

Commercial Loan Agreements

A Technical Guide for
Microfinance Institutions



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Consultative Group to Assist the Poor

Prepared for CGAP by Cleary, Gottlieb, Steen & Hamilton, LLP

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Purpose of Guidebook

This guidebook introduces borrowing microfinance institutions (MFIs or borrowers) to important provisions of a standard commercial bank loan agreement. It *does not* provide an exhaustive description of the contents of a loan agreement. (In any event, standard forms of loan agreements vary depending on several factors, including the lender, the country in which the lender is located, borrower characteristics, and loan size.) This guidebook, therefore, should be used by borrowers as general guidance.

Typically, lenders will want to use their own agreement form as the basis for negotiating with borrowers. Much of a draft loan agreement comprises standard (boilerplate) provisions, and banks are sometimes reluctant to consider changing these provisions. Other clauses in a loan agreement, however, are specific to the transaction. They may need to be customized to reflect the individual features of the lending relationship in question.

The first draft of a loan agreement proposed by lenders is just that—a draft. Borrowers should study its terms carefully and, where necessary or commercially reasonable, negotiate the terms to ensure funds will be available to them when needed and they will be able to carry on their normal business per the agreement. Theoretically, every loan agreement provision can be negotiated, but in practice, a borrower’s negotiating strength depends on its bargaining power. A local borrower may find that bargaining power increases with the longevity of its relationship with the lender.

This guidebook offers tips for drafting standard clauses. Borrowers should use this guidebook to help them understand the risks associated with some of the important provisions of a loan agreement. This guidebook also can help borrowers identify departures from generally accepted provisions that may negatively affect their interests.

Loan agreements commonly are evidenced by the signing of a loan agreement, a promissory note, or both. A loan agreement is a contract between the lender and the borrower that sets forth the terms and conditions of the loan (including its repayment) and the rights and obligations of both parties.

A promissory note, by contrast, is simply a written promise by the borrower to pay a stated amount of money in accordance with certain terms, which include the principal amount of the loan, a specified rate of interest, and a maturity date.

The main difference between a loan agreement and a promissory note is length. Promissory notes typically are much shorter and less detailed than loan agreements. Moreover, promissory notes often are used together with loan agreements to provide supplemental evidence of the promises to pay the amounts specified in the loan agreement. Occasionally, the debt obligation represented by a promissory note is secured by the borrower's specific assets, in which case the promissory note may be called a collateral note. Although promissory notes are not essential, because a loan agreement alone sufficiently records the transaction and binds the parties, they may provide some advantages to the borrower in certain jurisdictions. (For more information, see "Alternatives to a Loan Agreement—Promissory Notes.")

This guidebook addresses only standard commercial loan agreements governed by laws of common law legal systems.¹ However, it does flag, in broad terms, some notable distinctions between the way common and civil law handle terms and practices with respect to loan agreements and promissory notes.

The type of legal system that applies to the loan agreement is critical, because common law and civil law legal systems involve different approaches to the respective rights of creditors and debtors. Common law and civil law systems may use different legal terms; may recognize different types of liens (legal interests in the borrower's assets); may offer different types of self-help remedies to creditors; and may apply, through local courts, different interpretations to terms and conditions. Borrowers should ask local legal counsel whether the law governing the loan agreement follows common law or civil law principles and what the related implications are. Indeed, borrowers should seek local counsel to understand how this issue (as well as a number of other issues highlighted throughout this handbook) applies to them.

This guidebook describes various loan agreement structures and standard provisions, including those relating to representations and warranties, covenants, events of default, remedies, enforcement, and confidentiality. It also covers commercial loan agreements and certain alternative loan products, defines loan agreement terminology, and explains the risks and benefits of some common loan structures.

¹ Most Latin American and continental European jurisdictions have civil law systems, while most of the United States, most members of the British Commonwealth, and some former British colonies have common law systems. Among Asian and African nations (e.g., South Africa, Zimbabwe, Botswana, Philippines, and Sri Lanka), it is not uncommon to encounter "mixed jurisdictions" that have elements of both civil law and common law traditions. In some cases, most notably among Middle East countries (e.g., Iran, Egypt, and Syria), a jurisdiction's legal framework is "mixed" in that it integrates civil or common law concepts into a religious or tribal law framework.

