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Introduction

GENERAL INTRODUCTION

How to use this book

A word of caution is necessary at the outset. This book seeks to give readers the tools to enable them to negotiate loan agreements efficiently (i.e. with minimum expense in terms of time and money) and effectively (i.e. to result in a document which closely suits their corporate needs, whether they are borrower or lender). For this book to succeed in its aim it must be used appropriately—that is, as an aid to, and not as a substitute for, proper understanding of the commercial position of the parties. Readers need to keep in mind that loan agreements are used in widely differing commercial situations. Some examples (among the innumerable possibilities) are

- secured loans made to start-up companies owned by entrepreneurs;
- structured loans to special purpose companies, designed to achieve a particular tax effect or for the purpose of a particular project;
- loans to **investment grade** corporates designed to provide them with **liquidity**.

The basic precedent for all these situations will be remarkably similar, but the changes to that precedent which are appropriate in each case will vary enormously. Comments which are made in this book will only be appropriate in some (usually a minority) of the circumstances in which a loan agreement will be used. One size does not fit all. Moreover, there will be many comments which ought to be made in specific transactions which are not made in this book. The comments included are not intended to be (nor can they be) exhaustive. The comments in the book are intended to give the reader a better understanding of what the loan agreement does

and does not say, and to provide readers with a full set of tools with which to ensure that the final agreement meets their commercial objectives.

However, the most important commercial objective of the parties to a loan transaction is to reach an agreement on the documents quickly (time is money) and in a way which gives all involved confidence in their ongoing relationship (and does not result in disproportionate legal fees). If this is to be achieved, parties must identify the points they wish to make with care, and only make comments which are commercially significant in the context of the particular transaction. Failure to do this will backfire as the **counterparty** will quickly lose patience, probably resulting in a negotiation which fails to achieve the parties' real commercial objectives.

Readers are therefore urged to ensure that they do not lose sight of the ultimate commercial objectives, and that they use this book only as an aid to better understanding of the agreements, not as a 'checklist' of comments—a purpose for which this book was not designed and is not appropriate.

What should I be looking for in this loan agreement? Why does it have to be so long?

This introduction sets the scene for the discussion of the loan agreement by

- describing the main categories of loans (in section 1);
- providing an overview of the loan agreement (in section 2);
- looking at **LIBOR**-based lending (in section 3);
- discussing the scope of the agreement, including who can be affected by it, and whose activities can have an effect under it (in section 4);
- providing a brief overview of asset and project finance (in section 5);
- describing (in section 6) various commercial arrangements which, while not amounting to borrowing or giving **security** in a legal sense, amount to the commercial equivalent and therefore have to be treated in a similar manner for the purposes of the loan agreement.

This book uses the loan agreements that are published by the Loan Market Association ('LMA')¹ as the starting point for its discussions. In general, the LMA recommended form for a term loan is used as the basis for discussion, and is referred to in this book as the 'LMA Term Loan'. The book follows the structure and clause numbering of the LMA Term Loan, and references to clauses, unless stated otherwise, are to clauses of the LMA Term Loan. The text also comments on situations and documents which differ from the LMA Term Loan. Such comments are highlighted by **shaded text**.

¹ This association exists to promote the trading of interests in loans. See further paragraph 1 of section 2 of this introduction on p. 8.

SECTION 1: PRINCIPAL TYPES OF LOANS

Loans can be classified with reference to a number of characteristics. The principal categories are discussed here.

1 Classification on the basis of availability

Perhaps the main characteristic for categorizing loans is the issue of availability.

1.1 Term loan

A term loan is a loan which is made available to the borrower on the basis that it will be repaid by specified instalments over a set period of time. Once repaid it cannot be redrawn. It is generally used for a specific financing requirement such as an asset purchase. It is a long-term debt on the borrower's balance sheet.

1.2 Demand loan

A **facility** which the lenders make available but which the lenders are able to cancel or require repayment of at any time (or 'on demand') may be called an 'uncommitted facility' (because the lenders are not committed to maintain its availability) or a 'demand facility'. Facilities of this type do not require lengthy documentation as there is no need for undertakings or **Events of Default**, the lenders being free to terminate the facility at will. The lack of a commitment by the lenders is a significant disadvantage to a borrower. On the other hand, the capital adequacy treatment (Box 0.1) of such facilities, while they are not drawn down (as well as committed facilities with a maximum duration not exceeding 364 days) may result in them being cheaper for a borrower than committed facilities of a longer duration.

BOX 0.1

Under the Basel Accord (see Box 0.11 on p. 16), banks' capital must equal at least 8% of risk-weighted **assets**. Different types of facility have different risk weightings. The undrawn portion of an uncommitted facility (and of a **committed facility** of less than 364 days' duration) currently have no risk weighting² and are therefore cheaper to borrowers than longer committed facilities.

1.3 Overdraft facility

An overdraft facility is a facility that the borrower may draw on, repay and then draw again. This is as distinct from a term loan which, once the borrower has repaid, cannot be reborrowed. An overdraft facility is used for situations where the

² This will not be the case under **Basel II** (see Box 1.35 on p. 102) which gives a risk weighting to the undrawn portion of uncommitted facilities although the risk weighting will remain lower than that which applies to the drawn portion of a committed facility.

borrower has fluctuating financing requirements (e.g. for **working capital**). By having the ability to repay and reborrow, the borrower is able to ensure that levels of borrowing at any time do not exceed the financial requirements of the borrower at that time. An overdraft facility may be committed or uncommitted. In a committed facility, the lenders would commit to lend up to a specified sum for a given period, for example, 12 months. The borrower could draw up to the limit at any time, repay as it wished and have the comfort of being able to draw again, up to the limit, at any time within the committed period.³ If the facility is uncommitted or if the period of the commitment is short then the facility will be a current liability on the borrower's balance sheet, with the implications that it carries for the borrower's liquidity. Given its short-term (and in some cases, uncommitted) nature, lengthy documentation will not be required.

1.4 Revolving credit

A **revolving credit** is a committed facility which operates in a similar way to an overdraft (in that it may be repaid and reborrowed) but is of longer term. It is a long-term debt on the borrower's balance sheet. The documentation will be very similar to that for a term loan. The maximum amount available may remain the same throughout the facility period or it may reduce over time.

2 Classification on the basis of the lenders' credit decision

The second key characteristic of a loan is the question of the type of credit risk which the loan represents for the lenders. That is, what are they relying on in their assessment of the borrower's ability to repay the loan? Borrowers repay loans either by selling assets; by using income generated from a particular asset or project; or out of their general corporate resources. While this is a very broad generalization, these are the distinctions which underlie the classification of loans as 'corporate finance', 'asset finance' and 'project finance'.

2.1 Corporate finance

A corporate finance transaction (when the expression is used in this context, not in its wider meaning which encompasses corporate financings based on the capital markets) is one in which there is neither a specific asset nor a specific stream of income on which the lenders' credit decision is based, but rather they are relying on the general financial position of the borrower. This is also known as '**balance sheet lending**'.

2.2 Asset finance

An **asset finance** transaction is one in which the future value of the asset concerned is a key factor in the lenders' credit risk. This, of course, has major implications for the security and the documentation, as discussed in section 5 of this introduction.

³ However, the borrower will need to pay a commitment fee to the lenders for any part of the facility, which the borrower is not using at any time, and which the lenders remain committed to lend.

2.3 *Project finance*

A **project finance** transaction is one in which the income generated by the project is a key factor in the lenders' credit decision. It is described in more detail in section 5 of this introduction.

