdowns (utilisations) may take place at any time over the life of a revolving facility, borrowers are often more concerned as to the identity of the lenders in these facilities.

Some further issues arising from whether the loan is transferable or not are discussed in the section on loan documentation (see following page).

Many financial institutions are only willing to enter syndicated loans if they are entitled to receive a front-end fee for participating and then, to minimise capital adequacy requirements, quickly sell their portion of the loan. If the initial sale and subsequent transferability under a syndicated loan are restricted then the loan is referred to as a 'club loan'. Recently the syndications market has seen a rise in the number of funds participating as lenders, particularly in the leveraged market.

Some companies prefer to negotiate a series of bilateral loans rather than enter into an ad hoc collection of bilateral and syndicated loans. A company may do so on the basis of a standard form loan agreement prepared by the company itself. Banks may be prepared to accept this on the basis that each bank will be in a similar position to any other bank as if they had participated in a syndicated loan. A company may prefer this arrangement since it can more easily replace particular banks with other banks as it sees fit and may be able to negotiate better financial terms as individual facilities fall for renewal. The conformity of the documentation also enables the company to monitor its compliance with the terms of its loans more easily.

The Loan Market Association (LMA) has produced and promoted forms of standardised loan documentation. The documentation was drafted with the objective of meeting reasonable market expectations and therefore reducing the amount of time required to review and negotiate loan agreements. Also, because the documentation creates a recognised format it facilitates the trading of loan interests in the secondary markets. A more detailed discussion of loan documentation is set out later in this section.

Term/revolver

In a term loan, the lender (or lenders, if the loan is syndicated) commits to lend the company a specified amount of money for a period of time from the date of drawdown (utilisation) to the end of the agreement, although as discussed below, repayment will usually be in instalments. Most term loans have a short availability period for the disbursement of funds, often three months. If a longer availability period is required, for example where the proceeds are to be used to fund payment of various instalments of a building contract, (and sometimes even for short availability periods) the lender(s) may insist on receiving a fee by way of commitment commission for keeping the facility on standby.

A term loan is often drawn down (utilised) in one amount but there may be provision for it to be utilised in a number of smaller advances. This will enable the company to spread interest payments and, in a multicurrency loan, will enable it to have different amounts outstanding in different currencies. Prepayment of the loan may or may not be permitted (it usually is) but, in any event, any monies repaid will not be available to be utilised again.

In a revolving loan, the company has the right to draw down specified amounts throughout the course of the agreement but will be required to repay these at the end of short specified periods. This requirement is sometimes managed by the use of rollover provisions, which allow the company to rollover amounts borrowed for further interest periods. It may redraw any amount repaid provided at no time will the total principal amount outstanding exceed the amount of the facility. A commitment commission will be charged on the unutilised part of the facility.

Which of these two options is preferable depends on the purpose to which the funds will be put. A term loan is used to finance the longer-term needs of a company such as the purchase of plant or machinery. Because of the length of time for which the loan is being made, the lender will usually insist on the loan being repaid in instalments during its life.

This gives the lender a check on the company's continued financial soundness by observing whether there is difficulty in obtaining any of the scheduled payments from the company. The company will usually be expected to fund the repayments from the generation of profits during this period. If this is not possible (e.g. where the company is using the money to develop an office block and will receive no income stream until the building is completed) it may be able to negotiate the right to repay the loan in one instalment ('bullet repayment') or with the repayments weighted towards the later scheduled payments ('balloon repayments').

A revolving loan is used where the funding requirements of the company are more variable. For example, if a company is expanding and needs working capital during this period and it is believed that the period of growth will exceed one year, a term loan would be inappropriate since the day-to-day capital needs will vary.

A variant of the revolving loan is the revolving standby credit facility, a particular type of which is known as a swingline facility. A standby credit facility is a committed facility which is used in tandem with another cheaper source of finance such as a commercial paper programme. It is intended that the cheaper source of finance will be used in preference to the standby credit. However, if at any time it becomes impracticable for the company to utilise the cheaper source of funds then it may draw under the standby credit. A swingline facility is generally regarded as a standby credit facility that is available for same-day drawing with a short maturity, usually no more than seven or ten days.

Rating agencies will usually insist on such facilities before rating a commercial paper programme. The fact that under most normal circumstances the standby credit will not be used leads to a variation in the fee structure of the agreement.

The up-front fees are kept to a minimum (since otherwise it would be uneconomic for the company) but a utilisation fee may be added which imposes additional fees on the borrowing costs if the company over-utilises the facility. It is also important for the company to ensure that the utilisation provisions are not too restrictive so that the standby credit can be utilised when required (i.e. at the time that there is a problem preventing the use of the other source of finance) and that the funds are made available on short notice – in the case of a swingline facility, on the day requested.

