Key issues in bank lending
Introduction

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Key issues in bank lending

Introduction

So you’ve decided that loan finance is the way forward for your business. You have looked into other mainstream sources of funding such as asset finance, receivables finance, venture capital and private equity but none seem to suit your requirements as much as loan finance. You now need to focus on the precise type of loan facility and likely terms which may be available to you.

What are the critical issues you should consider and what outcomes should you seek? Loan documentation can be extremely complex. It may contain detailed assurances about how you will operate your business, reporting requirements and financial covenants with which the business must comply. All must be carefully considered. However the starting point should not be a line by line review of the precise wording used. Instead it should focus on the overall objectives you are seeking to achieve by obtaining loan finance and how any potential facility sits with those objectives. This article aims to set out the main areas to be considered in relation to this and to provide an overview of the manner in which a loan facility may affect them.

Key issues

A wide range of issues can arise in relation to a proposed loan transaction. Some crucial ones include:

How much do you need?

If you need a lot of money (ie in excess of, say, £30 million) the loan may need to be provided by a syndicate of banks (or, at least, one bank with other banks participating behind the scenes by providing funding, or commitments to fund, to that bank). This spreads the risk amongst the participating banks which can result in a larger loan amount being available and the cost being less than if only one bank lender were providing the monies. However it can make the relationship between borrower and funder(s) more complicated, particularly where amendments to the facility or waivers of breaches are needed, because there are a greater number of participants whose views must be considered.

However, it is very much more likely that the sum your business requires is a six or seven figure sum and as such a single bank lender or a loan from another source, such as another trading company, private individual or other type of financial institution, will be more appropriate.

What type of loan do you need?

Do you need committed or uncommitted funding? A bank overdraft will provide uncommitted funding where the bank can decide whether or not to allow you to draw down funds and repayment of which can be demanded by the bank at any time. This is tempered slightly by the practice of having a review date for such a facility and there generally being an understanding that the bank will not call in the overdraft unless and until your financial position or activities cause it concern.

A committed facility will provide more certainty that the monies will be available for the term of the loan (subject to complying with the conditions of the facility). However a committed facility often
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attracts additional cost because commitment fees will be required during the availability period of the committed funding.

If monies for working capital are needed then consider whether this is core working capital which is always needed, in which case a committed facility would appear preferable. Where such working capital is not a constant requirement an overdraft can provide readily accessible cash to meet any temporary shortfalls in working capital.

Are the loan monies needed for purposes which will require funding on an on-going basis or for a specific one-off payment? If the former is the case then a revolving facility from which you can draw to an agreed limit (subject to complying with the terms of the facility) and where any repayments you make replenish that limit is likely to be more appropriate. If funding is required for a specific project where a known amount is needed then a term loan which provides a fixed level of funding at the outset, or in staged drawdowns over an agreed time period, will be more appropriate; for example, if you are constructing a new site or wish to purchase capital equipment.

Repayment Terms

The period for repayment should match the commercial requirements and abilities of your business. If the facility is repayable on demand then clearly careful thought needs to be given to how the business will repay should demand be made. Where you opt for a term facility the repayments required under it should coincide with the predicted cash-flows of the business. Such predicted cash-flows should be stress tested to see how certain they are.

The stability of the funding is also relevant here. The more easily the lender can call in the loan (assuming it is not repayable on demand in the first place) the more carefully the proposed repayment profile needs to be considered. For example where the proposed facility documentation contains wide-ranging situations in which immediate repayment can be demanded. If you anticipate that there may be circumstances when you would wish to repay a term loan early, consider whether, and if so how, early repayment can occur under the terms of any proposed facility documentation.

Cost

The current UK tax regime favours debt finance because interest (unlike dividends) is tax deductible. In addition to interest various fees may be charged. Such fees differ between types of facility and depend upon the lender's assessment of the risk they are accepting in lending the monies.

