K&L GATES

Jonathan Lawrence, Finance Partner, London

Loans and Security Training

November 2014

LOANS AND SECURITY TRAINING

A. Entering into a loan facility
B. Managing an ongoing facility
C. Managing defaults

A. ENTERING INTO A LOAN FACILITY

1. Overview of a loan agreement
   a) Parties- lender and other finance parties, borrower(s), occasionally third party guarantor(s)
   b) Obligations of parties - Borrower must repay money in full with pre-arranged interest, and comply with all terms of agreement. Lender must allow borrower to borrow money based on agreement, and comply with all terms.

A. ENTERING INTO A LOAN FACILITY (cont'd)

c) Term sheets - created once lender has investigated the borrower, highlights key terms of agreement. Mostly non-binding but should contain a binding confidentiality clause and lender may insist that borrower pays lender's expenses even if facility agreement is not signed

d) Purpose of the facility - describes type and amount of loan, allows lender to specify how loan facility is to be used in order to limit chances of loan not being repaid

A. ENTERING INTO A LOAN FACILITY (cont'd)

2. Types of facilities

   a) **Overdrafts** - provide cash in a readily accessible form to meet any temporary shortfalls in working capital. Simple and quick to arrange, and uncommitted so no commitment fees and few legal fees. On-demand nature means high interest rates and bank charges, so not suitable for long term payments or large investments.

A. ENTERING INTO A LOAN FACILITY (cont'd)

2. Types of facilities

   b) **Term Loans** - lender commits to lending money to borrower for a specific amount of time, usually between one and five years. Allows certainty of repayment time and interest rate lower than an overdraft. Often borrower must take specified loan amount all at once. Cannot be re-borrowed once it is repaid, and limited in term.

A. ENTERING INTO A LOAN FACILITY (cont'd)

2. Types of facilities

   c) **Revolving Credit Facilities** - lender agrees to lend a specific amount of money, over a specific amount of time, but borrower can draw out and re-pay money as and when it chooses throughout the term of the loan. Committed loan with maximum flexibility. Bank, however, may impose a repayment schedule, may create upper and lower limits on what can be drawn at any one time, and there are usually high commitment fees.

A. ENTERING INTO A LOAN FACILITY (cont'd)

2. Types of facilities

d) **Syndicated loans** - A loan or other credit facility provided by more than one lender to a borrower (or associated borrowers) under the terms and conditions of one facility agreement. A lender may transfer, usually by novation, all or part of its commitment under the syndicated facility to another lender or lenders - reduces original lender's exposure and reward. Together the group of lenders are known as the syndicate.

A. ENTERING INTO A LOAN FACILITY (cont'd)

3. Introduction of example documents and scenarios
   a) Syndicated real estate term loan agreement
   b) Short form intercompany loan agreement
   c) Debenture

A. ENTERING INTO A LOAN FACILITY (cont'd)

4. Types of security:
   a) Charge - Security over an asset which gives the lender the right to have the particular asset and its proceeds of sale appropriated to the discharge of the debt in question. A charge does not transfer ownership; it is an encumbrance on the asset.
   b) Mortgage - The transfer of the ownership of an asset by way of security for particular obligations on the express or implied condition that it will be re-transferred on the discharge of the secured obligations.

A. ENTERING INTO A LOAN FACILITY (cont'd)

4. Types of security:

   c) Pledge - lender takes and retains an asset, but borrower retains legal title and ownership of asset. If borrower defaults on repayment, lender gains a legal propriety interest in asset, and becomes legal owner if borrower becomes insolvent. Tangible assets and documents of title to goods can be pledged, but not intangible assets or future assets. Asset must be delivered, physical delivery of asset or delivery of deed etc.

   d) Lien - A right which entitles a party to hold on to assets in his possession pending payment of a debt owed.

A. ENTERING INTO A LOAN FACILITY (cont'd)

5. Practical Issues/Commercial considerations
   a) Requirement of loan facilities
   b) Facts of consideration before entering into loan facility
   c) Solvency rules in different jurisdictions
   d) Expectations of repayment
   e) Consideration to type of facility: in accordance with business model? Cash flow secured?

A. ENTERING INTO A LOAN FACILITY (cont'd)

6. Lender's Principal Concerns
   a) Will it ever recover the capital sum advanced?
   b) In the interim, will it receive interest payments promptly?
   c) Who is the borrower and its sponsor?
   d) Reputational risk?

A. ENTERING INTO A LOAN FACILITY (cont'd)

7. Borrower's Principal Concerns - Objective to:
   a) Keep expenses to a minimum, particularly obligations to reimburse the lender for its expenses and additional charges that may be difficult to quantify.
   b) Ensure that the lender's attempts to monitor the borrower's activities (for example, in the covenants and events of default) do not interfere with the borrower's ability to run its business.