Some agreements provide for both term and revolving loans giving a very flexible arrangement. Of course, many variations exist in relation to both term and revolving loans. One such variation is an evergreen facility which will include provisions for its automatic extension, subject to service of a notice by the company requesting an extension (usually not less than 30 days prior to the expiry of the facility) and the lender not objecting.

Loan documentation

The negotiation of loan documentation raises a number of issues which are of interest to a company. The following is a discussion of some of the more common issues which arise. For the purposes of this discussion, references will be to a bilateral loan unless the issue being discussed is specific to syndicated loans.

Availability

The question of when and how the loan will be made available covers a number of matters.

First, there is the question of how much notice needs to be given before a proposed utilisation (drawdown) can be made. It is likely that the lender will wish to have time to fund itself in the interbank market before making the loan to the company. The time required by a lender to do this depends on the currency to be drawn. The lender will generally fund Eurocurrencies (i.e. any currency other than sterling which is funded in London) at 11.00 am on the second business day before utilisation but it will fund domestic sterling at the same time on the day of utilisation itself. Any additional time is solely for the convenience of the lender and, in the case of syndicated loans, to enable the agent to communicate with the lenders (and for the lenders to try to find potential buyers in the secondary market for the loan they are about to make).

In a syndicated loan, the lenders are unlikely to agree to any time later than 1.00 pm on the third business day (or the first business day in the case of domestic sterling) before utilisation. In relation to smaller advances lenders may not in fact match funds.

Second, the loan document may limit the number of the advances which may be outstanding at any time, and their size. This is also for the administrative convenience of the lender and the agent. The company may wish to negotiate more flexibility in order to help spread its interest payments or, in a multicurrency deal, to match receivables in different currencies with maturities of advances denominated in the same currency. There is however no point in negotiating the right to have a large number of advances if the requirement of their size in relation to the overall facility amount makes it impossible to achieve that number.

Third, the length of an interest period (or term in the case of a revolving loan) is also important to consider. Agreements often only provide for periods of one, two, three or six months. These periods are very common in the market and as a result the cost of borrowing for such periods can be lower than for other periods. However, the company may desire greater flexibility, in order to manage the interest payments. The agreement should therefore also provide for any other interest period as may be agreed between the company and the lender. Periods in excess of six months can be arranged, but the company will then be required to pay interest at the end of each six month period. This is required since, if the lender is funding itself in the market, it will be paying interest on the same basis. The potential advantage to the company is that if interest rates are low it can borrow at that rate for a long time.

Finally, the company should keep in mind the fact that the loan will only be available once it has satisfied any condition precedent obligations. The company should, therefore, check these obligations carefully and make sure that it can comply with them before it needs to utilise any of the facilities. Conditions precedent cover issues such as:

- evidence of the necessary authorisation by the company of the borrowing (e.g. a board resolution or equivalent authorisation for a non-UK company) and evidence that the company has power to borrow (e.g. review of the constitutional documents);

- evidence that all necessary governmental consents to the borrowing have been obtained (e.g. exchange control consents);
- legal opinions being obtained from all relevant jurisdictions asserting:
  - the validity of the legal documentation; and
  - the capacity and authority of the borrower and each company in the group who may borrow, grant a guarantee or security to enter and execute the documentation for the transaction; and
- if the loan is secured, the bank has received all the security which the company agreed to give.

The loan will also cease to be available if one of the events of default (discussed below) has occurred. In addition, the loan will not be available for drawing if the company cannot repeat its representations and warranties on any rollover date or on the date of any new advance. Companies may seek to avoid this by negotiating out the repetition of certain representations and warranties if they have a revolving loan as part of the facilities.

Currency

The choice of currency or currencies which may be drawn under the loan facility will usually reflect the denomination of the company's receivables. If the company knows in advance which currencies it will require then this can be set out in the agreement. Where the company needs more flexibility, this can be achieved by providing that the loan may be utilised in a specified currency (the 'base currency') or in any other currency agreed to in advance by the lender (the 'optional currency'). It is unlikely that a lender will commit funds in a large number of specified currencies although they are increasingly willing to commit funds in certain specified currencies. In a syndicated loan if the lender is unable to lend the optional currency, typically it is required to lend in the base currency. This is treated as an individual loan by that lender but is not taken into account for the purpose of the maximum number of loans.

If the company is unable to borrow a currency which it needs, it can borrow in the base currency and then convert to the required currency on the foreign exchange market. The disadvantage of this is that unless the company takes appropriate hedging measures (see next section on hedging and hedging documentation) it will incur an exchange risk. This is because it will have to repay the lender in the base currency at a time when it is anticipating receiving sums in the other currency and at that time the exchange rate may have adversely changed from the rate at which the initial exchange was made.

Of course, the choice of which currency to borrow may also be made with a view to taking advantage of anticipated future currency fluctuations. For example, if a company with numerous sterling receivables believes that the euro will devalue against the pound sterling over the next six months, it could borrow euro for six months and at the time of repayment buy euro with income from sterling receivables to finance the repayment.

