

5. Loan Agreements

General

A loan offer will generally be framed in such a way as to become a binding contract on acceptance by the borrower. Common law contract rules apply to the loan agreement. When signed, the bank becomes obliged to lend subject to satisfaction of the various preconditions or conditions precedents (conditions) within the period stated or implied. If there is an event of the default, the bank's commitment to lend will generally terminate.

The contents of the particular loan agreement (and the mortgage documents) is what principally governs the rights and obligations of the bank and the borrower in any particular case. There will always be so called special conditions which are unique to each case, in addition to the general conditions.

Regulation and Format

The loan agreement and the mortgage deed will set out the legal rights and obligations of the lender and borrower. Convenience and practical considerations usually lead to a separate loan agreement and mortgage deed. Difficulties may arise by reason of inconsistencies between the mortgage deed and loan agreement.

Many lenders use a relatively standard form of loan agreement. Particular conditions specifically relevant to the circumstances are usually inserted by way of special conditions.

The content and complexity of the loan agreement will depend on the circumstances. In some cases, the loan agreement be negotiated to an extent. In most retail transactions, the borrower is likely to have been offered the lender's form of loan agreement for the loan product concerned.

The Housing Loan provisions in the Consumer Credit Act may apply. In this event, the mandatory warnings, format and information required by Part IX of the Act must be inserted.

Unfair Contracts Regulations

Loan agreements with consumers are subject to the Unfair Contract terms legislation, which derives from European Union law. A consumer means an individual who is acting outside of his normal trade or business.

Where the regulations apply, an unfair clause is not enforceable against a consumer. The regulations may require that a clause is interpreted in such a way so as to limit its application to a fair and reasonable interpretation. The regulations also require that the agreement be in plain

and intelligible language.

The regulations apply, broadly speaking, to standard form contracts. A clause in a contract is unfair if it has not been individually negotiated and if contrary to good faith, it causes a significant imbalance in the parties' respective rights and obligations to the detriment of the consumer. Unfairness does not apply to pricing and other commercial conditions.

The regulations contain a list of types of clauses that are potentially unfair.

Contents

A loan agreement will generally contain clauses covering the following matters;

- ❖ purpose of the loan;
- ❖ drawdown preconditions;
- ❖ warranties and representations;
- ❖ ongoing covenants and obligations;
- ❖ events allowing termination of the loan;
- ❖ security over borrowers assets;
- ❖ fees and charges;
- ❖ governing law;
- ❖ provisions on assignment;
- ❖ where notices may be sent.

Purpose of Loan

When loan monies are advanced, they become the absolute property of the borrower. Generally, the lender has no

direct right to a fund of monies representing the loan proceeds or to any assets purchased with them. The lender has a general right to be repaid (i.e. the debt). This is a contractual right to enforce the debt against the borrower personally.

There is a limited exception to this rule where a loan is advanced for a particular purpose. The courts have, in some cases, taken the view, that where monies are advanced for a very specific purpose, the lender may have an interest in the proceeds of the loan monies, even after they are advanced to the borrower.

This is a matter of debate and would require court proceedings to assert. It should not be relied on as a general proposition, but the principle may prove to be of use in some circumstances. Where the principle applies, the lender may be able to trace entitlement to another asset which has been purchased with the loan monies. See our chapter which discusses trusts.

Repayment

The period of the loan, the capital repayments requirements and the interest rate basis will be key commercial terms. The loan agreement will set out specifically or by implication, the provisions for interest and repayment of capital. There may be a schedule of payments of interest and capital by

regular periodic payments.

Repayment may be on a specific date or in accordance with a schedule of payments. Early prepayment may lead to broken funding costs. The bank may require an indemnity in respect of loss incurred.

In commercial loans, repayment may be at a distinct point in time by way of a single bullet repayment. In construction and development loans repayment may be contemplated from a particular source at a particular time or over a period of time.

In many cases, repayment is on demand and is rolled over from time to time. This gives the lender considerable flexibility to demand repayment and terminate the facility.