A range of fees may be charged. Possibilities include:

- Arrangement fees for making the relevant facility available, regardless of whether or not any monies are drawn down under it
- Commitment/non-utilisation fees for the funder allocating funds to the facility which might otherwise have been used elsewhere
- (For large loans) syndication fees to the agent bank, arranger, bank underwriting the lending and to their professional advisers engaged to advise in relation to the facility
- Prepayment fees for repaying the facility early
- Drop-dead fees covering the expenses of a prospective lender (such as professional fees) whether or not a facility is provided

The likely overall level of cost should be carefully considered. For example interest on an overdraft may be at a higher rate than on a term loan. However in aggregate the overdraft may be cheaper
because interest is calculated daily on the amount actually borrowed and commitment fees are not charged. The commercial flexibility which a particular facility may provide should also be considered. In broad terms the lower the cost the less flexible the facility is likely to be but a more flexible arrangement may be more appropriate for your business. Such flexibility may justify the additional cost.

Comment is made below on the need to make sure that appropriate internal controls are put in place to ensure that all terms of the facility are complied with. This is particularly relevant to reporting requirements and to ensuring that the business is operated within the parameters imposed by the facility because there are likely to be penalties for any breach. The internal cost of ensuring such compliance should also be considered as this can add to the overall cost.

Security

The lender may (and these days probably will) require some form of security. Whether or not it does will differ depending upon the status of the borrower and the prospective lender’s attitude to risk. Very well established companies, i.e., large publicly traded companies, tend to be the only entities from which the lender will not require security. Such companies are of course in a tiny minority and “normal” borrowers therefore should assume they will be required to offer a comprehensive security package.

The most common security required by lenders is a fixed and floating charge (normally contained in a debenture document) over the borrower. This means all the assets of the company are potentially available to the lender to be sold should the loan not be repaid as required.

In many cases borrowers (and especially early stage borrowers) will have few assets and will be assessed by the lender as a poor credit risk. Accordingly, the lender would commonly then ask for additional personal security in the form of guarantees from directors or other interested persons as well as supporting security over personal assets, such as homes or life policies. This should of course be resisted if at all possible as it defeats the point of establishing a limited liability company. Some lenders might accept a comfort letter instead. This provides an indication, often from a parent company, of an intention to ensure that the borrower company will have adequate resources to discharge its liabilities. If such a comfort letter is available you should suggest this. Be that as it may, many lenders will not lend to growing companies without personal guarantees thereby leaving the borrower with no room for negotiation.

As with the facility agreement itself the terms of any security should be carefully considered to ensure that its terms do not restrict the business in a way which is commercially unacceptable or impractical. If you are required to offer a personal guarantee then you should read the document carefully and consider the following:

- What are you guaranteeing and do you have control? You should avoid being personally responsible to the lender for the company’s default if you cannot ensure in the first place that the company uses all its resources to avoid any such default.
- Will there be more than one personal guarantor? If so how will liability be shared between all guarantors? It would be preferable to persuade the lender to require all guarantors to pay their share of any default separately to the lender, but in reality the lender is likely to be able pursue any guarantor for the full amount. In practice this may mean that the lender will take action only against the wealthiest guarantor. If that is you then you will want a pre-agreed right and method to receive a contribution from the other guarantors. You should seek this anyway, as the wealth of the guarantors may
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alter over time. If the lender pursues you then, whether or not you are the wealthiest guarantor, an express right to recover from your fellow guarantors will be preferable to relying upon rights of contribution which the law implies between guarantors.

- Does the guarantee provide for a grace period? Again you should ask for this. Without a grace period the lender can enforce its security against the guarantors immediately. If the guarantor is permitted a grace period then he will have an agreed period to reorder his affairs rather than the lender having a right to take immediate action.
- Is there a cap on liability of each guarantor? Again, you should ask for this. The lender will have a minimum level of security it must have for borrowers not required to provide security relative to each loan. If that level is known to you then you can argue that the guarantors will provide security up to, but not beyond it.
- Are there negative pledges in the guarantee? If so these need to be read carefully, it is not impossible for the guarantee to be so tightly worded that the guarantor taking a car loan or a home mortgage whilst the guarantee remains in effect could be prevented.
- Does the guarantee provide for board changes? If a guarantor ceases to be a director and is succeeded by another director are there provisions that will allow the new director to step into the shoes of the old director thereby releasing the old director from the guarantee?