In the context of asset and project financing, it should be noted that the lenders are often taking a mixture of asset risk, project risk, and corporate risk. For example, lenders providing ship finance (which is regarded as asset finance) will not only assess the future value of the ship. They will often also look at the operator's balance sheet and financial ratios and at the likely income which the ship will generate. In other words, the lenders will take asset, project, and corporate risk within a facility which is traditionally regarded as an asset finance transaction.

2.4 *Limited recourse financing*

Some transactions (most commonly project finance) are put together on a '**limited recourse**' basis. This involves the lenders accepting that they will only be repaid out of specified assets. This may be done by having a contractual limitation on recourse (see Box 0.2).

Alternatively, it may be done structurally, by establishing a special purpose entity which will only own the assets (e.g. project assets and income) to which the lenders are intended to have recourse, with the lenders lending to that entity.

BOX 0.2

Under a contractual limitation on recourse, the lenders agree with the borrower only to pursue certain assets, such as income from the project in question, and that if the income in question is insufficient, the lenders will suffer a loss and will not be able to claim further repayment from the borrower.

3 **Classification on the basis of the purpose of the loan**

The third major attribute of a loan for classification purposes is the question of its purpose. While there are as many purposes as there are borrowers there are certain categories which are commonly used to describe loans.

3.1 *Acquisition finance*

Acquisition finance is finance used to acquire something, usually a company.

3.2 *Bridge finance*

Bridge finance is finance made available to bridge a gap. For example, a company may require financing for a corporate acquisition. It may intend to raise the bulk of

that finance through issuing bonds on the capital markets but need interim finance to cover the period during which circulars are issued to the public, etc. A bridge finance loan (which is usually high margin, short-term debt provided by the relationship bank) could bridge the gap.

3.3 *Mezzanine finance or venture capital*

Mezzanine finance or **venture capital** is finance used where traditional finance is not available in sufficient amounts to meet the borrower's needs. Generally companies meet their financing requirements by a mixture of debt (borrowing from third parties) and equity (the company's own money, either as invested by shareholders or as profits which would otherwise be available to shareholders). Where the level of debt is high compared to the amount of equity, the company is described as 'highly **leveraged**' or 'highly geared'. Where equity plus the amounts available from traditional lenders will be insufficient to meet the need, borrowers may approach mezzanine financiers to make up the difference. These financiers specialize in providing funds for a particular project, such as a management buy out or a major acquisition, which supplement moneys available from traditional lenders for that project. The finance they provide will be subordinate to the traditional loan. It will carry more risk and therefore the **margin** will be higher. Generally the mezzanine financier will also require some form of '**equity kicker**'—that is, in addition to the margin they will require a share in any profits from the transaction. The finance may be provided by way of subordinated debt or by way of **preference shares**.

3.4 *Refinancing*

Refinancing is finance made available to repay existing debt. This may be done to achieve less onerous **covenants** or more favourable margins, to reflect new corporate structures, to increase leverage, as part of a restructuring following a default, or for numerous other reasons.

3.5 *Mismatch facilities*

These are facilities which seek to match the difference between what is available to a borrower from a given source and what the borrower needs. For example, in a securitization a borrower may require a mismatch facility to bridge the gap between dates of payment of **receivables** and due dates on **commercial paper** issued.

3.6 *Swingline facilities*

Swingline facilities are facilities which are available to meet short-term liquidity needs (such as to replace funds which, but for a market disruption, would have been available to a borrower by the issue of commercial paper). They will be available with minimum (same day) notice and only to cover short-term needs. They often have a maximum period for advances to be outstanding of 3–5 days.

4 Classification on the basis of the number of lenders

4.1 *Syndicated loans*

Syndicated loans are made available by a number of lenders who all join together to make the loan. With the exception of certain fees, which are for the benefit of individual lenders in the syndicate, the lenders have equal rights (or rather, rights proportionate to the amount each has lent—i.e. **pro rata**) against the borrower under a single loan agreement.

4.2 *Club loans*

These are syndicated loans where there are few syndicate members. The lenders, who are called a **club** and who will participate in the loan, are known from the outset and there will be no need to market the facility to the wider banking community as with a large syndicate.

4.3 *Bilateral facilities*

Bilateral facilities are made by a single lender to a single borrower.

5 Miscellaneous categories

5.1 *Sovereign debt*

This is debt made available to a sovereign entity.

5.2 *Export credit*

Export credit is debt that is supported in some way (e.g. by some form of guarantee of payment) by a government in order to encourage exports from their country.

5.3 *Acceptance credit facility*

Under an **acceptance credit facility**, instead of the lenders agreeing to lend money to the borrower, they agree to accept bills of exchange on behalf of the borrower. The terms of the facility document will be similar to the term loan with changes reflecting the mechanical differences in the forms of financial support.

SECTION 2: LOAN AGREEMENT OVERVIEW

The loan agreement is generally produced by the lenders' lawyer. Its purpose is to ensure that the lenders have all the rights and powers they require, bearing in mind that, at least in a simple, single drawdown, term loan the lenders will have handed over a large sum of money and received in exchange, this document (plus perhaps security). Therefore, by custom, the lenders have what is a major negotiating advantage—the right to produce the first draft of the agreement.

1 The Loan Market Association recommended forms

In London, LMA⁴ has produced recommended forms for unsecured, corporate risk term loans and revolvers.⁵ These are now widely accepted as a common negotiating platform, albeit often with variations reflecting a law firm's own preferences.

The first LMA documents were introduced in 1999 with a number of aims, including, in particular, the aim of promoting efficiency in the original negotiation of the loan, and, subsequently, on its transfer, to facilitate review of the agreement by proposed investors. The recommended forms were negotiated and agreed by representatives of borrowers, lenders, and law firms, with the aim of producing documents which were not overly favourable to any party. To a large extent, these documents have been successful in their aims and it has become market practice to use these documents as a basis for loan documentation in the London market and beyond. The LMA recognized on launch of the recommended forms that some provisions would need to be negotiated on a case-by-case basis. They therefore divided the loan into 'hard' and 'soft' provisions, with the soft provisions (**representations, undertakings**, financial covenants, events of default, transferability, and conditions precedent) being put forward simply as a starting point, which would need negotiation on a case-by-case basis. The remainder of the agreement (the 'hard' provisions) was expected not to require adjustment in most cases.

A number of adjustments to the 'soft' provisions of the recommended form will need to be made in any given transaction.

- Some parts of the recommended form have been left blank as there is no standard market practice for these provisions. Such provisions need to be negotiated on a one-off basis. Examples are the financial covenants and the material adverse change clause.
- If the loan is to be secured then a number of the provisions may be drawn more tightly than for the LMA Term Loan which assumes an unsecured loan.
- The document will need tailoring to reflect the credit decision—that is, additional representations, undertakings, and events of default are likely to be necessary, reflecting specific concerns relating to the borrower's business. In particular, if the lenders are taking any project or asset risk in the transaction, substantial additions will be needed as discussed in section 5 of this introduction.
- The lenders may have certain policy requirements, for example, as to transferability which they wish to have incorporated.
- The borrower may have certain policy requirements, for example, as to agreeing cross acceleration clauses only, which they have agreed with the lenders.

⁴ The LMA was established in 1996 as a forum for dealing with issues relating to the syndicated loan market.

⁵ The forms available are for multicurrency term, revolving, or combined term and revolving, facilities. There are also options, discussed at the end of clause 5, for a swingline (Dollars or Euros) and for a letter of credit option.