Negotiating Perspective of the Borrower

General Overview

A borrower's principal objectives in negotiating a loan are as follows:

- Ensure funds will be available when needed.
- Obtain funds at the most advantageous financial terms possible (e.g., the lowest interest rate possible).
- Provide for the repayment of the loan over a period that will not place an undue burden on it.
- Ensure it can comply with all other terms of the loan agreement (such as financial covenants) in its ordinary course of business.

The lender's objectives for the loan agreement are as follows:

- Set out the conditions under which it will be obligated to disburse funds under the loan agreement.
- Enable it to monitor the borrower's financial situation and, when necessary, to take remedial action if the borrower experiences serious financial difficulties.
- Provide itself with a legally enforceable claim to its funds, or access to other remedies, if the borrower defaults.

Preliminary Considerations

Term Sheet

Most loan negotiations begin with the lender preparing a document variously called a term sheet, mandate letter, or engagement letter. This document sets forth important terms of the loan, including key financial terms, such as the interest rate and repayment period. A term sheet can be thought of as the genetic code that will govern the contents of the final loan agreement. It should specifically state that it is not intended to be a binding obligation for either party so that neither party can assert that it is

enforceable or that one party is liable to the other for costs incurred or action taken based on the term sheet.

Borrowers usually are asked to indicate consent to the terms set forth in the term sheet by countersigning it. Accordingly, the best time for borrowers to negotiate or clarify financial terms is at the term sheet stage, because lenders will argue that their proposed lending terms are based on the term sheet. Borrowers should not assume that these basic terms will remain open for discussion after the draft loan agreement has been prepared, because lenders often receive approval from their credit committees or other internal bodies based on the term sheet.

Local lenders with informal lending procedures may not always use term sheets (particularly for short-term borrowing and off-the-shelf loan products). Even if a lender does not require or prepare a term sheet, the borrower may wish to draft one for its own records or for use as a planning and negotiation tool when discussing specific terms of a prospective loan both internally and later with prospective lenders.

Alternatives to a Loan Agreement

PROMISSORY NOTES

Borrowing may be documented with a promissory note rather than with a loan agreement. These types of promissory notes stand alone and are not used in conjunction with a loan agreement. They are sometimes called long form promissory notes because they are longer than those used to evidence loan agreements, and they contain many of the same types of provisions as those used in loan agreements.²

A promissory note differs from a loan agreement in that only the borrower signs a promissory note. Thus, it is only the borrower (referred to as the maker or the issuer of the note) who undertakes any obligation under it: the promise to pay a fixed amount of money to the lender (referred to as the note holder) on demand or at definite times.

Using a promissory note instead of a loan agreement typically benefits the note holder (the lender) more than the issuer (the borrower). First, a promissory note is a more liquid

² In certain civil law jurisdictions (e.g., Brazil) long form promissory notes are not used. In other civil law jurisdictions, promissory notes must be issued with a loan agreement. In such jurisdictions, promissory notes typically are short documents that refer the reader to the loan agreement for detail regarding terms and conditions. Furthermore, in civil law jurisdictions where promissory notes are common, the form of the promissory note is quite flexible. As long as the essential terms (mandated by statute) are present, the instrument will be fully enforceable regardless of length or the presence of a corresponding loan agreement. In fact, in such jurisdictions, banking institutions often document medium- and long-term loans with both a loan agreement and a long form promissory note.

asset than a loan agreement. Because a promissory note may be a negotiable instrument, meaning that it can be freely transferred without the borrower's permission, the lender can transfer ownership of the note fairly easily. In fact, in many jurisdictions, unless the promissory note provides otherwise, the lender can separately transfer its rights to individual payments under the note to one or more parties.³ This means that the lender could transfer half of the amounts outstanding to one party and the other half to a different party, or it could transfer the outstanding principal amount to one party and the interest component to another party.

A second advantage to the lender is that, in some jurisdictions, the rights and obligations provided under a promissory note are easier to enforce than those provided under a loan agreement. This is because promissory notes often qualify for more streamlined enforcement proceedings that may provide more efficient remedies against defaulting borrowers.

