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REPRESENTATIONS, COVENANTS AND EVENTS OF DEFAULT - UNDERSTANDING THE BASICS OF LOAN AGREEMENTS

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INTRODUCTION

Representations, covenants and events of defaults (the "Core Clauses") are the foundations of loan agreements, and a number of these clauses are often found in a loan agreement. Unfortunately, their importance could be easily overlooked when drafting loan and other facility agreements. The drafters of such agreements may be tempted to take a shortcut and adapt templates and standards without first ensuring that each representation, covenant and event of default best serve the interests of their clients for the particular purpose(s).

Representations, covenants and events of defaults are the ABCs of loan agreements and parties may be easily caught out by one of their provisions if they are unaware of or do not understand the rights and obligations that stem from these clauses.

The Core Clauses are negotiable, and the specific wording used for the clauses depends on the negotiating power of the party. However, in order to comprehend what a party agrees to – either as a borrower or lender –the party must appreciate the marked differences between the Core Clauses and the different purposes they serve.

This article gives an overview of the Core Clauses in loan and other facility agreements. It also examines points to consider when negotiating representations, covenants and events of default, from the borrower and lender's perspectives.

Definitions of the Core Clauses

Representations are express statements made in a loan agreement concerning the legal and commercial position of the borrower and any obligor in the transaction. These statements represent the legal and business realities of the borrower and obligor(s) at the beginning of the deal. The lender assesses the borrower based on its representation and induces the advancement of a loan by the lender. Representations are usually only applicable to the borrower(s) and any other obligor(s) under the agreement.

Covenants are actions or omissions which one party promises the other party to do or not do (i.e. positive covenants and negative covenants). The inclusion of covenants in a loan agreement means that they become contractual obligations, some of which may lead to an event of default if there is non-compliance. Covenants are usually keenly negotiated by lenders to ensure the borrower maintains the status quo, especially concerning the financial health of the company. Covenants give lenders a certain level of control over the borrower's business.

Events of Defaults are circumstances that, upon their occurrence, give rise to the right of a party to declare a breach of the contract and exercise rights available under the contract such as premature repayment of the loan or enforcement of assets used to secure the loan.

It should be noted that not every default may lead to the termination of the contract; for example, some events of default may lead to suspension of payments until the borrower cures the default.

As can be seen from the above, within the definitions of the Core Clauses there are different types and purposes to Representations, Covenants and Events of Default.

Types of and Purposes of the Core Clauses

Representations

Representations may be split into legal and commercial representations.

Legal representations are representations on the legal reality and position of the borrower. They speak to the borrower's ability to perform its obligations under the loan agreement. Legal representations are usually evidenced by documentation such as certificates, licences and the likes, an example being the certificate of incorporation for a company. Common legal representations found in loan agreements include representations that the borrower has the legal capacity to enter into the agreement which would be valid, binding and enforceable against the borrower and representations as to the tax obligations in relation to the agreement. In practice, there are little or no negotiations concerning the legal representations lenders will require from borrowers as these have to do with the legal integrity of the borrower and the lender usually presents the legal representations on a 'take it or leave it' basis.

Commercial representations are representations regarding the financial reality and the commercial standing of the borrower in the market. They are used by lenders to assess the ability of the borrower to repay the loan. The commercial representations a borrower is required to make may include confirming that the tax returns of the borrower are up to date; that the financial information provided to the lenders are true and accurate in all particulars and that the borrower's satisfaction of the loan obligation to the lender (either through enforcement of the security interests provided by the borrower or otherwise), would take priority.

Lenders may require that borrowers repeat the representations at certain stages of the contract. Borrowers may negotiate the frequency of these repetitions, the process of repetition and the representations that need to be repeated.

Repetition of representation is essential to lenders as it assures that the information upon which they had provided the loan or other facility remains accurate. Lenders may push for the representation to be repeated on each day of the loan period, the first day of each month during the loan period, bi-monthly or other such periods.