2 Loan agreement structure

2.1 Function of the clauses

Each provision of the agreement is of one of three types:

- first, there are the administrative provisions—dealing with calculation of interest, mechanics of advances, repayment, and the like;⁶
- second are the business critical provisions (Box 0.3) such as representations, undertakings, and events of default;⁷
- third, there are the boilerplate clauses dealing with important issues such as indemnities, notices, **jurisdiction**, changes in circumstances (such as increased costs), and the relationship between the lenders (such as the agency clause).⁸

BOX 0.3

It is in the business critical provisions that most negotiation should usually focus since this is the part of the agreement which will have a significant ongoing effect on how the borrower conducts its business, and how much power the lenders can wield.

2.2 Stages of the transaction

The business critical provisions of the agreement seek to protect the lenders at three different stages of the transaction.

(a) Before drawing. First, the document protects the lenders, before any money is lent, through those provisions which operate to release the lenders from their obligations to advance funds. At this stage, the lenders have three types of protection operating at the same time: the due diligence (which the lender and their lawyer will conduct prior to signature of the loan agreement), the borrower's representations (in clause 19 of the LMA Term Loan), and the conditions precedent (in clause 4 of the LMA Term Loan).

BOX 0.4

In other words, the borrower is being asked to state that certain facts are true (in the representations), to prove that they are true (in the conditions precedent), and the lenders are also checking that they are true (in the due diligence).

⁶ In the LMA Term Loan, these provisions are in clauses 1–17.

⁷ In the LMA Term Loan, these provisions are in clauses 18–23.

⁸ In the LMA Term Loan, these provisions are in clauses 24–38.

This triple layer of protection is designed to minimize the risk of error. As a practical issue it means that the conditions precedent, representations, and legal opinions duplicate each other to a large extent, so that if adjustments are made to one area in a loan agreement, it will often be necessary to make corresponding adjustments to the other areas.

(b) After drawing. Second, the document protects the lenders after the money has been lent and while it is outstanding. This is the remit of the undertakings (or covenants). Their role is to ensure that the status quo (or something near to that) is maintained during the life of the loan and that the lenders are given the information they need (Box 0.5).

BOX 0.5

Except in limited recourse transactions such as some project finance, it makes little difference whether any particular issue is dealt with as an undertaking or as an Event of Default since a breach of undertaking is an Event of Default.⁹ The tradition is to include as undertakings those things which the borrower can promise (e.g. not to grant security) and as Events of Default those which it cannot (e.g. material adverse change).

(c) Termination. Third, the document sets out the circumstances which the lenders regard as changing the position so completely that they require the right to be repaid immediately. These are the Events of Default¹⁰—which give the lenders the right to accelerate the loan. In practice, often the result of an Event of Default is a renegotiation not acceleration, but it is the existence of the right to accelerate which gives the lenders the necessary leverage to renegotiate.

3 Key concerns

3.1 Borrower's concerns

A borrower's key concerns in reviewing the documents are:

(a) control

- to what extent do they remain free to conduct their business as they see fit and to what extent do they require consent for their activities?
- if they need consent (see Box 0.6) for some acts—what level of consent is needed (e.g. Majority Lenders' consent or unanimous consent of all lenders) and might any requirement for consent impose unacceptable delays in their action (e.g. do they need freedom to act if there is no response to a request within a specified period of days)?
- what companies within their group are restricted?¹¹

⁹ There are often grace periods before breaches of undertakings become Events of Default, but these could equally be built directly into the Events of Default.

¹⁰ Or compulsory prepayment events—see clause 8.2.

¹¹ See discussion on the scope of the agreement at section 4 of this Introduction at pp. 17–24.

BOX 0.6

At some point in the negotiations, the lender may make the point that the borrower should not be too concerned about giving the lenders rights to object to certain things, because the lenders will only use their rights when it is sensible to do so. Nevertheless, borrowers should treat this argument with caution and seek to negotiate an agreement which will enable them to conduct their business with minimum need to make requests for consents or waivers because

- requests for consent will involve the borrowers in spending time and money (and, in some cases, the lenders charge a fee for consents);
- if consent is required, the lenders may take the opportunity to raise other issues of concern to them and link those to the issue of consent;
- there may be a change in personnel or policies at the lenders' office which may result in a different approach to the granting of waivers and consents;
- wherever the lenders have the right to accelerate their loan then other lenders will have the same right under their **cross default** clauses.

(b) certainty of funds

- in what circumstances might the loan cease to be available?
- are all those circumstances within the borrower's control (e.g. change of ownership of the borrower¹²)?
- are all those circumstances objectively tested or are some matters of opinion, and, if so, by what standards can an opinion be tested? For example, 'material' or 'reasonable';¹³
- should some of those events more properly result in a change in margin rather than a right to accelerate, for example, minor breach of a financial ratio.¹⁴

3.2 Lenders' concerns

Lenders' key concerns in reviewing the agreement are:

- equality with other creditors (this is one of the reasons for the **pari passu** clause (clause 19.12), the **negative pledge** (clause 22.3), and the cross default clause (clause 23.5) in an unsecured facility);
- ensuring they are provided with sufficient information, in good time (clause 20);
- protection of their profit (by the ability to pass on changes in costs such as changes in capital adequacy cost—clause 14);
- certainty as to the effect of the agreement (hence the importance of the choice of law and jurisdiction clauses at clauses 37 and 38);

¹² See discussion of clause 8.2 and see also section 1 of the discussion of clause 23.

¹³ See section 1 of the discussion of clause 23.

¹⁴ See discussion of clause 21.

- ability to withdraw (i.e. right to accelerate) if there is a change in circumstances which may affect the lenders' view of the credit risk involved (clause 23);
- maintenance of the borrower's assets and income—hence financial ratios at clause 21 and asset or project specific covenants.

4 Hazards in reviewing a loan agreement

Four principal difficulties arise in reviewing a loan agreement, which are worth highlighting here. These are the difficulty of spotting what is not there, the potential for conflict between different parts of the agreement, the significance of the precise wording of the definitions; and appreciating the impact of repeating representations. These issues are discussed in turn in the following paragraphs.

4.1 *Spotting what is not there*

It is easy to see and comment on what is there, but harder to spot what is not there. In order to see the wood for the trees it is often helpful to summarize the key issues before reading the draft agreement. This will help the reader to spot what is not there and minimize the risk of being drawn into making minor comments on what is there while failing to spot the bigger picture.

4.2 *Potential conflict between provisions*

Potential conflicts arise because, as discussed at para 2.2 on p. 9, the agreement protects the lenders at three different stages.¹⁵ Any particular issue is therefore touched on in a number of different places in the agreement, some of which may conflict with others (Box 0.7).

It is therefore sensible, as well as reading the agreement from start to finish, to check, in relation to each key issue, how it is dealt with at each point of the agreement (conditions precedent, representations, repeated representations, covenants, and events of default) to get a complete picture and also to ensure that any conflicts between the provisions are ironed out. This is worth doing on later drafts as well as initially, because changes negotiated in one area of the document are often inadvertently missed in corresponding parts of the agreement.

BOX 0.7

For example, to find out in what circumstances litigation against the borrower can impact on the loan, it will be necessary to look at the representations; conditions precedent; repeated representations; undertakings; and the events of default.

¹⁵ The provisions of the representations and conditions precedent, and the wording of any attached legal opinion, are also inter-related.