Countering these advantages for the lender are certain disadvantages for the borrower. One notable disadvantage is that, because the lender is not a party to the promissory note, it does not have any obligations it would otherwise have in a loan agreement (for example, obligations to mitigate damages, act reasonably, etc.). For this reason, where there is both a loan agreement and a promissory note, the borrower should ensure the promissory note refers to the loan agreement so that, in an enforcement action, the note cannot be deemed to stand alone without reference to the other loan agreement terms.

Laws governing promissory notes vary considerably from country to country. In some countries, promissory notes may not provide for principal amounts to be paid in installments (also called amortization); instead, in these jurisdictions, notes must specify that principal amounts are to be paid in a single installment (also called a bullet). In other cases, courts are entitled to disregard certain types of clauses when they are included in a promissory note. Even provisions covering interest payments can be problematic. Therefore, it is important to be familiar with local laws when using and structuring a promissory note.

OVERDRAFT FACILITIES

An overdraft facility is a form of borrowing in which the lender provides the borrower a line of credit up to a specified maximum principal amount during a set period. It usually

³ Civil law jurisdictions may have significant restrictions to transferring negotiable instruments, such as promissory notes. For example, in Mexico, promissory note transfer or assignment, called an endorsement, must be unconditional; any condition or a partial endorsement will void the transfer. Furthermore, if rights are transferred by any means other than an endorsement, the transfer is defective and will not be enforceable against the transferor.

is meant to be used for short-term borrowing to fund the borrower's cash flow shortages or to bridge the borrower's needs until it enters into a standard loan agreement. As a result, the duration of a facility is short (e.g., not more than 24 months). Some overdraft facility agreements require that borrowed funds be repaid in full periodically (e.g., every 90 days) to ensure the facility is used only for short-term financing needs.

The borrower pays interest only on the amount of money it elects to borrow (called the drawdown.) The borrower typically can repay and then re-borrow funds as many times as it elects throughout the life of the facility, as long as it does not exceed the maximum borrowing limit at any given time. (The act or process of paying back the money is often referred to as the payback.) Overdraft facilities also may require a form of credit enhancement whereby the borrower must maintain cash or other financial assets (such as a certificate of deposit) with the lending bank during the life of the overdraft facility.

Advantages and disadvantages. Borrowers tend to like overdraft facilities because they are a simple and flexible way to borrow. This is particularly the case for borrowers that are uncertain of their exact debt financing needs over a specified period or that expect their debt financing needs to fluctuate during a specified period (i.e., borrowers using the proceeds of overdraft draw downs to fund seasonal peaks in lending operations). In many cases, however, the lending bank has the right to demand repayment of the full amount drawn down at any time. Moreover, each time the facility expires (which may be frequently, because the facility is intended for short-term borrowing), it must be renewed and renegotiated, which leaves the borrower open to, among other things, fluctuations in interest rates.

Security and set-off. The bank offering the overdraft facility may require the borrower to provide some form of security or credit enhancement for the facility. This may be cash collateral in the form of a fixed deposit of money kept with the lender (possibly in a foreign currency, such as euros or dollars).⁴ The terms of an overdraft facility also may provide for a contractual right of set-off against any of the borrower's accounts with the lender. This means that, if the borrower defaults, the lender has the right to subtract the amount of money owed to it from the borrower's fixed deposit, without first going through judicial procedures.

Fees. There may be fees associated with establishing an overdraft facility, in addition to the interest to be paid on money borrowed. These fees often will be charged each

⁴ In some civil law jurisdictions (e.g., Mexico) only corporations—as opposed to individuals—may open a bank account in a foreign currency.

time a new facility is opened. Fees may include a commitment fee (charge for opening the facility) or a fee for the perfection of collateral (charge for costs of verifying the validity and adequacy of the collateral offered as security for the loan). Borrowers should ensure these amounts are clearly defined in the agreement and, if possible, that the agreement establishes a maximum amount the lender can charge. A borrower generally will be required to pay a penalty if the lender permits the borrower to withdraw more money than the maximum allowed under the facility.