A. ENTERING INTO A LOAN FACILITY (cont'd)

7. Borrower's Principal Concerns- Objective to:
   c) Temper its obligations in the agreement with reasonableness and materiality thresholds. These mechanisms add an element of uncertainty for the lender, something which is unpopular if and when determining whether an event of default has occurred or a covenant has been breached.
   d) Ensure certainty by including objective rather than subjective tests if terms are conditional on a third party's opinion.

A. ENTERING INTO A LOAN FACILITY (cont'd)

7. Borrower's Principal Concerns- Objective to:
   e) Increase flexibility with grace periods and mitigation clauses before events of default are triggered.
   f) In the case of a syndicated loan, allow amendments to the loan documents with the consent of a certain majority of the lenders, thereby facilitating waivers and preventing a single lender from having a power of veto.

A. ENTERING INTO A LOAN FACILITY (cont'd)

8. Interest & Costs

a) Margin, LIBOR- rate of interest a lender will offer to lend to other lenders- will change for each successive interest period under a loan

b) Rates available for each type of facility-

The interest rate on each Loan for each Interest Period is the percentage rate per annum, determined by the Lender to be the total of:

- the Margin;
- LIBOR; and
- the Mandatory Costs (if any).

A. ENTERING INTO A LOAN FACILITY (cont'd)

8. Interest & Costs

   c) Rates for renewal of facility

   d) Default interest - The rate of default interest payable in loans is usually 1% or 2% above the rate payable in the ordinary course of the agreement where all the sums are paid on time.

A. ENTERING INTO A LOAN FACILITY (cont'd)

9. Covenants

a) Financial Covenants and Ratios - lender will prepare financial projections of how loan is to be repaid. Financial covenants are a series of tests to assess if the performance of the borrower is living up to those projections.

b) Non-Financial Covenants

- The ranking of the borrower's obligations under the facility agreement (so as to preserve the status of the lender in relation to other creditors of the borrower)

A. ENTERING INTO A LOAN FACILITY (cont'd)

9. Covenants

- Restrictions on acquisitions, investments and capital expenditure, sometimes restrictions on dividends paid by the borrower (but not normally where the borrower is a listed company).
- Restrictions on incurring contingent liabilities (for example, guaranteeing the indebtedness of a third party).
- Control of change in the nature of its business.
- Restrictions on further borrowing.

A. ENTERING INTO A LOAN FACILITY (cont'd)

9. Covenants

c) Negative Covenants, Negative Pledge- borrower agrees not to create (or allow) any other security without the lender's consent

d) Information Covenants → Diary Reminders - cover the accounting information that needs to be supplied on a regular basis from borrower to lender.

A. ENTERING INTO A LOAN FACILITY (cont'd)

10) Representations & Warranties

a) Repetition of Representations & Warranties - lender seeks to minimise risks by producing list of representations it wants borrower to make regularly. Borrower can then consider list, and decide if possible. An attempt to ascertain position of the borrower.

A. ENTERING INTO A LOAN FACILITY (cont'd)

11) Security & Guarantees

a) Guarantee - promise to ensure that a third party fulfils its obligations and/or a promise to fulfil those obligations if that third party fails to do so. It is a contractual agreement that creates a secondary obligation to support a primary obligation of one party to another. Either Personal Guarantee or Corporate Guarantee.

A. ENTERING INTO A LOAN FACILITY (cont'd)

11) Security & Guarantees

b) Indemnity - promise to be responsible for another's loss. Unlike a guarantee, it is a primary obligation given by the indemnifier to the person to be indemnified. It is independent to, and not contingent on, the obligations of the borrower. This means that, if the underlying transaction is set aside for any reason, the indemnity will remain valid.

A. ENTERING INTO A LOAN FACILITY (cont'd)

11) Security & Guarantees

c) Letter of Comfort - written assurance often provided by a parent company in respect of its subsidiary's financial obligations to a lender. It is usually used where the parent company is unable or unwilling to give a guarantee but wishes to give some comfort to the lender in respect of the subsidiary's ability to perform its obligations. It is not usually intended to be legally binding but it may give rise to a legally binding obligation depending on the wording.

A. ENTERING INTO A LOAN FACILITY (cont'd)

12. Overview of Events of Defaults, Cross defaults, MAC/MAE clauses
    - Non-payment
    - Non-compliance
    - Misrepresentation
    - Financial condition
    - Cessation of business

A. ENTERING INTO A LOAN FACILITY (cont'd)

13. Cross-defaults

- A clause which operates by automatically defaulting a party under Agreement A where borrower has defaulted under Agreement B. A cross-default provision effectively gives the non-defaulting party under Agreement A the benefit of the default provisions in Agreement B. Cross-default provisions therefore have a domino effect.

A. ENTERING INTO A LOAN FACILITY (cont'd)

14. MAC / MAE Clauses

- Clauses which highlight an event or circumstance which could have a material adverse change or material adverse effect. Not commonly used to default the borrower.