4.3 Definitions

Loan agreements contain detailed definitions. There are a number of reasons for this. One reason is to keep the complexities out of the body of the agreement. Another is to avoid ambiguity. The difficulty for the reader is that it is hard to comment on (or to fully appreciate the implications of) any particular definition out of context. It is sensible to start reviewing any loan agreement, not at the definitions, but, instead, at the operative clauses (those which operate to actually do something as opposed to the definitions clause which simply describes things). When a defined term (usually signified by capital letters, but see para 1.1 on p. 36) is encountered, return to review its definition. This will make it easier to appreciate the detail of the definition.

4.4 Repeated representations

A final word of caution relates to the repeated representations. As we will see in relation to clause 19 of the LMA Term Loan, certain representations may be repeated during the life of the loan. After full **drawdown** on a term loan, the result of this is that, if a repeated representation becomes untrue, the lenders will be entitled to accelerate the loan. The same result would have been achieved by phrasing the issue as an undertaking (if it is something which the borrower can promise) or an Event of Default (if not). By using a repeated representation instead, the possibility of conflict between different parts of the document has been increased.¹⁶

SECTION 3: LIBOR-BASED LENDING

1 Interbank markets

Most lenders¹⁷ borrow money in order to lend. They may borrow in the capital markets (e.g. by issuing bonds or commercial paper) or they may borrow in an interbank market. For the purpose of international lending, most (not all) loans are LIBOR based—and are written on the assumption that the lenders are funding themselves by raising money in an interbank market. This may be a domestic currency market (e.g. borrowing Sterling in London) or a **Eurocurrency**¹⁸ market (e.g. borrowing Dollars in Tokyo) (Box 0.8 on p. 14). Market practices (e.g. period required for notice of drawing, what constitutes a banking day, conventions for number of days in a year for calculating annualized payments, and the like) are different as between the domestic and international markets.

Whether the lenders are funding themselves in a domestic or international market, if a payment falls due in the relevant currency, then, in order to get value for a

¹⁶ See further section 1 of the commentary on clause 19.

¹⁷ Unless raising money from taxes or other contributions.

¹⁸ 'Eurocurrency' is used here in its traditional sense of meaning a currency being traded outside its home country. It does not necessarily involve Europe.

payment made in that currency (and not continue to be charged interest on it) the lenders' correspondent banks need to be open for business in the principal financial centre for the currency concerned. So, for example, to make a payment in Yen, Tokyo must be open.¹⁹

BOX 0.8

This explains the distinction between *Euribor* (which is the domestic interbank interest rate for borrowing Euros in one of its home countries) and *Euro Libor* (which is the international interbank interest rate for borrowing Euros in London).

2 Cost-plus lending

LIBOR-based lending is a 'cost-plus' basis of lending (as opposed to an inclusive basis).

An inclusive basis is where the lender charges a single rate, such as its **base rate**, which encompasses all its costs of funding and some profit. This rate will be set at a level which allows a fair degree of variation in the lenders' costs to be absorbed without its having to change its base rate. The base rate will be changed from time to time when there are step changes in the lender's funding costs. Any such change in base rate will take effect immediately under the loan agreement. The rate which the lender will charge to the borrower will usually be higher than the base rate, with the amount of uplift reflecting the perceived credit risk of the borrower.

The cost-plus basis of charging interest, on the other hand, involves the lender in agreeing a fixed level of profit (the Margin) with the borrower and charging the borrower interest at the lender's actual costs plus the agreed Margin.

2.1 LIBOR

Typically, interest under a Eurocurrency loan agreement, where the lender is funding itself in London, will be charged at LIBOR (Box 0.9 on p. 15) plus Margin.

LIBOR means the London Interbank Offered Rate. It is the rate of interest at which a bank offers to place deposits with another bank in a specified amount of a specified currency on a specified date, for a specified period, in the London Interbank Market (Box 0.10 on p. 15).

The practice in the London market is that a lender wishing to fund itself in the interbank market enters into a commitment to borrow two business days before the money is required and the rate of LIBOR will be settled at the time the commitment is made. The moneys are borrowed for the specified period (typically one, three, or

¹⁹ See Ross Cranston *Principles of Banking Law*, chapter 2—'Interbank networks' for a review of the mechanisms for interbank payments. Also Goode *Commercial Law* chapter 17.

BOX 0.9

The first letter of 'LIBOR' stands for London, and will be different if the lender is funding itself in a different market, for example, where the lender is funding itself in Tokyo, the reference will be to TIBOR. Nevertheless, in some markets, the practice is to refer to LIBOR despite the fact that the lender funds itself in a different market, with LIBOR being used simply as a benchmark rate and with the lender recognizing that it will not always accurately reflect its cost of funds.

BOX 0.10

Hence simply to say LIBOR is meaningless. The expression only has a meaning in relation to

- a given amount
- a specified currency and
- a set duration.

For example, six-month \$ LIBOR on \$10 million or three-month Euro LIBOR on 10 million Euros.

It is also necessary to define whether the intention is to refer to a Screen Rate or to a particular bank's actual rate of LIBOR.²⁰

six months, although other periods are available, possibly at a premium reflecting the unusual nature of the period) and repaid, together with interest, at the end of that period.²¹

2.2 Yield protection

The risks of all eventualities which may result in the lender incurring additional costs are passed on to the borrower through the 'yield protection' clauses.²² The types of costs which these clauses protect the lender against are the costs of complying with capital adequacy requirements (see Box 0.11 on p. 16); the cost of complying with mandatory liquid asset requirements (see Box 0.11 on p. 16); the cost incurred if there is a **withholding tax** (see clause 13); and the cost of funding in different markets if the relevant interbank markets are disrupted (see clause 11.2).

²⁰ See commentary on LIBOR in clause 1.

²¹ See commentary on definition of LIBOR in clause 1 for a further discussion of LIBOR.

²² The increased cost clause (clause 14), the market disruption clause (clause 11.2), and the gross up clause (clause 13.2(c)).

BOX 0.11

There are two main types of regulatory costs which a lender may seek to pass on to a borrower under a loan agreement in which interest is calculated on a 'cost-plus' basis. These are

- costs of compliance with capital adequacy requirements, and
- costs (known as 'mandatory costs' and previously referred to in the London Interbank Market as 'mandatory liquid asset costs') of maintaining any required level of liquid assets with the central bank and of any fees payable to the banking regulator.

CAPITAL ADEQUACY

Banking regulators require internationally active banks to maintain a minimum level of capital to support their activity. The amount of capital required is dependent on the types of business conducted by the banks, with different types of transaction having a different effect. For example, loans which are guaranteed by International Finance Corporation carry a lower risk weighting, and therefore require a lower level of capital, than loans without such a guarantee.²³

Any changes in the level of capital required in relation to any given transaction will have an impact on the bank's profit for that transaction, and any additional costs resulting from such changes are therefore generally passed on to the borrower for that transaction. See further clause 14.

MANDATORY COSTS

Central banks in many jurisdictions require banks which are active in those jurisdictions to place interest free deposits with the central bank. The income from these deposits is used to help fund the regulatory activity of the central bank. In England, the requirement is for banks and other regulated institutions to pay fees to the Financial Services Authority ('FSA') for its supervisory role. These fees are based on the amount of the lender's "eligible liabilities" (including the interest it will be required to pay on deposits obtained to fund LIBOR-based loans). Any changes in the level of fees or deposits required will have an impact on the lender's profits from those types of transactions which are taken into account in calculating the amount of those fees or deposits. Any additional costs resulting from such changes are therefore generally passed on to borrowers of those types of facility.

²³ The regulations for internationally active banks are currently based on the Basel Accord of 1988, at which the Group of 10 countries (G10) adopted the 1987 proposals of the Basel Committee. After much discussion, revisions to the Basel Accord have been agreed and are due to be implemented by the end of 2006. The main effect of Basel II is discussed in Box 1.35 on p. 102.