Undertakings

Depending upon the nature of the facility, extensive representations, warranties and covenants may be included. A warranty is a contractual promise that a statement of affairs is true. A representation is a promise that the lender can rely on when deciding whether to lend. In both cases the lender can sue the borrower should such a warranty or representation turn out to be untrue (see below for further detail). These may cover a wide range of issues but with the following overall purposes in mind:

- Information Disclosure

The representations are primarily intended to achieve two purposes for the lender. The first is to obtain information for the lender on the basis of which it can make its credit decisions. The second is to allocate risk between the borrower and the lender. If any representation turns out to be incorrect this will typically enable the lender to stop making further advances and will also trigger an event of default under the facility.

The lender will often wish to use the representations to maintain a consistent level of risk in its lending to the borrower, the idea being that the representations portray a picture of the borrower’s position which should be maintained throughout the life of the facility. A number of methods might be used to achieve this including providing that:

- the representations are to be repeated at the time of each drawdown (ie further lending) under the facility
- the representations (or at least some of them) will be repeated during each day of the loan (known as "evergreening" and such a provision should be considered carefully by the borrower as to accept these will mean the borrower must meet the standards and tests they set every day without exception, see "Future Control" below)
- one of the borrower’s officers is required to provide a certificate at specified times confirming that the representations are still true (as with personal guarantees this too should be reviewed carefully and the director in question should fully understand his liability).
Typical representations cover the following (amongst other matters):-

- the borrower's status as a lawful organisation with power to own its assets and carry on its business
- the borrower having power to enter into and perform its obligations under the facility and this not conflicting with any laws, the borrower's constitution or any other agreement entered into by the borrower
- the borrower having obtained all authorisations required to enable it to enter into the facility
- there being no event of default (see “Default” below) which is continuing or which may result from use of the facility
- financial information provided to the lender having been prepared in accordance with relevant accounting principles and presenting a true and fair view of the borrower's financial condition and operations
- no material litigation or other proceedings having been started or threatened against the borrower
- the borrower and any third party not having taken any steps to initiate the insolvency of the borrower

• Future Control

The lender will want to control the future activities of the borrower to the extent that such activities may affect the lender's position. Again this is effectively a risk control issue where the lender wishes to maintain a consistent level of risk in its lending to the borrower. The representations can contribute to this but the main method of doing so is by the inclusion of covenants in the facility agreement obliging the borrower to do or refrain from doing certain things during the life of the facility.

Covenants should be very carefully considered. They may have an impact on the day-to-day operation of the business which may restrict it in ways which may cause difficulties for the borrower. If they are breached this will be an event of default under the facility which may lead to acceleration of repayment of the loan. It may also lead to acceleration of repayment of other loans if they contain wording that it is a default under them if a default occurs under the loan facility. It may even cause the rate of interest being paid to be increased.

Covenants might be split into the following categories:-

A. Financial

Financial covenants may be aimed at specific aspects of the borrower's business such as its overall worth, ability to cover the interest payments (known as the interest cover test) due under the facility or the relationship between the borrower's worth and its level of borrowing (known as the loan to value ratio).

As with all of the covenants and the other provisions of the proposed facility, attention should be given to how financial covenants may affect the development of the business in future. Consideration should be given to your objectives for your business during the life of the facility. What plans are there for growing or reorganising the business and what is it intended to look like over time? How will such plans affect its financial position including its overall borrowings? This is particularly relevant when considering whether or not particular financial covenants requested by the proposed lender are acceptable. It is important to ensure the terms of the borrowing truly suit your business now
throughout the term as having to revert to a lender and renegotiate the terms of your borrowing can be time consuming and expensive.