Uncommitted facility. The agreement may include a provision that states that the lender can demand repayment of its money at any time. This type of overdraft facility is sometimes called an uncommitted facility and is a type of demand note. (See “Demand Loans” for a more complete discussion.) Committed facilities (i.e., facilities where the lender is not free to demand repayment at any time) are less common, but also exist. Usually, the lender can demand repayment for any reason, related or unrelated to the borrower.

Calling off the facility. The lender’s demand of repayment is commonly referred to as calling off the facility or recalling the facility. The borrower should make sure the overdraft facility agreement requires the lender to give the borrower an agreed number of days of advance notice in writing before the lender can recall the facility. Of course, the longer the advance notice, the better for the borrower. Two weeks’ or 30 days’ advance notices are typical.

The overdraft facility should include a provision that allows the borrower—not only the lender—to call off or discharge the facility, although the lender may charge a fixed processing fee for this. If the lender is holding a sum of the borrower’s money as security or credit enhancement for the facility, then the agreement also should provide for the prompt return to the borrower of that money.

Renewal. Although an overdraft facility generally is renewable after it expires, the lender reserves the right to refuse to renew the facility.

Distinguished from a revolving line of credit. A revolving line of credit is similar to an overdraft facility in that both allow the borrower to borrow up to a certain limit within a specified period, with the flexibility of borrowing and repaying as much as the borrower wishes as long as the limits of the agreement are respected. (See “Revolving Credit.”) However, an overdraft facility differs from a revolving line of credit in several ways. A revolving line of credit is a feature of a loan; it is more often used for longer-term borrowing (its duration is often several years, rather than several months); and it typically involves a firm commitment from the lender to make funds available to the borrower up to a specified limit for the duration of the loan, in contrast to an uncommitted facility.

Type of Loan

The following is a discussion of several issues a borrower will confront when negotiating a loan agreement.

LOCAL OR FOREIGN CURRENCY

The choice of whether to borrow in local or foreign currency is complex. The borrower must consider several factors, including, but not limited to, the laws of the country where the borrower is located (which may limit or prohibit hard currency borrowings, or impose other obligations or taxes that increase the costs of hard currency borrowings). As a general rule, borrowing in local currency is recommended when the borrowed funds will be used for re-lending in local currency, and when loan repayment will be funded primarily through local currency revenues. Borrowing in local currency enables the borrower to avoid the risks of currency devaluation and exchange control restrictions that may limit the availability of hard currency with which to make interest and principal payments. Conversely, borrowing in a foreign currency entails these risks, unless the risk is otherwise mitigated, and should be done only after careful consideration.⁵ Addressing these risks may require a more complex loan structure and, hence, more sophisticated debt management expertise within the borrowing MFI.

CREDIT ENHANCEMENTS

Overview. An unsecured loan generally is supported by a borrower's revenues and assets, but does not include a specific lien or other security interest in any particular assets of the borrower. Thus, the borrower's overall creditworthiness influences the lender's proposed interest rate and repayment terms. In a secured loan, conversely, the borrower grants the lender a priority claim to a particular set of assets or revenue stream as security for the loan. A borrower may reduce the level of perceived risk of default by offering some form of credit enhancement, such as pledging collateral as security. Letters of credit and third-party guarantees are other types of credit enhancements borrowers can use to reduce perceived risk of default.

⁵ For more information about mitigating foreign currency risk, please see CGAP Focus Note 31, "Foreign Exchange Rate Risk in Microfinance Institutions: What Is It and How Can It Be Managed?"

Because a secured loan or a loan benefiting from another form of credit enhancement (such as a letter of credit or third-party guarantee) is a less risky investment for the lender, the interest rate for such a loan may be lower. In determining the appropriate interest rate for a loan, the lender makes a risk assessment: the higher the perceived risk of default, the higher the interest rate.