SECTION 4: SCOPE OF THE LOAN AGREEMENT

In every loan agreement, some fundamental issues relating to the scope of the agreement need to be addressed,

- Who can make use of the facility?
- Who are the lenders, the **Agent**, and the Security Trustee?
- Who can be called on to repay?
- Whose activities can cause difficulty for the borrower under the loan agreement?

See Box 0.12 for a description of the concepts used in the LMA Term Loan to address some of these issues discussed in the paragraphs below.

BOX 0.12

THE LMA STRUCTURE

The LMA Term Loan describes the various categories of persons affected by the agreement by the following definitions:

'Original Borrowers' These are the companies in the group which are initially entitled to borrow as specified in a schedule to the agreement.

'Original Guarantors' These are the companies specified in a schedule to the agreement which are initially required to guarantee the loan.

'Company' This is the ultimate holding company of the group or sub-group (which may or may not also be a borrower or guarantor).

'Borrowers' These are the members of the group which, at any particular time, have borrowed or remain entitled to borrow moneys under the facility. This will be the Original Borrowers plus any other company in the group which has been accepted by the lenders as a borrower but excluding any who are no longer entitled to borrow under the agreement.

Guarantors These are the members of the group which, at any particular time, are liable under guarantees of the loan. This will be the Original Guarantors plus any additional group companies which have guaranteed the loan but excluding any whose guarantees have been released.

Obligors These are the borrowers and the guarantors.

Group This is the Company and all its Subsidiaries²⁴ at any given time.

1 Who can make use of the facility?

In many loan agreements this is limited to certain specified persons. In other cases (including the LMA Term Loan) additional group companies may make use of the facility subject to certain conditions. Those additional companies will become party

²⁴ See definition of 'Subsidiary' in clause 1.1 at p. 51.

to the loan agreement at a future date by a mechanism agreed at the start.²⁵ Borrowers will wish to ensure that this process is a mechanical one, as far as possible, and that the conditions precedent do not effectively make the extension of the loan to new group members discretionary on the part of the lenders.

2 Who are the lenders?

Most commonly there will be a syndicate with the identity of lenders changing from time to time and new lenders becoming party to the agreement at a future date, by a mechanism agreed at the start.²⁶ Borrowers will wish to be sure that any changes in lenders or change in **lending office** do not cause any adverse consequences, such as additional costs under the **gross-up** clause,²⁷ for the borrower. The original Agent and Security Trustee will be specified, but there may be provisions allowing these roles to be passed on to others over time.

3 Who can be called on to repay?

Often there will be specified guarantors in addition to the borrowers. The LMA Term Loan also contains a mechanism for guarantors to change²⁸ (subject to approval of the lenders) allowing flexibility, for example, if the holding company wishes to dispose of a group member which is a guarantor or to release it from those requirements of the agreement which relate to guarantors.

4 Whose activities can cause difficulties for the borrowers under the loan agreement?

What is the scope of the loan agreement in relation to the group?

For example, do financial ratios relate to the consolidated position of the group as a whole? Are there negative covenants relating to companies in the group which are not borrowers? (See Box 0.13 on p. 20 for a diagram of the position under the LMA Term Loan).

This issue is of particular importance to all parties.

- *Lenders* need to ensure that the agreement provides them with sufficient powers in relation to all those issues which are relevant to their credit decision, which may well extend to issues involving members of the group which are neither borrowers nor guarantors.
- *Borrowers* will be concerned to insulate themselves as far as possible from problems which may arise in other parts of the group. They will also want to avoid the possibility that activities of other group members, particularly those over which the borrowers have no control, may result in the withdrawal of the borrowers' funding.

²⁵ See clause 25.

²⁶ See clause 24.

²⁷ See clause 13.

²⁸ See clause 25.

- The ultimate holding company will want to maintain the flexibility to restructure the group and, if appropriate, sell parts of it, without interference by the various lenders to group members under their different financing arrangements.

The parties therefore need to consider the following questions, considered in turn here.

- Is consent of lenders required to sale of a group member or acquisition of a new group member?²⁹
- Should certain companies be excluded from the covenants altogether?³⁰
- Which (if any) provisions should relate to group companies which are neither borrowers nor guarantors?³¹
- Do the lenders have different concerns in relation to different members of the group?³² So, for example,
 - Should some provisions be tested on a groupwide, as opposed to an individual company, basis?
 - Should some provisions allow transactions between different group members?

4.1 Is consent of the lenders required to sale or acquisition of a group member?

Some loan agreements restrict the borrowers from forming subsidiaries³³ and restrict group members from being sold out of the group. A common way to achieve this is to attach a group structure chart to the agreement and require the borrowers to undertake to make no changes to the group structure from that indicated in the chart.

Other loan agreements prevent sale of a subsidiary less explicitly, as they include undertakings relating to specific named group companies or companies which are members of the group on the day of the loan agreement's signature. The result is that such companies cannot be sold out of the group, since, if they were, the continued compliance with the relevant provisions would be outside the control of the group. See Box 0.14 on p. 21 for a description of the position under the LMA Term Loan.

4.2 Should certain companies be excluded from the covenants entirely?

Two types of companies are often excluded from the covenants in the loan agreement, being insignificant companies and non-recourse companies.

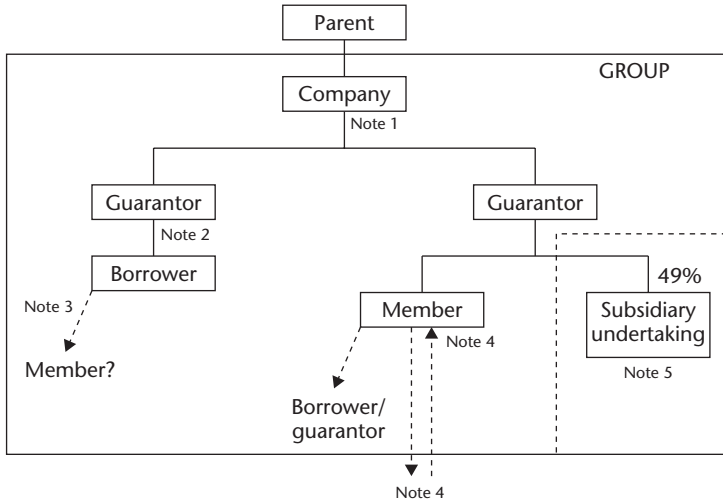
²⁹ See paragraph 4.1.

³⁰ See paragraph 4.2.

³¹ See paragraph 4.3 on p. 22.

³² See paragraph 4.4 on p. 23.

³³ Indeed, in a loan to a single borrower which has no subsidiaries it is usually sensible to either include potential future subsidiaries in the undertakings or to include an undertaking against forming subsidiaries to ensure that the purpose of the negative undertakings cannot be avoided through activities of unregulated subsidiaries.

BOX 0.13**IMPACT OF LMA TERM LOAN ON SPECIMEN GROUP STRUCTURE**

Note 1. The 'Company' administers the facility. It assumes miscellaneous payment and other obligations. The loan must be prepaid if there is a change of control of the Company.

Note 2. Guarantors must remain in the Group, unless they resign as guarantors, which they can do with the consent of all Lenders. They are bound by the covenants relating to 'Obligors'.

Note 3. Borrowers must remain in the Group unless they resign as borrowers. They may resign as borrowers if they repay those advances which were made to them and if there is no **Default** at the time of their resignation. They are bound by the covenants relating to 'Obligors'.