Whether this is beneficial to the company will depend on the difference in the exchange rates at the beginning and end of the six month period and on the different rates of interest which the company will be required to pay on the different currencies.

Fees

Payment of large up-front fees increased in the early 1990s. This was because of the desire of the big name banks in syndicated loans to make their profit from these fees and quickly pass on the loan to the secondary market and because companies were willing to pay these fees in return for a lower margin (since higher margins may be interpreted as a sign of poor credit rating). In more recent years, as credit has become more readily available again, these up-front fees have reduced. It is still the case that the majority of fees (other than commitment fees) are only applicable to syndicated loans.

Examples of the range of fees that may be levied are:

- *Commitment fee* – an annual percentage fee payable on the undrawn portion of the facility. It is typically paid quarterly in arrears. In a term loan the fee will cease when the availability period ends and for a short availability period this fee is often not charged.
- *Utilisation fee* – this fee is commonly found in standby revolving credits and is payable on the average level of utilisation during a specified period of time. It is intended to increase the lender's return on a facility that was not expected to be utilised to any great extent.
- *Front-end fees* – these are paid on signing or, if later, by first utilisation. They are paid on the whole of the facility regardless of whether the facility is subsequently under utilised, cancelled or prepaid. They include fees listed below.
  - *Lead management/arranger fee and management fee* – this will only apply in major loans where there are lead managers/arrangers and/or managers. The lead management fee is paid in recognition of the work done by the lead manager/arranger in obtaining the mandate, organising the syndication and leading the negotiations. The managers' fee is in recognition of the larger commitment taken by the managers. Recently some companies have adopted a greater role in arranging such loans themselves (although not where the loan has been driven by a particular event such as an acquisition transaction) thereby reducing the lead manager's/arranger's role and fee.
  - *Participation fee* – this fee is often paid out of the management fee but may in certain circumstances be required from the company.
  - *Underwriting fee* – this will only be payable if the loan is being underwritten by a group of banks, usually the lead managers (it is a percentage of the sum being underwritten).

- *Agency or facility fee* – an annual administration fee payable on the full amount of the facility, sometimes by reference to the number of lenders in the syndicate.
- *Security trustee fee* – an annual administration fee payable to the security trustee on secured syndicated loans.

In addition, the company will be expected to pay the legal fees (subject to these being reasonably incurred and to any agreed caps) of the bank/lenders/agent/security trustee (if used) incurred both in the negotiation of the documentation and in taking any subsequent action under the agreement.

Margins

Interest on a loan of this type is made up of three elements – first the cost of funds (Libor or Euribor), second the margin and third mandatory costs (the cost to a lender of complying with Bank of England mandatory deposit rules and fees payable by banks to the Financial Services Authority). Mandatory costs are generally small, particularly for non-sterling loans, where they may not even be charged.

The margin may either remain fixed throughout the period of the agreement or it may change (up or down) according to an expressed formula based on the financial performance and/or credit rating of the borrower. The size of the margin is, of course, a commercial point. However, as mentioned above, any downward negotiation on the margin may be met by the imposition of higher fees.

Gross-up provision and 'increased costs'

The gross-up provision is contained in the taxes clause or the section on 'additional payment obligations' of the loan document and is often negotiated. Almost all external loans are based on the principle that the lender will lend to a borrower at an agreed margin (its profit) above its costs of funds. The grossing up provision, together with other similar provisions ('change in circumstances' or 'increased costs'), are intended to ensure that if there is a change in the cost to the lender of making the facility available or funding the loan during the course of the agreement then the company must make payments to the lender to put it in a position as if no such change had occurred.

It may be considered appropriate to exclude increases to a lender's regulatory capital costs arising from Basel II (which is likely to be implemented in two stages; 1 January 2007 for the basic framework and 1 January 2008 for the advanced approaches and which will alter the regulatory capital regime applying to banks) from the 'increased costs' provisions. This is open to negotiation.

The gross-up provision covers the possibility that a withholding tax may be imposed on payments to be made by the company. In that situation, the company will be required to make additional payments to the lender to make sure that it receives a sum which is free of any tax liability (other than the tax on income which it would ordinarily have to pay). The provision will probably be drafted so that, in addition to ensuring that the lender receives in its hands the full amount owing to it free of any withholding tax liability, the lender will also be indemnified for any additional tax it may have to pay on its income as a result of the increased payments by the company. For example, this would cover the situation where the lender has an increased tax liability on its income as a result of its being deemed to have received the amount of withholding tax paid to the tax authority in addition to the sum it actually receives from the company.

Because of the complexity of international payment methods and the diversity of nationalities in a syndicate of lenders it is not always easy to be sure that no tax will be payable. Tax advice will, of course, need be sought before entering a transaction.