If a borrower anticipates that it may have more than one outstanding loan at a time, then it must carefully consider how credit enhancements are addressed in one loan and the impact on its ability to enter into other types of loans in the future. In some loan agreements, a lender may restrict the borrower's ability to provide the same type or any type of credit enhancement to future creditors. Negative pledge clauses (also called restrictions on liens) are an example of this and constitute a standard feature of unsecured or partially secured loans. Because unsecured loans are based on the borrower's general revenues and assets, a negative pledge representation and similar covenant often are included in unsecured loans to prevent the borrower from pledging certain types or amounts of assets it has available. The result is to prevent the borrower from obtaining future secured loans.

Some lenders may opt to gain the benefit of a negative pledge clause through an affirmative covenant. In this scenario, the lender permits liens in favor of future lenders but requires the borrower to either (i) ensure the lender will share ratably and with equal priority in any lien posted to benefit a future creditor or (ii) provide additional, proportionate collateral to secure the lender's loan. In the latter case, the additional collateral must be made subject to a lien that is of the same kind and priority as the lien posted to benefit the future creditor.

Generally, when a borrower considers the terms of a negative pledge clause in an agreement, the borrower should make sure the terms provide for some exceptions and limitations to the negative pledge, so the borrower is not precluded from future secured borrowing. These exceptions or provisions are called carve-outs or baskets. For example, a good compromise might be to include language in a negative pledge clause that places a ceiling (or cap) on the amount of money or other property a borrower may pledge as security for future loans or that provides for a limited type of collateral for narrow purposes (such as purchase-money financing, which allows the purchase of an item on credit secured by the item itself). Such a provision gives lenders some assurances, while providing borrowers the flexibility needed for future secured borrowing. (See "Restrictions on Liens [Negative Pledge].")

Collateral security. One form of credit enhancement is a pledge of assets as security for a loan. The assets serving as security are called collateral and can be in the form of cash, specific other assets of the borrower—either tangible or intangible—or all assets

of the borrower.⁶ In the case of cash collateral, unless the borrower defaults on the loan, a lender can neither use nor dispose of the cash or other assets it holds in a fixed deposit to ensure repayment. Many loan agreements contain a provision that grants the lender an automatic right of set-off in the case of default. This means the lender will have the right to take any money owed to it from the fixed deposit if the borrower defaults on its loan, without needing to seek a judicial determination or other remedy.⁷

Although the range of assets that can serve as noncash collateral is quite broad, an MFI's loan portfolio (i.e., its pool of revolving microcredit loans entered into with its clients) often is used. However, a lender who accepts a loan portfolio as collateral likely will also want the ability to restrict the kinds of loans the MFI makes to minimize the portfolio's risk profile. This may not be appealing to an MFI concerned about preserving its autonomy. In any event, a borrowing MFI should consult with local counsel to determine whether a loan portfolio pledge is possible under local law. The laws of a particular country might not readily provide for a legal framework to use intangible short-term assets, such as a microfinance loan portfolio, as security. If an MFI were to agree to pledge its loan portfolio in a jurisdiction whose legal framework does not recognize such pledges, its inability to do so (because of the legal framework) could trigger a default on the loan.⁸

Letter of credit. An alternative to securing a loan with collateral is to use a letter of credit issued by a third party to enhance a borrower's credit. A letter of credit is a promise by the issuer of the letter of credit, typically a bank (referred to as the issuing bank), to pay a specified amount to the recipient of the letter of credit (referred to as the beneficiary) when the beneficiary presents a document to the issuing bank stating the conditions (most commonly, an event of default on a loan or other obligation) specified in the letter of credit have been met. A letter of credit is typically issued at the request of a party (referred to as the appli-

⁶ There are restrictions on the types of assets that can be subject to a security interest in some civil law jurisdictions. For example, in Brazil, only creditor rights (i.e., rights resulting from holding a beneficial interest in another party's debt obligations), equity interests (shares or *quotas* in a company's capital stock), and tangible assets can be subject to a lien. Additionally, banks in civil law jurisdictions tend to prefer using real estate and physical assets as collateral for securing loans.

⁷ The lender is not entitled to take the collateral itself in lieu of the payment in some civil law jurisdictions. Instead, the lender must sell the collateral and receive the proceeds of the sale to satisfy its claim.