Note 4. Members of the Group are bound only by the 'Group' covenants (summarized in Box 0.17), which are less extensive than the 'Obligor' covenants. They need not remain in the Group. They may become Borrowers or Guarantors subject to certain conditions, including delivery of a satisfactory legal opinion.

Note 5. If this company is effectively controlled by a Group member it may be a 'Subsidiary Undertaking', and, if such companies are included in the definition of 'Subsidiary', it will be affected by the Loan Agreement in the same way as other Group companies.

BOX 0.14

The LMA Term Loan requires Obligors to remain members of the group,³⁴ but allows other group members to be sold and allows new companies to become part of the group. Change in the ultimate control of the group gives lenders the right to require to be prepaid.³⁵ By virtue of the provisions allowing Obligors to cease to be Obligors,³⁶ even Borrowers can be sold out of the group as long as they first repay any loan they have borrowed. Guarantors can only be released from their obligations (and hence become free to be sold) with consent of all lenders.

Insignificant companies. Borrowers will often ask for insignificant companies to be exempted from the covenants. Often the test of significance for this purpose looks at the **Tangible Net Worth** of the company concerned and exempts it if that represents a minor (e.g. less than 5%) part of the Tangible Net Worth of the group. This is often calculated with reference to the latest audited accounts at the relevant time.

Comment Borrowers need to be cautious with this approach as a company which was once exempt may be caught at a later point if its relative importance in the Group changes. This may even result in an **Event of Default** by virtue of things done while the company was exempt. If this type of exception has been agreed, the group needs to keep a check on whether exempt companies might cross the threshold and cease to be exempt (Box 0.15).

BOX 0.15

An example might assist. Assume that a loan agreement includes a negative pledge clause saying '*The Company shall ensure that no ... [Material Subsidiary] shall ... permit to subsist any Security.*' Assume that

- (a) the company grants security at a time when it is not a Material Subsidiary; and
- (b) the value of the company increases relative to that of the Group and it becomes a Material Subsidiary.

Unless the security falls within one of the exceptions to the negative pledge clause, the company will need to discharge the security before it becomes a Material Subsidiary in order to avoid being in breach, as the covenant is not to '*permit Security to subsist*'.

Non-recourse companies. The second type of company which is commonly exempted is a company which is established for the purpose of a particular non-recourse transaction. These companies are established as vehicles for particular projects. The argument

³⁴ See clause 23.9.

³⁵ See clause 8.2.

³⁶ See clause 25.

for excluding them from the provisions of the loan agreement is that difficulties with the project vehicle are usually not the responsibility of the group and therefore should not impact on the group's commercial borrowing. (If excluded from the covenants, they would also then be excluded for all purposes, including, e.g. financial ratios.) Hence a definition of 'Non-Recourse Company' is often inserted (Box 0.16).

BOX 0.16

“Non Recourse Company” means, at any relevant time, a company which, at such time, has no Financial Indebtedness other than Non Recourse Indebtedness.

“Non Recourse Indebtedness” means Financial Indebtedness incurred by a company (the “Project Company”) for the purposes of financing a particular project where

- (i) the principal assets and business of the Project Company are constituted by that project; and*
- (ii) the provider of the Financial Indebtedness has no recourse against any member of the Group or its assets except the assets of the Project Company comprised in the project.’*

4.3 Which provisions should be extended to relate to group companies which are not Obligators?

Borrowers, as noted earlier, want the covenants and other provisions to apply only to Obligators and not to be extended to any other company in the group. There are three main reasons for this.

- The result of extending the provisions to a company which is not an Obligor will usually be that a downturn in that other company's financial fortunes will cause a potential problem for the borrower.
- The borrower may not be in a position to control the activities of that other company, and so to prevent that other company from doing things which cause an Event of Default under the borrower's loan.
- The group may wish to maintain flexibility as to company sales and purchases.³⁷

Given that lenders have no claim against group companies which are not Obligators (and, in the LMA Term Loan, such companies may be sold without consent of the lenders) it may be questioned why, for example, the negative pledge or the no disposals covenant extend to those companies. Often the lenders will justify this on the basis that, whatever the legal situation, if a subsidiary were to have financial difficulties (such as that caused by cross default,³⁸ or which may be heralded by

³⁷ See paragraph 4.1 on p. 19.

³⁸ See clause 23.5.

asset stripping³⁹ or a breach of the negative pledge⁴⁰) the ultimate holding company may well find itself bound up with the financial difficulties of its subsidiary, even if not legally bound to support it. The solution needs to be agreed on a case-by-case basis and usually on a clause-by-clause basis, taking account of the credit decision. The result (as in the LMA Term Loan—see Box 0.17) may well be that some clauses will apply to all group members and others to Obligor only. However, any extension of any clause to companies which are not Obligors needs very careful consideration by the borrower, as to whether it is justified, and acceptable, in the context of the particular group.⁴¹

BOX 0.17

The LMA Term Loan provides for the following covenants to relate to group companies (as opposed to Obligors).

The items marked * in particular need careful consideration by the borrower (as does clause 19.13, if it is included in the definition of 'Repeated Representations') as their effect is to tie the borrower's financing to the fortunes of other group members.

- Representation (clause 19.13) as to no litigation.
- Financial information (clause 20.1 requiring consolidated financial statements for the Company).
- Information generally (clause 20.4).
- Negative pledge (clause 22.3)*.
- No disposals (clause 22.4)*.
- No merger (clause 22.5)*.
- No change of business (of the group, not individual members)—clause 22.6.
- Cross default (clause 23.5)*.
- **Insolvency** (clauses 23.6 and 23.7)*.
- Execution of judgments (clause 23.8)*.

4.4 Do the lenders have different concerns about different members of the group?

In agreeing which clauses should extend to group members and which should be limited to Obligors, the parties also need to consider whether the lenders may have specific concerns in relation to individual group members or whether they are looking at the overall financial position of the group. For example, are the lenders

³⁹ See clause 22.4.

⁴⁰ See clause 22.3.

⁴¹ If the eventual agreed position is that some provisions extend beyond the Obligors, the borrower may seek to mitigate this by providing for extended grace periods for Events of Default which relate to companies that are not Obligors.

concerned to ensure that value is maintained in those parts of the group (the Obligors) against which they have a direct claim, or are they content that the value is maintained in the group as a whole? The answer will impact (among other things) on the following questions:

- whether any relevant limits, such as the effect which is to be treated as material for the purpose of the definition of ‘Material Adverse Change’⁴² or the threshold amount for the negative pledge,⁴³ or the test of change of business,⁴⁴ is set on a company-by-company basis (and then, whether it is set with reference to any Obligor or with reference to any group member) or with reference to the position of the group as a whole.
- negative covenants—the borrowers may request that these relate to the group as a whole and that transactions between group members should be excluded from, for example, the no disposals clause. The lenders, on the other hand, may be happy to permit such transactions as between Obligors, but not between other group members. See Box 0.18.

BOX 0.18

For example, in relation to the no disposals undertaking at clause 22.4, the borrower may request the ability to transfer assets between group members without the restrictions of that clause. The lenders, on the other hand, may be concerned to ensure that specific assets remain within a company to which the lenders have direct access, in which case they may agree the exception, but only in relation to transactions between Obligors.

- at which levels the financial ratios are tested. The lenders may require ratios to be tested both at a consolidated level (probably excluding any companies such as non-recourse companies which have been excluded from the undertakings), and also for particular Obligors. If certain companies have been excluded from the financial covenants, the lenders may well want to restrict certain transactions, such as making loans or giving security, which benefit those companies.