By managing the make-up of the syndicate and the location of lenders' facility offices, deals are usually structured to make the imposition of a withholding tax unlikely. Still, the risk that withholding tax may be imposed must be allocated between the parties and this is generally borne by the borrower. However, the loan document may contain a list of exemptions (see below), which, if applied to the lenders (known as 'qualifying lenders') would mean that no withholding tax should be payable. In that case, the burden is on the lender to ensure that it falls within the definition of qualifying lender at the time that it becomes a lender under the agreement – if the lender is not a qualifying lender then the gross-up obligation does not apply. However, if the lender ceases to be a qualifying lender due to a change of law or its interpretation, the risk is borne by the borrower.

The company can also ensure that if withholding tax liability arises it has the right to repay early part or all of the loan to any affected lender.

If the company has to make gross-up payments, then it is usually required to also provide the lender with the corresponding tax receipts (or evidence of payment). The recipient lender may then be able to obtain a tax credit with its tax authority. If successful, the lender will then be in a better position than if withholding tax had not been payable.

Companies naturally ask that if this happens they will be paid an amount equal to the benefit obtained. Lenders object to this because it is very difficult for them to allocate this tax credit, and other tax credits they may receive from elsewhere, to particular profits. A common compromise is for the lender to agree to pay to the company such sum as the lender considers to be equivalent to the benefit it has obtained.

In circumstances where the loan is made available to a UK company, there are two key exemptions: a borrower should normally insist that the lender or any transferee of the lender satisfies the Inland Revenue's requirements for its concession to interest being paid gross (i.e. without the imposition of a withholding tax). This is known as the 'Section 349' exemption. (In 2001 the law was relaxed to enable UK borrowers to pay interest without withholding tax to UK companies and UK branches of non-UK companies.)

A further concession is to restrict lenders in a syndicate whose facility offices are outside the UK to those lenders which are resident in a jurisdiction which has a suitable double tax treaty with the UK (the 'Double Tax Treaty' exemption).

Representations and warranties

The purpose of the representations is to verify to the lender the information that it requires to be true in order for it to be willing to lend to the company. The representations are divided into legal and commercial statements.

The legal statements cover such matters as:

- the status of the company and its power to borrow (or give security);
- the authorisation of the borrowing by the company;
- the obtaining of any governmental consent; and
- the enforceability of the company's obligations under the agreement.

The commercial statements cover such matters as:

- the accuracy of the company's accounts;
- the fact that there has been no material adverse change in the financial condition of the company since the date of its last accounts;
- the company not being involved in any material litigation; and
- the absence of insolvency proceedings.

Where the representations are to be made by reference to a group of companies headed by a guarantor of which the borrower is a subsidiary, thought should be given as to which company will give which representations. It is likely that both the borrower and the guarantor will give the legal representations but that any commercial representations covering any member of the group will be given only by the principal company in the group.

If a representation is untrue at the time of utilisation an advance need not be made by the lender. In addition, many of the representations may be deemed to be repeated on each date on which a payment of principal or interest is made under the agreement or there may be a covenant requiring the company to notify the lender at any time when one of the representations becomes untrue. In either case, a representation which becomes untrue will eventually constitute an event of default (see 'Events of default' later in this article). For this reason, it may be appropriate in the case of a standby revolving credit for the company to exclude some of the commercial representations from being repeated otherwise it may find that it is unable to utilise the facility at the very time it is envisaged being used (see the section on committed facilities in 'An introduction to debt securities' and 'Types of loan finance' earlier in this article).

A common source of contention with representations is with wording that refers to events which 'might' happen. A company often argues that it would be fairer to talk about events that 'would' happen. This in turn is unacceptable to lenders because of the difficulty of proof. A common compromise is to talk about events 'which might reasonably be expected to happen'. Another source of contention relates to the repetition of representations of legal matters over which the borrower has no control, e.g. the imposition of withholding tax. In these situations, the company should try to restrict the representation to the situation as at the date of the agreement.

The material adverse change (MAC) clause always ignites considerable debate. Companies see this (which may appear either as a representation, covenant (undertaking) or as an event of default) as unnecessary and unfair. Borrowers and parent companies argue that the numerous specific representations, covenants (undertakings), financial covenants and events of default have more than covered the concerns of the lender. In essence, that is often correct and in practice it is rare for a lender to rely on this clause in place of a more specific representation or event of default (although it does happen). The reason for this is because of the use of the word 'material' which, as discussed later, makes it very difficult for the lender to be sure that a breach has occurred. Even if the meaning of 'material' is sufficiently clear, it is very unlikely that at least one other specific provision has not also been breached. However, unexpected events may occur and lenders and their lawyers will seek comfort by adding this catch-all clause.

The clause is, therefore, a comfort to a lender (and, in the case of syndicated loans, an aid to helping the syndication process) without, in most circumstances, being a substantial threat to the company. The company should, however, seek to ensure that any representation on material adverse change refers to material adverse change since the date of the latest financial statements and not the original financial statements, since the latter would disregard any changes for the better which occurred between the first set of statements and the latest and would take account of adverse changes which year-on-year are not material. Those companies which have a strong negotiating position as a result of having a high credit rating may seek to resist the inclusion of a MAC clause.