Interest

The loan agreement will specify the applicable interest-rate. The bank may set a base rate with reference to its overall average cost of funds. It may set a floating rate based on a basis rate plus a margin. This basis rate may be the bank's marginal cost of funds on the interbank market.

The interest rate may be set by reference to some internal or external benchmark. In commercial loans, interest is more likely to be set by reference to the bank's cost of funds on the inter-bank market or some

equivalent benchmark.

The rate of interest for Euro loans will often be Euribor plus certain costs plus margin. Euribor is the rate at which Euro interbank term deposits are offered by one prime bank to another prime bank within the EMU zone, and is published at 11:00 a.m. (CET) for spot value. The choice of banks quoting for Euribor is based on their market standing and they are selected to ensure that the diversity of the euro money market is adequately reflected.

Costs usually refer to mandatory costs arising from the costs of regulatory deposits (if any). The margin will be set as a commercial term, depending on the borrower's status and risk profile.

There may be provision for a higher default interest rate, if the borrower fails to pay the sums due. Provided that the default interest can be justified as reasonable compensation for having to deal with the default, the clause should be upheld, at least in non-consumer loans.

Generally, there is no statutory restriction on the rate of interest that may be charged if the borrower is not a consumer. Clauses allowing for variation of interest agreement are lawful under Irish law subject to the provisions of Consumer Credit legislation.

Withholding Tax on Interest

Under some circumstances, there is an obligation on an individual or company paying interest to withhold tax. This risk can apply in particular, to cross border payments. There is usually a clause in the loan agreement dealing with this risk which requires the payment to be grossed up+ (increased) so that the bank receives the required interest after tax is withheld. The purpose is to protect the bank from withholding tax, but the clause can substantially increase the cost to the borrower.

Companies are generally required to withhold tax on interest payments under Irish tax law. There are some important exceptions which are generally available to Irish banks and many overseas banks.

Security

The loan agreement will stipulate the security required. This will include one or more properties in the case of a property investment loan. Buildings insurance should be required. The interest of the lender should be notified to the insurer. It is possible to take security over the benefit of the insurance policy itself. Security over a life policy, a deposit or other assets may be required.

It is desirable to specify that the secured property is security for all sums due on all accounts between the borrower and lender. This means that the security will be

available to cover shortfalls on other loan accounts.

In the case of development, construction or commercial loans, the required security may be more extensive than a mortgage or charge over property. In many cases, additional security over other assets such as insurance policies, bank accounts, contracts, guarantees and rents receivable may be required.

It is possible to give security over a wider class of assets than just property and buildings, even in the case of security by individuals. See our chapter on security over non-property assets.

A company may give security over its circulating trade assets by way of a floating charge which it continues to use in the course of its trade until enforcement. See our chapter on security by companies.

Representations and Warranties.

Representations and warranties are promises on the part of the borrower in relation to existing matters. The bank relies on the truth of the representations or warranties in advancing the loan.

The representations should represent the truth and accuracy of the facts on which the loan has been underwritten. The bank will have obtained information and

documents to vouch the borrower's personal and financial status. If any material matter turns out to be false or inaccurate, this will usually be an event of default, entitling the bank to demand repayment and enforce.

There are usually standard representations and warranties in relation to such basic matters as the borrower's legal capacity, absence of adverse litigation, insolvency, the accuracy of existing information and the priority of the loan. There will usually be a clause to the effect that there has been no material adverse change between the loan agreement and drawdown date.

Generally, when misrepresentation has taken place, the bank can terminate the commitment to lend. Where a fraudulent or deliberate misrepresentation is made by a third party, there may be a right to sue for compensation for loss incurred.

Covenants and conditions

A covenant or condition is a promise by the borrower which applies throughout the loan agreement. Breach of covenant generally entitles the bank to terminate the loan. A wide range of covenants, varying significantly in scope and sophistication, is possible.

Breach of covenant can also be a means of bringing the borrower to the table for

negotiation, even if it is not desired to declare an event of default, demand full repayment and resort to full enforcement. This may give the opportunity to re-negotiate the security or the other terms of the loan agreement.