SECTION 5: ASSET AND PROJECT FINANCE

1 Asset finance

Asset finance is financing of an asset (often a moveable asset) where the lender regards the value of the asset being financed as a significant factor in its credit

⁴² See definition of ‘Material Adverse Change’ in Box 1.15 on p. 49.

⁴³ See clause 22.3(c)(viii).

⁴⁴ See clause 22.6.

assessment. The expression is commonly used for ship finance, aircraft finance, financing of rolling stock, satellites, containers, and other major assets.

Key issues in asset finance, which need to be addressed by the documents⁴⁵ and by due diligence, include:

- conflict of law (e.g. the law chosen for the loan agreement, the law applicable to the security, and the law in the place where the asset is at the time any security comes to be enforced);
- whether to structure the transaction as a mortgage financing or as a **title financing**,⁴⁶
- liabilities of a financier (such as the issue of whether the financier will be exposed to environmental liabilities, either simply as a result of taking security over the asset, or as a result of ownership of it in a title finance arrangement, or as a result of enforcement of security over the asset);
- detention rights of third parties relating to the asset, if it is a moveable asset. The issue here is to identify what parties may be entitled to detain the asset and prevent its profitable use. Examples are the lien which a repairer has on an asset until the repair bill is paid and the right of port states to detain vessels for safety reasons;
- maintenance of the asset—the lenders will want to be sure that the asset is properly maintained and, perhaps, that funds are set aside for this purpose;
- preservation of value of the asset generally, including loan to value ratios,⁴⁷
- insurance—the lenders will want to have security over the asset's insurance so that, if there is damage to it, the lenders have replacement security. They will also want to be satisfied as to the insurance for potential liabilities to third parties arising in respect of the use of the asset;
- impact of insolvency—are there risks that enforcement of security on the asset may be impeded as a result of insolvency proceedings such as **administration** in England, or that transactions such as guarantees may be vulnerable to be unwound in the event of an insolvency;
- registration—where does the asset and any security on it need to be registered and what are the consequences of non-registration;
- ability to sell the asset free of liens and other interests—and can the lender exercise self-help remedies, or will any sale have to be effected by a court?

2 Project finance

Project finance involves lending against the income of a project. It usually involves:

- the development or exploitation of a right, natural resource or other asset;

⁴⁵ See, for example, the comments on clause 4.1 in an asset finance transaction, on p. 62, and section 2 of the commentary or clause 22.

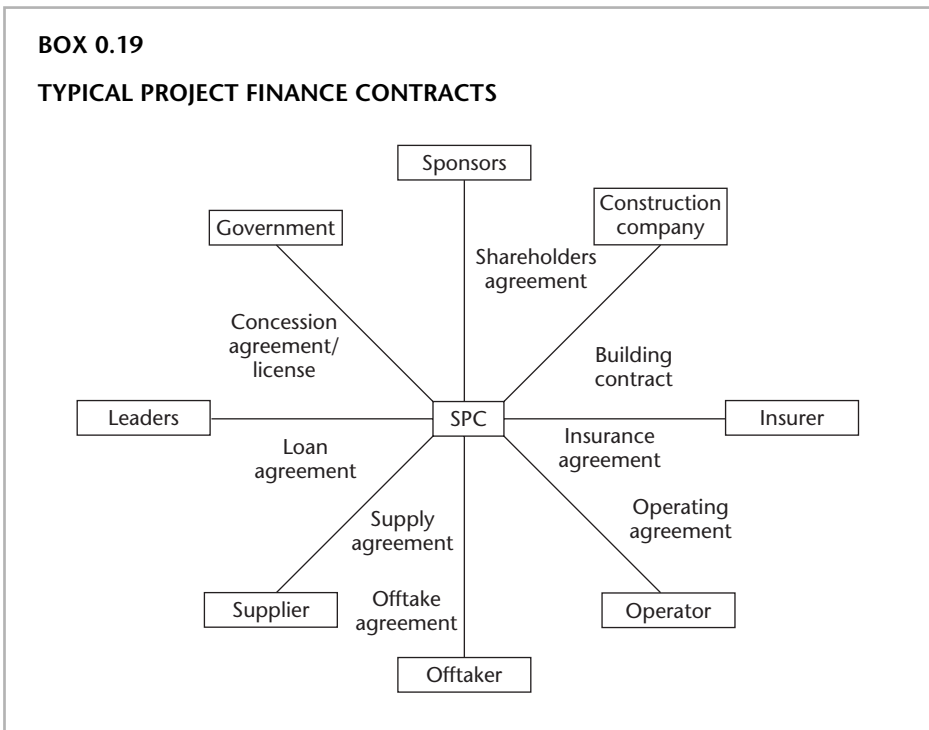
⁴⁶ See section 6 of this Introduction.

⁴⁷ See commentary on clause 21.

- limited recourse lending;
- income capture with the debt being repaid out of the revenue generated by the project.

In relation to the loan agreement, key characteristics will be:

- strict undertakings in relation to the key contracts in the project, (see Box 0.19 for an illustration of some common key contracts) for example, undertakings not to amend them, **assignments** of these contracts to the lenders, and direct agreements between lenders and the counterparties to those contracts—allowing the lenders step in rights (i.e. the right to step in and perform the contract on behalf of the borrower);



- the availability of funds from the lenders will be dependent on ratable contribution from other lenders and/or **sponsors**;
- extensive information provision for the lenders;
- detailed project forecasts and budgets agreed in a financial model before the loan agreement is signed, with variations from the base case having numerous consequences, such as restricting drawings of the loan; restricting payment of **dividends**; changing the Margin; setting the amounts of repayments; and ultimately, triggering an Event of Default;

- long drawdown period during construction, with interest possibly being capitalized, and drawings paid to a **disbursement account**;
- detailed expert evidence required as to state of the project at various points during the drawdown period, as conditions precedent to further drawing;
- ‘waterfall’ for payment (see Box 0.20) of project income;

BOX 0.20

The ‘waterfall’ is the expression commonly used to describe the series of accounts used to hold income generated in a project finance transaction. Typically these include:

- The revenue account, into which income is paid.
- The operating account, which is used to hold up to an agreed sum for ordinary operating expenses.
- The debt service account, which is used to hold sufficient funds to cover debt service for an agreed period.
- The debt service reserves account, which builds up an agreed cushion for future **debt service**.
- The maintenance reserves account, which builds up an agreed cushion for major maintenance costs.
- The distribution account—available to pay dividends to sponsors, subject to certain conditions.

- often, release of certain security (e.g. completion guarantee) once evidence of completion of the construction phase is provided;
- special purpose company undertakings—restricting the ability of the borrower to undertake other activities;⁴⁸
- security over all project assets;
- limited recourse to sponsors (shareholders in the project company);
- extensive insurance covenants;
- additional events of default if:
 - remaining development cost exceeds available funding;
 - ratios are not met;
 - insurance becomes voidable;
 - any relevant consent or license is altered;
 - any physical damage occurs to project assets;
 - the project is abandoned;

⁴⁸ See section 2 of the commentary on clause 22 - General undertakings.

- **force majeure** occurs under a project document in excess of a specified period;
- the project is expropriated;
- completion is delayed or
- any project document is terminated.

SECTION 6: QUASI SECURITY AND FINANCIAL INDEBTEDNESS

1 Quasi security⁴⁹

Quasi security means arrangements which have the same commercial effect as security. It comprises both title financing and other arrangements.