Financial reporting obligations

There are two main concerns for a company. First, it is usual in loan documents for the company to be required to furnish full accounts and half-yearly accounts within specified time limits and to supply other financial information as reasonably required by the lender. The time limits are often 120 days for the full accounts and 90 days for the half-yearly accounts. A company which is required to produce consolidated accounts including foreign subsidiaries may argue that the time limits are too short. A lender, however, will not want to wait longer to be able to monitor the company's well-being and to verify for itself that the company is, for example, in compliance with any financial covenants it has undertaken. A compromise in this situation is for the lender to be given management accounts at an earlier date. In any event, a lender cannot be expected to agree to time limits in excess of the statutory maximum for delivery of accounts.

The second issue is on what basis the accounts should be prepared. A lender will try both to regulate the identity of the company's auditors (or at least to ensure that they are independent and of good repute) and to ensure that the accounts in each year during the course of the agreement are prepared on a consistent basis. The latter requirement is to enable the lender to monitor compliance with financial covenants more easily. However, it may be necessary or desirable for a company to change its accounting basis. In that situation, the company will not wish to be burdened by the requirement to produce a second set of accounts on the original basis solely for the benefit of the lender.

Most publicly traded companies governed by the law of an EU Member State are required to prepare their consolidated financial statements in conformity with adopted International Financial Reporting Standards ('IFRS') for financial years beginning on or after 1 January 2005. Accounts which are prepared under IFRS are likely to be different from accounts previously prepared under other accounting principles. For example, accounts which were prepared under the old UK GAAP and which are subsequently prepared under IFRS are likely to show changes in reported earnings and to the look of the balance sheet.

A typical provision in a loan agreement is 'frozen GAAP' which requires the financial statements to be prepared on the same basis as the original financial statements unless there has been a change in GAAP, in which case the company undertakes that it will provide sufficient information to the lender to enable it to make the year-on-year comparisons that it requires. There may also be a provision requiring the parties to negotiate in good faith to amend any financial covenants affected by the change in accounting principles.

Covenants (undertakings)

Covenants (undertakings), tend to be more contentious than representations since they impose continuous obligations on the company to do, or not to do, something for the duration of the agreement. They are intended to ensure the continued soundness of a lender's asset and to give the lender certain inside information. They are tailored to each company but common covenants (undertakings) include:

- not to grant security over its assets to third parties (the 'negative pledge' clause);
- to maintain the value of its assets by adequately insuring its assets and not disposing of them;
- to maintain its financial condition by controlling its other borrowings and by restricting the dividends it may pay (this is sometimes excluded where appropriate financial covenants are included);
- to preserve the type of business being financed by restricting changes to the company's business and limiting the acquisitions which it can make; and
- to preserve the identity of the company by restricting or prohibiting it from amalgamating or merging with others.

As mentioned in relation to representations, it will be important where the parent company of the borrower is guaranteeing the loan to decide which company will give which covenants (undertakings). Lenders often seek to impose covenants (undertakings) on the parent company and all its subsidiaries. This is quite onerous and a preferred solution would be to apply the undertakings to the parent company, the borrower and material subsidiaries (defined by reference to a percentage of profits, turnover or gross assets of the group).

Perhaps the most important of the covenants (undertakings) is the 'negative pledge'. Its purpose in an unsecured loan is to ensure that no other creditor of the company is put in a better position than the lender. The negative pledge clause will prohibit the creation or continuation of any security interest (encumbrance) which will be defined widely to include security over any asset of the company unless there is an express exclusion in the document. The company should, therefore, be very careful to negotiate any exceptions it needs. Failure to do so will put the company at the mercy of the lender if it becomes clear in the future that the company will need to seek a waiver of the covenant (undertaking).

The company should consider seeking exclusions for:

- existing security interests;
- security in respect of indebtedness, such as equipment, leasing or hire purchase arrangements, which is in the nature of a loan;
- liens and pledges arising in the ordinary course of business including the financing of imports and exports;
- the granting of security over assets which are to be purchased;
- security interests securing indebtedness up to a specified figure; and
- netting and set-off arrangements in the ordinary course of its banking arrangements.

It may also be possible to negotiate the right to grant security if, at the same time, equivalent security is granted to the lender. The scope of the definition of 'security' or 'encumbrance' and exceptions to the 'negative pledge' clause should also be carefully considered. Negative pledge clauses frequently include title retention, contractual set-off and sale and leaseback arrangements which may not be considered by a finance director or treasurer to constitute security in the usual sense and therefore exceptions need to be considered with care to allow the everyday business of the company to continue without breaching the covenant (undertaking).