The nature and extent of the covenants and conditions in the loan agreement will depend on the nature of the loan. More extensive covenants and conditions are likely to be required for commercial, construction and development loans than for property investment loans.

Covenants required for owner occupied mortgages will be less onerous. In the case of owner occupied mortgage property, there will usually be an obligation to occupy the property as the principal residence of the borrower. Letting and sharing occupation will generally be prohibited.

In the case of commercial and development loans, there are likely to be detailed covenants in relation to the borrower, particularly in the case of a company. Any factor which might point to the risk of the insolvency of the borrower is likely to be a breach of a loan covenant. The lender will wish to have the power to accelerate the repayment of the entire loan monies at the earliest sign of financial distress, if only to allow it to negotiate a better position.

Covenants can require the borrower to meet certain standards. For example, there may be financial conditions affecting the borrower's business and the security as shown in the accounts. Financial covenants may set out limits and ratios for financial performance. These may be set by reference to the borrower's projections and the bank's minimum necessary requirements.

There may be a commitment by the borrower to maintain a minimum net worth. This is more common in corporate loans. There may be limits on other outstanding exposure. There may be commitments on profitability, liquidity, interest cover and other key ratios.

Information covenants entitle the bank to information and act as an early warning mechanism. Annual accounts, management accounts, cash flow statements, forecasts and budgets may be required. The bank will usually be entitled to further specific information on request and to access to books and records.

There will be covenants to protect the value of the security. Insurances and licences will be required to be maintained. A negative pledge clause is an undertaking not to create a further security over the assets to any entity, other than the lender.

There may be restrictions on substantial

acquisitions and disposals. In the case of a company, there may be pre-conditions and limitations on paying dividends.

Events of Default

An event of default is a circumstance that entitles the bank to terminate the loan and demand repayment of the entire loan monies. Typically, an event of default will also constitute circumstances in which a mortgage or charge can be enforced. The following are common events of default;

- ❖ Failure to pay or late payment. Late payment may signal deterioration in cash flows and is an early warning signal;
- ❖ Cross default. If a borrower defaults under another loan obligation or fails to pay on a court order, this will be indicative of insolvency. There may be a domino effect of other enforcement;
- ❖ Breach of loan condition;
- ❖ Commencement of insolvency;
- ❖ Change of control. This may apply to a company borrower, where the key sponsors cease to control the company. This is effectively a change of identity of the borrower;
- ❖ Material adverse change. This is frequently used as a sweep up clause to protect the lender against unforeseen

circumstances, there must be some substantial basis in order to use the clause.

Certain events of default may have a grace period in which the borrower can remedy the default. On default, the bank will usually have a number of rights. It may cancel undrawn parts of the facility. It may demand the entire loan monies and may enforce the security.

The bank may not necessarily wish to take all or any of these actions. The appropriate course may be to negotiate with the borrower to remediate the position. The renegotiation may involve increased margin, tighter covenants, reduced loan to value, more security etc.

A bank can be legally liable to a borrower if it demands repayment or enforces security, where it is not entitled to do so. It is desirable to consider the loan agreement's terms. A demand will often be necessary as a pre-condition of entitlement to the full loan monies and the exercise of enforcement options.

Fees and Costs

Fees may be provided for by the loan agreement. There may be a front end fee in consideration of the initial set up of the loan. There may be a commitment fee in relation to the commitment to make money available and to cover costs. The

Consumer Credit Act restricts the charging of fees in consumer cases.

A loan agreement will usually require the borrower to pay incidental costs in connection with the set up and running of the loan. This may include registration fees and other outlay. There is no stamp duty at present on mortgages or loans.

Governing law

The governing law of the loan agreement will specify the country whose law is to apply. The loan agreement may be governed by the law of the country with which it has closest connection, in the absence of a specific clause. In the case of a loan agreement in Ireland between an Irish bank and an Irish based borrower, the appropriate law to govern the loan agreements will usually be Irish law.

This is an extract from our "Legal Guide to the Management and Enforcement of Security in Ireland" (2009). The Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances. It should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances. While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in it. The reader should rely only on specific legal or taxation advice. This extract is based on the law as of 1st October 2009.

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