B. MANAGING THE ONGOING FACILITY

1. Information Covenants-

   Provide for the basis on which the accounts are to be prepared following generally accepted accounting principles applied on a consistent basis from year to year and will specify the frequency of the delivery of information. This will certainly include the audited annual accounts and probably unaudited semi-annual accounts if they are published and, in some cases, the lender may attempt to obtain more frequent management accounts.

B. MANAGING THE ONGOING FACILITY (cont'd)

2. Accounting Information-

Lender may request annual financial statements and proforma balance sheets in order to check up on borrower's financial situation.

B. MANAGING THE ONGOING FACILITY (cont'd)

3. Notification
4. Certification and Ratio Calculations
5. Other information

C. MANAGING DEFAULTS

1. Events of Default
   a) Non-payment - borrower fails to pay any money when due, unless non-payment caused by administrative error/ technical problem/ disruption events and payment is made within three days
   b) Non-compliance - borrower fails to comply with any provision of the Finance Documents and such default is not remedied within 14 days of either the lender notifying the borrower of the default and asking for a remedy, or the borrower becoming aware of the default

C. MANAGING DEFAULTS (cont'd)

1. Events of Default
   c) Misrepresentation - any representation, warranty or statement made that proves to be untrue, incorrect
   d) Financial condition - any requirement of financial condition is not satisfied
   e) Cessation of business - borrower suspends or threatens to suspend continuation of business

C. MANAGING DEFAULTS (cont'd)

2. Cross defaults
   a) Any Borrowed Money is not paid when due or within any originally applicable grace period.
   b) Any Borrowed Money becomes due, or capable or being declared due and payable, prior to its stated maturity by reason of an event of default (howsoever described).

C. MANAGING DEFAULTS (cont'd)

2. Cross defaults

   c) Any commitment for any Borrowed Money is cancelled or suspended by a creditor of the Borrower by reason of an event of default (howsoever described).

   d) Any creditor of the Borrower becomes entitled to declare any Borrowed Money due and payable prior to its stated maturity by reason of an event of default (howsoever described).

C. MANAGING DEFAULTS (cont'd)

3. Material Adverse Change (MAC) clauses

In the context of lending transactions, a clause which acts as a "catch all" provision and aims to allow the lender to call a default if there is an adverse change in the borrower's position or circumstances (for example, a large negative variation shown in successive financial statements of the borrower). MAC clauses are a common feature of facility agreements. Although they are always heavily negotiated, MAC clauses are not commonly used to default a borrower.

C. MANAGING DEFAULTS (cont'd)

4. Security Documents

a) Debenture - This standard document creates a mortgage over properties, fixed charges over a range of other assets and assignments by way of security over the benefit of contracts and insurance policies, together with a floating charge over assets not otherwise mortgaged, charged or assigned.

b) Mortgage - Deed required to be given to lender if legal mortgage over land.

c) Pledge- physical possession of the assets

d) Lien- A right which entitles a party to hold on to assets in his possession pending payment of a debt owed.

C. MANAGING DEFAULTS (cont'd)

4. Security Documents

   e) A standard form director' certificate (also known as an officer's certificate) is a form of security, to be provided by a director of a company which is a borrower or which is giving a guarantee or other security under a loan facility agreement.

C. MANAGING DEFAULTS (cont'd)

4. Security Documents

   f) Assignment - The transfer of a right from one party to another. For example, a party to a contract (the assignor) may, as a general rule and subject to the express terms of a contract, assign its rights under the contract to a third party (the assignee) without the consent of the party against whom those rights are held. Can be used in finance as security over choses in action.

C. MANAGING DEFAULTS (cont'd)

5. Bank's options
   a) Remedies - call in loan immediately; produce a waiver letter (often waiving breach in exchange for something); produce an amendment agreement; changing terms of loan
   b) Grace periods - allotted amount of time during which repayment of loan is not expected

C. MANAGING DEFAULTS (cont'd)

5. Bank's options

   c) Financial covenant breaches - Financial Covenants are often the first event of default to be triggered as a result of a deterioration of a borrower's financial position: they are designed to be an early warning signal that the business is not performing to plan and that the borrower may have problems in the future in servicing and repaying its debts. Can be worked out using "equity cure" or permitting shareholders of borrower to insert capital into business.

C. MANAGING DEFAULTS (cont'd)

5. Bank's options
   d) Flexibility of wording - can agreement be interpreted in different ways?
   e) Accounting policies - Selected principally through consideration of relevance, reliability, comparability
   f) Information covenants - as above

C. MANAGING DEFAULTS (cont'd)

5. Bank's options

   g) Compliance certificates - A certificate accompanying the financial statements given by a borrower to a lender (usually annually and semi-annually) under the terms of a facility agreement. The form of certificate is usually attached to the facility agreement as a schedule. Typically, the certificate:

   - Sets out details of financial covenants contained in the facility agreement as at a certain date or for a certain period.
   - States whether the borrower has complied with the financial covenants.