Financial covenants frequently required of corporate borrowers are maintenance of a ratio of earnings to interest payable, a ratio of borrowings to earnings and a ratio of current assets to current liabilities although companies with high credit ratings may find that they are able to resist the inclusion of such financial covenants. A borrower needs to pay particular attention to the covenant levels set in relation to the definitions agreed, and needs to be aware of a number of issues when negotiating such financial covenants including the scope of the definition of borrowings or financial indebtedness which will frequently include debentures, lease and hire purchase obligations and deferred indebtedness, all of which constitute a form of credit. Borrowings are also frequently defined to include contingent liabilities such as guarantees and indemnities. The latter should be limited to financial guarantees. Intra-group liabilities should be excluded from computations.

Any changes in GAAP are likely to have an effect on the financial covenants (e.g. the adoption of IFRS) as these will have been set on the basis of GAAP applicable at the time the loan was entered into. Financial covenants (such as those outlined above) which are based around the balance sheet and the profit and loss account should be reviewed carefully to assess the impact of the different entries on the balance sheet and the profit and loss account. The parties may also wish to include a clause requiring good faith re-negotiation of accounts based financial covenants if there are significant changes to the applicable accounting principles.

Consideration should also be given as to whether borrowings should be calculated on a net basis after deduction of cash at bank or liquid assets like commercial paper. Financial covenants are frequently calculated on a consolidated basis and consideration needs to be given to the consolidation calculations particularly in the case of subsidiaries which are not wholly owned and subsidiary undertakings. Exclusion may be appropriate for special purpose subsidiaries financed on a limited recourse basis.

Another issue is whether the various ratios should be tested as of the dates at which financial statements are produced or whether they are applied on a daily or other periodic basis.

Finally, in the case of a company which may make acquisitions, it may be appropriate to negotiate a dispensation of the application of covenants to after-acquired subsidiaries either on a permanent basis or for a suitable period of time after the acquisition to enable the newly acquired subsidiary's financing arrangements to be reorganised.

There has been extensive debate in The Treasurer *magazine about covenants. For further information, visit* www.treasurers.org/thetreasurer

Events of default

Together with the covenants, these provisions are perhaps the most negotiated of all provisions in a loan document. This will not come as a surprise since breach of them will give the lender the right to demand repayment and/or cancel its obligation to make further advances.

They may be limited to actions (or inactions) of the company but commonly they are also expressed to cover the actions (or inactions) of the company's subsidiaries.

This may be unreasonable for a company with a large number of subsidiaries and in that situation it may be appropriate for the company to restrict the application of the provisions to material subsidiaries only (as already suggested with reference to the covenants (undertakings)). Whether they should extend to subsidiary undertakings and special purpose subsidiaries which are financed on a stand alone or limited recourse basis should also be considered.

Events of default cover:

- failure to make any payment of interest or principal under the agreement on the due date;
- breach of other clauses of the agreement including breach of any representation when made and non-compliance with financial covenants or any other covenant (undertaking);
- default in payment by the company of sums due under other agreements (the 'cross-default clause');
- changes which mean that the company is less likely or less willing to meet its obligations under the agreement (e.g. insolvency of the company, execution against its assets by third parties, material litigation and a material adverse change in the financial condition of the company);
- unlawfulness; and
- changes in control of the company.

Companies will naturally seek to reduce the number and extent of these events of default while lenders will be concerned to see that they retain control over the company's assets. In addition, the lender will want to ensure that it is always clear when an event of default has occurred.

Consequently, it will be unwilling to use words such as material or substantial which necessitate the making of value judgements and appropriate threshold levels should be agreed as an alternative, where relevant. During negotiation of the documents this may mean that threshold levels are inserted into covenants (undertakings) and representations whose breach would constitute an event of default. In the case of subsidiaries appropriate exceptions for voluntary reorganisations should be negotiated in the context of events relating to winding up, disposals of assets, cessation of business etc. In practice, however, the two parties' positions need not be too polarised. This can perhaps best be explained by considering two of the most frequently negotiated clauses; the cross-default clause and the change of control clause.

The cross-default clause is intended to make sure that the lender will be treated at least as favourably as all other unsecured creditors of the company. It gives the lender a right to demand repayment of its loan if any other debt of the company to any other creditor is unpaid when due or is accelerated or is in danger of being accelerated.

The company may try to limit the scope of the clause by arguing that:

- it should apply only to other indebtedness which is 'financial indebtedness', i.e. which is similar in nature to the lender's loan and not trade debt;
- debts below a specified value may be excluded;
- if the creditor whose debt can be accelerated chooses not to accelerate then the lender should not be able to accelerate, i.e. the clause should be restricted to a cross-acceleration clause and not a cross-default clause;
- debts which are being disputed in good faith should be excluded;

- voluntary prepayments and repayments made as a result of the illegality, change in circumstances or tax provisions should be excluded; and
- defaults which are occasioned by third parties should be excluded (e.g. a change in policy by an exchange control authority).