The level of information to be provided to the prospective lender in terms of the administrative burden and any confidentiality issues should also be considered.

B. Information

These will apply to on-going financial information (in the main up to date accounting information to allow the lender to assess performance against the financial covenants) to be provided to the lender by the borrower. The facility documentation will make specific provision for:

- the frequency of such information (annually, quarterly, monthly etc.)
- the nature of such information (audited, unaudited or management information)

Provision will also be made for other information to be provided to the lender including:

- telling the lender about the occurrence of any event of default or event which may become an event of default
- providing the lender with details of any material litigation against the borrower
- giving the lender such information as it may request relating to the business and assets of the borrower.

C. Other restrictions

The facility documentation will also contain several further restrictions which may include limits concerning:

- potential dividends to be paid by the borrower to its shareholders
- potential acquisitions, investments and capital expenditure by the borrower
- potential disposals of assets by the borrower
- the granting of further security by the borrower (known as a negative pledge)
- changes in the control of the borrower or in the nature of its business

You should consider how such restrictions may affect your business and whether or not any exceptions are needed. For example that disposals of assets are allowed where equipment needs to be replaced or where such assets are below a certain value. Any exceptions negotiated should also be reflected in any security documentation which contains similar restrictions.

Default

Put simply, a default is a breach of the terms of the facility agreement. While a default could relate to any breach, in most cases the documentation specifically sets out what will constitute an event of default. Chief amongst these will be breaches of the undertakings, restrictions and tests (e.g. interest cover test) imposed on the borrower. Once an event of default has occurred the facility agreement will proscribe what action the lender may then take to protect its position. Care must therefore be taken to consider the proposed facility agreement as a whole to ensure that it can be complied with.
The events themselves and the rights they give to the lender if they occur should be carefully considered. The events can cover a wide range of areas but common ones include:

- failure to pay interest or principal amounts due to the lender under the facility
- breaches of commitments in the facility agreement other than the obligation to pay (and as such where the wording of representations and covenants becomes important)
- default by the borrower under other commitments (particularly financial ones, though ideally, from the borrower’s perspective, only where above a certain minimum limit and excluding contracts with trade creditors)
- insolvency related events occurring in relation to the borrower
- a change of control of the borrower
- material adverse changes in the borrower (which can cause difficulty because of the potential breadth of such a provision)

In general an event of default will allow the lender to:

- accelerate repayment of the loan (i.e. place it as being repayable on demand)
- cancel any further commitments to lend
- alter the fee structure which applies to the facility
- enforce any security given to the lender by the borrower

Internal controls

You should consider carefully how commitments entered into in facility documentation are to be monitored and satisfied. A checklist of the required information should be prepared. Large companies and groups will typically implement central reporting to ensure compliance with the terms in the facility. In smaller companies it is much easier to disseminate the relevant information, but the logistics still need to be considered and the directors should ensure a mechanism exists to ensure all relevant corporate actions that the company might undertake are permitted under the terms of the facility agreement. Failure to ensure that proper information is provided and that the activities of the business are monitored to ensure that they fit within the commitments undertaken could be costly. Such commitments may be wide and cover financial performance, asset disposals, third party claims against the business etc. and if not satisfied will give rise to events of default, possible acceleration of repayment of the facility and, ultimately, enforcement by the lender.

Summary

Care should be taken with any facility to ensure that it fits in with the commercial requirements and future plans of your business. If it does not discussions should take place with the lender or their advisers about making amendments which may overcome this (e.g. materiality provisions, cure or grace periods for putting right events of default or, where relevant, limiting provisions to specific parts of your group).

Once the terms of the facility have been agreed drawing up a list of reporting requirements and relevant restrictions can be invaluable in ensuring compliance with the facility agreement or at least identifying areas where requests for amendments or waivers of breaches should be made to the lender to avoid default.

Failure to consider the terms of the facility carefully and to plan for its operation can cause major issues for your business, at worst contributing to its failure and at best talking up valuable management time in dealing with the problems inappropriate facility terms can cause.
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