⁸ In both civil and common law jurisdictions, there are three common hurdles an MFI might encounter in attempting to use its loan portfolio for credit enhancement: First, relating to enforceability, the security interest is not effective unless the MFI borrower provides notice to the counterparties of each of the loan agreements in the MFI's portfolio. Second, a loan portfolio might be too intangible, and local law would require a pledge of each current loan agreement comprising the MFI's loan portfolio, rather than a pledge of the portfolio as a whole and every future loan the MFI might make. Finally, in the (rare) case of a jurisdiction that does not allow pledges of intangible assets at all, the MFI would have to convert all of its loans to promissory notes, because promissory notes are typically regarded as tangible, negotiable instruments and not intangible contractual obligations.

cant) who, in turn, deposits cash in an account maintained at the issuing bank as collateral to secure the issuance by such bank of a letter of credit to the beneficiary.⁹

Thus, in practical terms, a letter of credit is a mechanism that substitutes the creditworthiness of the issuer of the letter of credit for that of the borrowing MFI (the applicant). If the borrowing MFI defaults on the loan, the lender (the beneficiary) will be entitled to be repaid a specified amount by the issuing bank. In short, a letter of credit ensures the lender that it will receive prompt payment of amounts owed to it under the underlying loan, even if the borrowing MFI encounters financial difficulties. The borrowing MFI, meanwhile, must reimburse the issuing bank for the amounts paid by the issuing bank and, furthermore, may be obligated to secure its reimbursement obligation to the issuing bank with collateral. Assuming, however, that the borrowing MFI does not default on the loan and repays the principal due at maturity, the letter of credit will expire without any payment being made by the issuing bank. At that point, the issuing bank will release to the MFI any cash deposited, along with any other items that may have been pledged to it.

Using a letter of credit helps the borrower avoid some of the risks related to keeping cash collateral on deposit with a local lender. In some countries, for example, if a local bank goes bankrupt, the cash deposits kept with the bank as collateral may not be guaranteed by the government, and the deposits may not be recoverable. Another possibility is that the local government may decide to freeze local bank accounts, preventing or significantly delaying depositors from recuperating their own money.

There nearly always will be a cost to using a letter of credit. The borrower typically must pay a fee charged by the issuing bank to maintain the letter of credit. Such costs may be partially offset, however, by the interest paid by the issuing bank to the borrower on any cash deposited as collateral for the letter of credit, by a lower interest rate, or by other favorable terms as a result of the credit enhancement. In addition, although the interest rate on a loan to a borrower supplying a letter of credit will be more favorable than the rate charged when no form of credit enhancement is made available, that rate may not be as favorable as the rate the local lending bank charges a borrower who keeps cash collateral directly with the local lending bank.

Guarantee. A third-party loan guarantee is another form of credit enhancement. It is an agreement among the borrower (the MFI), the local bank, and the guarantor whereby the guarantor agrees to pay the local bank money owed to it by the borrower in the event the borrower defaults on the loan. A loan guarantee may be either complete, covering the entire loan amount, or partial, covering a specified percentage of the value of the loan, just interest,

⁹ In some instances, the issuing bank will require collateral in addition to cash deposits.

or just principal amounts, or even only certain (often later) payment installments, such as the last principal payments due.

The advantages of a loan guarantee include the following:

- It offers some of the same protections that a letter of credit does; a borrower can use it to avoid the risks associated with keeping cash collateral on deposit with the local bank.
- A guarantee may provide a borrower with the advantage of capital that it otherwise would be unable to obtain. If the borrower does not have money to offer as collateral for a local loan, a guarantee from a development bank or from an organization (such as the U.S. Agency for International Development) may be an acceptable substitute.
- In cases where unsecured financing is available to an MFI, the guarantee, like other credit enhancements, should allow the MFI to borrow at a lower interest rate than that charged for an unsecured loan (although the cost of the guarantee, if any, also must be considered).

There are several disadvantages to using a guarantee as a credit enhancement:

- The guarantor may require the MFI to pay an initial and/or annual fee for the guarantee.
- The institution providing the guarantee may place certain restrictions on how the MFI may use the loan proceeds, such as prohibiting the MFI from engaging in any lending that the guarantor considers high risk.
- A guarantee may cover only a portion of the loan.
- As with a letter of credit, the borrower may be able to obtain a lower interest rate on a loan secured with cash collateral deposited directly with the lender, because the lender is able to realize this collateral with much less effort and cost.
- The MFI will be obligated to reimburse the guarantor for any amounts paid under the guarantee, for which the guarantor may require collateral as security.