Some of these limitations may be acceptable to a lender provided that any compromise can be defined so that it is clear when a breach has occurred.

The second clause mentioned, namely the 'change of control' clause, may, of course, be an unwanted constraint on the commercial options for a group of companies but it may also, in different circumstances be of benefit to the company. This would be the case where the company is concerned about potential unwanted takeover interest.

The fact that change of control may trigger an event of default and, therefore, potentially damaging cross-default, may be sufficient to deter the unwanted takeover interest. Often change of control is structured as a mandatory prepayment event (i.e. an event requiring the loan to be repaid early) rather than an event of default.

A company may be more willing to grant concessions to a relationship bank which has agreed not to transfer the loan than in the case of a syndicated loan where lenders are free to transfer without restriction. However, it needs to be borne in mind that the documentation for one transaction may be used as a basis for another leaving less flexibility to negotiate.

Transfers

The following discussion is confined to the rights of the lenders (and not the company) to transfer and/or assign their participation in the loan since lenders will invariably insist that the company be restricted from transferring any of its rights or obligations under a loan.

There are three principal methods available to lenders to 'sell' the loans which they have made. These are novation, assignment and sub-participation (sometimes called participation).

- Novation is an agreement by all the parties to substitute one lender for another. It is the only method which can effectively pass the obligations of the transferring lender on to the new lender. In syndicated deals, a method for obtaining the consent of the other parties, on day one of the agreement, to any future transfer is contained in the loan agreement in the form of a transfer or novation certificate. The form of the transfer certificate is contained in a schedule to the loan agreement in standard terms to facilitate the secondary market in loans.
- Assignment is an agreement to transfer rights (and not obligations) which is executed solely between the two lenders involved. The lenders may choose to give notice to the company but this is not required. However, one of the main disadvantages of failing to give notice is that the company is entitled to continue making payments through the existing lender. The rights of the assignee are also significantly reduced.
- Funded sub-participation does not have a technical legal meaning. It is used to describe a funding arrangement between the seller and the participant under which the participant places funds with the original lender. Those funds will only be repaid to the participant together with interest (sometimes, but not always, at a slightly lesser rate than the contractual rate) if and when the seller receives corresponding sums from the borrower. The borrower is usually unaware of this arrangement and its consent is usually not required. There is no contractual link between the new party and the borrower. Many companies seek to impose contractual restrictions in the loan document on the voting rights of sub-participants. The seller will need to disclose information to a potential participant about the facility and the borrower/group prior to a participation which will give rise to confidentiality issues for the company. However, if a loan is fully sub-participated by the seller the relationship which is thought to exist between the seller and the company may be regarded as being terminated for practical purposes.

Whichever of these methods is preferable to a lender is dependent upon the reason for the lender seeking to make the transfer. Possible reasons include:

- the need to reduce the capital adequacy requirements of a bank;
- the desire to make a profit by transferring the asset but retaining a skim on the margin;
- the need to avoid exposure to a single borrower or a particular geographical area or business sector; and
- when time does not permit a syndicate of lenders to be found before signing (market practice permits one lender to make a large loan with the intention of syndicating the loan after the date of signing).

The first of these is almost always relevant. To reduce a bank's capital adequacy requirements, the transfer method must ensure that the risk of non-payment by the borrower is permanently transferred to the transferee. If the bank remains subject to capital adequacy requirements, then the transfer is unlikely to be economic. Nevertheless, the transfer may still be desirable if one of the other reasons applies and no other method of transfer is available. A consideration for both the lender and the company is whether the new lender will obtain the full benefit of the loan documentation including any indemnities which the company has given to the original lender or lenders. One of these indemnities is the gross-up provision discussed earlier. A novation would pass these rights to the transferee, a sub-participation would not. The position of an assignment is less clear but would probably pass the rights if notice of the assignment is given to the company.

As discussed earlier in relation to the choice between syndicated and bilateral loans, it may be important to the company to restrict the rights of the lender so it may only transfer the loan to a lender with whom the company already has a relationship. The company may, therefore, wish to restrict one or more of the above possible methods of transfer. An outright prohibition is unusual and it is more common to find that transfers are permitted to an affiliate of an existing lender or to another lender in the syndicate without the need for the borrower's consent. If the potential transferee falls outside these categories, then the prior consent of the borrower must be sought (which shall not be unreasonably withheld). The LMA documents contain the provision that the company is deemed to have given its consent to the transfer unless it advises the lender to the contrary within five business days of the request. Generally, a UK company will want to ensure that any assignment or transfer does not result in greater withholding tax or increased costs liabilities.

It has not been market practice to expressly restrict the right to effect participations. This is usually acceptable to the company since the lender remains the lender of record at all times. A company will however be concerned in relation to confidentiality. Normal banking relations would impose an obligation on the bank to keep any privileged information given to it by the company confidential.