Title financing. This is using title (or ownership to property) instead of security, such as is done in finance leases or hire purchase agreements (as discussed here). Most title financing arrangements involve the separation of legal ownership (or title) to an asset from the economic ownership of the asset (or the commercial risks and rewards which go with ownership such as the risk or reward of a loss or gain in value of the asset). There are many different reasons for using title finance. In some cases, a tax or accounting advantage is sought. In others, the structure is used as an alternative to security because of unavailability of satisfactory security in the relevant jurisdiction. Whatever the purpose of the arrangements, their commercial effect is equivalent to the effect of security (but see also Box 0.21). Therefore any provisions in a loan agreement which deal with security must also deal with these arrangements.

Other arrangements. Other arrangements, such as rights of set off, do not amount to title financing but can also have a similar impact to security and therefore are discussed together with title financing in this section 6.

Examples of title financing include the following.

1.1 Finance or capital leases (as opposed to operating leases)

Finance leases are leases in which the lessor (or owner) is simply a financier and the lessee has the commercial risks and benefits of ownership. The lessor funds the purchase of the asset and receives rent through the lease sufficient to pay off the funding cost plus interest. Once paid, the lease may continue at a nominal rent or the asset may be sold, with proceeds payable to the lessee. The effect is as though the lessor had lent the funds to the lessee and the lessee had given security over the asset. **Hire purchase** is simply an example of a finance lease in which, once rent has been paid sufficient to pay the funding cost plus interest, the lessee acquires title to the asset for no significant further payment.

1.2 Title retention

If a seller gives credit to the purchaser of an asset and retains title to the asset until paid, the commercial effect is as if the purchaser had given security over the asset

⁴⁹ See generally Goode *'Legal Problems of Credit and Security'*, pp. 1-16-1-38.

BOX 0.21

Title financing is often used as an alternative to security but careful **due diligence** is necessary, not only as to the legal effect but also as to the tax, accounting, and regulatory effect. The person who is treated as the 'owner' of the asset for accounting purposes may be different from the 'owner' for tax purposes; the 'owner' for regulatory purposes;⁵⁰ and the owner for other legal purposes. In some countries, the structure will not be treated, for legal purposes, in accordance with its apparent effect, but will be '**recharacterized**' in accordance with its substantive effect. This may lead to a requirement that such arrangements be registered as though they were security (as in New York) or to the arrangements not being effective at all.

for the amount of the credit.⁵¹ Another example is an instalment sale agreement, or a conditional sale agreement under which title only passes on payment of the final purchase installment or fulfillment of other conditions.

1.3 Selling receivables but keeping the associated risk (as in some securitizations)

A distinction needs to be drawn between situations where the receivables are sold together with the risk⁵² and where they are sold but the risk is retained by the seller.

For example, compare the situation where

- debts with a face value of \$10 million are sold for \$8 million and
- the same debts are sold at the same price but the seller keeps the risk (e.g. by giving a **guarantee** to the buyer of the payment of the debts).

Assume the debtors pay only \$6 million. In the first case, that is of no concern to the seller. In the second, the seller must compensate the buyer. The commercial effect of the second case is as though the seller had borrowed \$8 million from the buyer and given security over the receivables.

1.4 Forward sale

This may be illustrated by an example. Let us assume that a manufacturer of watches, in order to raise finance, agrees with a 'lender' in January, for a price paid by the 'lender' at that time, that the next 500 watches produced will belong to the

⁵⁰ For example, is a temporary owner of shares under a repo treated as the owner for regulatory purposes such as duty to disclose major shareholdings?

⁵¹ In some countries, the seller is automatically given a security interest for unpaid purchase moneys so that title retention would be unnecessary.

⁵² Often referred to as a "true sale", and, depending on the purpose of the securitization, the requirement of a true sale may be key to its effectiveness.

'lender'. In other words, the 'lender' will purchase the watches in advance of their manufacture.⁵³ The 'lender' may then appoint the manufacturer as his agent to sell the watches with a requirement that a certain part of the sale proceeds be paid over to the 'lender' and with the manufacturer guaranteeing to make up any shortfall between the proceeds of sale recovered by the 'lender' and the advance price originally paid by the 'lender' plus 'interest'. The commercial effect is as though the manufacturer had given security over the watches to raise a loan.

1.5 *Forward purchase (as in repos)*

This is an arrangement where a company owns an asset, such as shares, and, in order to raise finance, sells those shares to a financier for, say, \$5 million, and agrees to repurchase them in six months time for \$6 million. The commercial effect is as if the company had borrowed \$5 million and given the shares as security.

1.6 *Set off*

Set off is a procedural rule which allows a party which owes money to another to reduce the amount he pays to that other by an amount which that other party owes to him.

The availability of this right of set off is a matter of law in the courts in which it is asserted. It may have the same commercial effect as security in some cases. For example, if a borrower of a loan of \$10 million has a bank account with its lender with \$5 million deposited, and the lender, if unpaid, can set off the amount in the bank account (leaving it with no obligation to pay over the deposit and with the amount of its loan reduced to \$5 million), the commercial effect is as though the lender had security over the bank account.⁵⁴

1.7 *Cash deposits*

Depositing money with a party could have the same commercial effect as security either because of the set off rights which will arise or because of formal or informal arrangements allowing that other party to forfeit the sums deposited in certain circumstances or because those sums are part of a payment mechanism.⁵⁵

1.8 *Trust arrangements*

If a company holds an asset on trust for others then that asset is, just as it would be if security had been given over it, not available to that company's creditors generally in the insolvency of the company. A **trust** can therefore have the same commercial effect as security.⁵⁶

⁵³ To be effective, the relevant jurisdiction would need to recognize agreements to sell future property as being binding.

⁵⁴ But a right of set off is not as good as security in all cases (and may even be better than security in some instances). See para 4.6 of section 2 of Appendix 1 on p. 279.

⁵⁵ See Goode 'Legal Problems of Credit and Security', para 1-38.

⁵⁶ In fact, it may amount to a registrable security interest—see Goode 'Legal Problems of Credit and Security' para 1-53 and compare para 1-38.

2 Financial indebtedness

In considering quasi security it is also useful to look at the breadth of arrangements by which finance can be raised and which can have the same commercial effect as borrowing money. Examples of such arrangements are described here.

2.1 *Acceptance credit facility*

This is an agreement by a lender to accept (or become liable for) bills of exchange issued by the company. The effect is that the lender agrees to make payment to a third party under the **bill of exchange** on behalf of the company. The effect is as if the lender lent the equivalent amount to the company.

2.2 *Bonds (like notes or commercial paper)*

Bonds are simply promises to pay, which are traded in the capital markets. A company will issue a bond (or note, or paper) which will be purchased in the capital markets and then traded. The purchase price will be paid to the company. The company has effectively borrowed the amount paid to it.

2.3 *Note purchase facility*

This is a facility under which a financier agrees to buy **promissory notes** issued by the company.

2.4 *Loan stock*

Money borrowed from investors and represented by certificates which can be sold by the investors in whole or in part. Loan stock may be secured, in which case it is known as debenture loan stock. It may be convertible into shares on terms specified in the stock, in which case it is known as convertible loan stock.

2.5 *Seller's credit*

Where a seller sells goods but agrees to delayed payment.

2.6 *Forward sale*

Selling assets which are not owned yet may amount to borrowing money. For example, assume a furniture store sells furniture and requires payment in advance of the purchase of that furniture by the store. The store has effectively borrowed money from its customers.

2.7 *Other title financing*

Other methods of title financing discussed above amount to borrowing on a secured basis, being finance leasing; forward purchase (e.g. repos) and selling receivables on recourse terms.

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