However, borrowers may negotiate for repetition to only occur on the first day of each interest period or drawdown dates or in the event of a significant change in the parameters of the loan such as renewal or amendment of a loan agreement. Borrowers must take note of the frequency of the repetitions required and ensure, though onerous, that the representations do indeed remain true as a breach may give rise to an event of default.

Repetitions may be embedded in the agreement to occur automatically during the relevant period. Alternatively, the agreement may require that the lender send a notice to the borrower requesting it to confirm its representation at the commencement of each relevant period. The notice may also request that the borrower set out the details of any misrepresentation that may have occurred.

It should be noted that certain representations become superfluous after a particular stage of the agreement has passed and therefore, it is not necessary to repeat such representations as they are set in time. An example is representations relating to the original financial statements of the borrower. Also, where other obligations cover the representations under the agreement, such as covenants, repetition of the representation may be rendered redundant.

Covenants

Covenants are undertakings in a loan agreement which either limit the actions a borrower can take or require the borrower to take specific steps during the course of the loan term. Covenants serve as a means of protecting the interests of the lender. They also give the lender a certain level of control over the business of the borrower. Covenants serve as a way to deal with everyday problems associated with debts such as the dilution of a lender's security interest by granting security on the same assets to other creditors with an equal or prior claim.

Negotiating covenants to be included in a loan or other facility agreement is especially important to the borrower and lender as the breach of a covenant may give rise to an event of default, which affords the lender the right to renegotiate the loan or impose sanctions against the borrower.[1]

Covenants may be categorised into financial covenants and non-financial covenants. Non-financial covenants regulate the actions the borrower may or may not take with regards to the general business of the borrower (general covenants) during the loan term and the type of information the borrower is obligated to disclose to the lender and the time the borrower is expected to make these disclosures. Examples of non-financial covenants borrowers make include:

[1] Paul Mather, 'The Determinants of Financial Covenants in Bank-Loan Contracts' [2004] *Journal of International Banking Law and Regulation* 33.

- compliance with all relevant laws of the borrower's country;
- payment of all taxes;
- ensure priority or *parri passu* ranking with other creditors on the security interest;
- no new security interest may be granted over the lender's collateral;
- no assets of the borrower may be disposed of;
- no mergers or acquisitions may occur involving the borrower;
- the borrower may not change its business object;
- the borrower cannot grant loans or guarantees;
- restriction on the payment of dividend;
- the disclosure of any material adverse change.

Financial covenants are pre-agreed limits or tests which the borrower undertakes to meet or maintain, with regards to the financial performance of the borrower. They serve as an objective means for the lender to continually assess the borrower and its ability to repay the loan. Breach of a financial covenant would usually trigger an event of default. Major financial covenants include:

- Maintenance of a minimum EBITDA to Finance Charges (interest cover) ratio, that is, the cost of servicing the debt (interests and fees) versus the Earnings Before Interest, Taxation, Depreciation and Amortisation (EBITDA);
- Maintenance of a minimum Net Debt to EBITDA ratio, that is, the total debt of the borrower minus cash on hand versus the borrower's EBITDA;
- Maintenance of minimum net worth (equity versus debt);
- Maintenance of a minimum Cash Flow to Net Debt Service ratio, that is, the debt obligations (scheduled repayments) in a period versus the available cash flow in that period.

Majority of covenants, as seen above, serve an economic role in ensuring that the relationship between the borrower and the lender is not adversely affected. The covenants control the actions which management of the borrower may take that have the potential to affect the interest of the lender.[2] For example, restrictions on mergers and acquisitions are put in place so as not to change the borrower/group the lender is contracting with, restrictions on the granting of loans/guarantees and payment of dividends are also put in place to control the money being paid out by the borrower to persons other than the lenders under the agreement.

Negotiations of the covenants to be included in a loan or other facility agreement are usually charged and witness many pushbacks by borrowers who view these covenants and the control the lender exercise through them, as an intrusion into its management's liberty to run the business.[3]

[2] Judy Day and Peter Taylor, 'Bankers' Perspective on the Role of Covenants in Debt Contracts' [1996] *Journal of International Banking Law* 201.
[3] Ibid.