However, if a lender is to be able to sub-participate it will need to be able to disclose some of this information to a prospective participant. A provision may be contained in the loan documentation allowing the disclosure of information to a potential sub-participant subject to it signing a confidentiality undertaking and the company should consider whether it needs to try to limit this provision.

Security

The purpose of security is simply to improve the lender's chance of recovering any money which the company owes it and to put the lender in a better position than the unsecured creditors of the company. Security may be divided into two types – personal and real. The first type is where a third party agrees to pay some or all of the borrower's debts if the borrower fails to do so without nominating any particular asset which may be used for this purpose.

Examples of this are guarantees and comfort letters. These are usually required where a lender is willing to make a loan on the basis of the strength of the consolidated accounts of a group of companies but the loan is to be made to only one of the companies within the group. In this situation the parent company or other companies in the group may be required to guarantee the debts of the borrowing company.

The second type is where a particular asset is used as collateral in some way, by granting a security interest over it, so that if the company fails to repay the lender, the lender may use that asset to recover its money. There are many ways in which the asset may be secured. These include methods where the lender obtains possession (e.g. a pledge) or where it does not obtain possession (e.g. mortgages and charges). Their legal and practical consequences vary and are too numerous to outline here. However, there are issues for the company which are common to all types of security.

First, the company will need to check that it has the necessary power to enter into such arrangements. This is a matter of law on which advice should be sought.

Second, it will need to check whether it will be in breach of any other agreement to which it is a party if it gives the requested security. The main concern here is that it may breach a previously granted negative pledge clause (see Covenants (Undertakings) earlier in this article for a discussion of the negative pledge clause).

Third, the company must check that the granting of the security will not inhibit its ability to perform its day-to-day business. For example, in English law a charge which is intended to take effect as a 'fixed' charge will have to contain terms which restrict the use of the asset and should not be granted over items (such as stock in trade) as the company may wish to sell these items in line with its business plan and budget, otherwise the company will need to obtain the lender's consent to sell them. In this situation, the lender may be willing to accept a 'floating' charge instead. In English law the disadvantages (from the lender's perspective) in accepting a floating charge in place of a fixed charge are that:

- the company may dispose of the secured assets without permission and so it is difficult for the lender to know the value of its security at any time;
- if there is an insolvency of the company, the lender will rank below creditors which are given a preferential status by the law applicable in the relevant jurisdiction. The Enterprise Act 2002 abolished preferential status for debts due to the Crown (HM Revenue and Customs and social security contributions) in the UK. Preferential status remains for contributions to occupational pension schemes, remuneration of employees and levies on coal and steel production. In addition in the UK, unsecured creditors now have a right to a proportion of the floating charge recoveries, (currently capped at GBP 600,000) (if the Company has net property of GBP 10,000 or more) which rank ahead of the floating charge holder;
- if the company is placed into administration (a type of insolvency procedure) the lender will rank behind the (largely uncertain and unquantifiable) costs and expenses of the administrator appointed to the company. The Company Law Reform Bill contains a provision (unlikely to come into force before Spring 2007) that the expenses of a winding up will be paid out of the assets of a company ahead of both unsecured claims and, subject to new rules to be drawn up by the Insolvency Service, the claims of floating charge holders; and
- the company could grant a fixed charge over the same assets to another creditor who would then rank above the lender (although this would usually be in breach of the terms of the floating charge).

Fourth, in relation to guarantees, it should be checked exactly what obligation the guarantor is accepting. Although the term 'guarantee' implies that the guarantor will only be looked to if the original debtor fails to perform its obligations it will usually be the case that the guarantor is being asked to grant a guarantee and indemnity and be primarily liable. This will almost certainly be required to cover the situation where it is subsequently discovered that the borrower had no legal power to borrow the loan in the first place.

A final point to bear in mind is that the granting of security can be a costly and time-consuming business. However, part of these costs may be recovered by the fact that it may be possible to negotiate lower margins on a loan. This is because secured loans may have lower capital adequacy costs for the lender and there is a reduced credit risk.

It needs to be remembered that there are restrictions in the UK Companies Acts on companies giving financial assistance in connection with the financing of the acquisition of their shares or the shares of any of their holding companies. Although for private companies (unless subsidiaries of a public company) this is due to be abolished when the Company Law Reform Bill comes into (unlikely to be before Spring 2007). Some jurisdictions have similar restrictions where specific legal advice should be taken.

Recourse

This expression is often met in relation to loans to fund particular projects which a company may be undertaking. For example, when lending to a company to build and lease an office development, a lender may be willing to limit its recourse to the assets of the project and not to other rights and assets of the company. This is a fairly unusual situation since more frequently the company simply sets up a new subsidiary to deal solely with the proposed project and then the lender will, unless agreed otherwise, only have recourse to that company's assets. In either situation security may be taken over the project assets and the cashflows generated by the project.