Borrowers may concentrate on negotiating for specific covenants and carve-outs rather than covenants with a blanket restriction. For instance, a limit on the grant of a loan/guarantee above a stated financial threshold or restriction on the disposal of a material asset without the written consent of the lender, consent not to be unreasonably withheld and given within a set period or the permission of disposals of assets that remain within the borrower/obligor group such as from a borrower to a guarantor under the agreement. The inclusion of such qualification to the covenants gives the borrower a degree of flexibility.

Borrowers may also negotiate the parties to whom the covenants should apply, such that the covenants only apply to the borrower and guarantors under the agreements. In cases where the borrower is part of a group, the lenders may push for the covenants to also apply to the parent company/subsidiaries of the borrower. Once again, the covenants a borrower has to contend with, depend on the negotiating power of the borrower.

Nonetheless, it is important for lenders to note that while covenants must be restrictive enough and optimally designed to protect the interest of the lender while controlling the potential opportunism of a borrower, they must not be too restrictive as to constrain the borrower's optimal management strategies. The reason for this flexibility is because covenants that are too restrictive may make the happening of an event of default inevitable, which may end up being costly for both parties.[4]

Events of Default

Events of Default are circumstances or events which when they occur, are deemed as a breach of the loan agreement, such that it gives rise to the power to enforce the rights and remedies available under the agreement; for instance, the violation of a covenant or representation in the agreement may be an event of default. Other common events of default include:

- Commencement of insolvency proceedings against the borrower;
- Change of control of the borrower;
- A materially adverse change;
- Cross default/ cross acceleration, that is, the trigger of an event of default or acceleration against the borrower in another loan transaction will trigger an event of default in the instant loan agreement;
- Occurrence of a force majeure.

The purpose of events of default is to afford lenders the opportunity to state conditions on which they may demand immediate repayment of the loan and all outstanding interests/fees (acceleration). Events of default must be carefully

[4] Paul Mather, 'The Determinants of Financial Covenants in Bank-Loan Contracts' [2004] *Journal of International Banking Law and Regulation* 33.

negotiated to ensure a fair balance between the interests of the lender and the interests of the borrower, so as not to give lenders an unlimited ability to call for

repayment. Events of Default clauses must be drafted and negotiated in light of events that have been identified, after careful consideration of the particular (present and anticipated future) circumstances of the borrower, which may threaten the security of the loan.[5] However, the events of default must not be so broad as to restrict the borrower from utilising the loan for the intended purpose or from optimally conducting its business. The representations and covenants under the agreement must also be considered when drafting event of default clauses as the three Core Clauses work hand in hand.

Borrowers may negotiate for the inclusion of grace periods before the right to call for immediate repayment of the loan or facility becomes effective. This grace period affords the borrower the opportunity to put its house in order before the lender calls for repayment. Additionally, in cases where the loan or other facility is provided to the borrower in instalments, events of default may be negotiated to lead to a suspension on the provision of a future loan or facility instalments, rather than immediate repayment of such loan or other facilities.

An important point to note is that the emergence of the lender's right to call for an event of default does not automatically mean that the loan agreement has to be forfeited. However, the lender must make a conscious decision to exercise its right. The parties may also take it as an opportunity to renegotiate the terms of the agreement. However, a lender will usually retain its right to accelerate repayment of the loan or other facility.[6]

Conclusion

The Core Clauses are very vital to a loan agreement and they could make or break the transaction. In negotiating these clauses, the risk and advantages of both parties must be carefully considered and balanced. While this is dependent on the negotiating power of each party, an agreement that is heavily skewed in favour of one party is ultimately not beneficial, as it may be costly and ineffective for the transaction and both parties. Ultimately, the aim of each party should be to contain the risk exposures and maximise the protections the agreement affords it.[7]

[5] Richard Youard, 'Default in International Loan Agreements-Part 1' [1986] *Journal of Business Law* 276.
[6]ies Ibid.
[7] Richard Youard, 'Default in International Loan Agreements-Part 2' [1986] *Journal of Business Law* 378.

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