SINGLE OR MULTIPLE DISBURSEMENTS

A loan may be disbursed in full on a single date or in installments, which may be disbursed according to a schedule set forth in the agreement or from time to time upon request of the borrower.

TERM VERSUS DEMAND LOAN

Term loan. A term loan is repaid on a specified payment date (also called the maturity) and thus provides the borrower with some certainty as to when repayment must occur.

However, depending on the provisions of the loan agreement, it may or may not allow for early repayment. Even when early repayment is permitted under the agreement, there may be penalties imposed for early repayment.¹⁰

Demand loan. A demand loan (also called a demand note) is a loan due at any time the lender decides to request payment, rather than on a specific date.¹¹ Overdraft facilities, for example, are typically repayable on demand. Although the overdraft facility expires on a set date, the lender may have the right to demand its money back at any time before that date for certain reasons, or sometimes for any reason. (Loans evidenced by loan agreements or promissory notes also can be payable on demand, although this is not common market practice.) The lender can demand the money back for any reason, such as the loss of confidence in the creditworthiness of the borrower or simply its own desire for more liquidity. The reason need not have any relation to the status of the borrower, though the demand note typically will set forth certain procedural requirements the lender must satisfy to demand repayment. At the very least, a demand note should contain language requiring the lender to provide the borrower advance notice by a specified number of days if repayment is demanded before the loan expires. A longer advance notice period is advantageous to the borrower, insofar as it affords the borrower more time to obtain the funds to be repaid.

When borrowing money with a demand note, the borrower must be particularly aware of the risks related to cross-default provisions in other borrowing instruments.¹² A typical cross-default clause provides that an event of default under any or certain specified loan obligations of the borrower (other than the loan obligation documented by that specific agreement) constitutes an event of default under that specific loan agreement as well. Thus, for example, if the borrower fails to repay a demand loan upon demand and if that failure falls within the definition of default under another, unrelated loan agreement, that failure would trigger the cross-default provision in the other agreement. If a borrower has multiple loans outstanding, a default under any single loan agreement could have a domino effect, requiring the borrower

¹⁰ Because a loan may serve as a vehicle for developing relationships with funding sources, an MFI borrower should negotiate a loan agreement with an eye toward transforming a lender into a long-term equity investor. Convertible debt should be considered. Rather than requiring repayment upon maturity, the lender has the option to convert all or some portion of outstanding debt into equity securities of the MFI borrower or of portfolio companies of the MFI borrower.

¹¹ Certain civil law jurisdictions require that specific payment dates (either one-time or periodic) be articulated in the loan document. This is because the elements required to form a loan are provided by law and must be included in order that a document establish a *bona fide* loan. This requirement typically does not prevent parties to a loan agreement from contracting for loan terms that mimic the effect of a demand loan structure.

¹² Sensitivity to the issues raised by cross-default clauses is important for any loan agreement that includes such provisions. (See "Events of Default.")

to repay all loans simultaneously. A borrower must consider this risk when negotiating the language of the cross-default provision in any agreement. To protect against this, a borrower should always try to limit the scope of its cross-default provisions. Because carving demand loans out from the definition of indebtedness may be difficult, cross-default provisions can be limited to loans with maturities over one year or loans over certain amounts to reduce the possibility that demand loans will fall within the scope of the cross-default. In addition, when negotiating the terms of a demand loan itself, the borrower should take precautions to limit both the circumstances in which the lender can demand repayment of the loaned amount and the circumstances constituting an event of default under the demand loan.

Revolving credit. Under a revolving line of credit (also referred to as a revolving credit agreement, a line of credit, or simply a revolver) funds that are disbursed and repaid may subsequently be reborrowed during the life of the loan agreement (as long as the amount outstanding at any one time is not greater than the total amount of the lender's commitment under the loan). Revolving credit agreements can be useful when a borrower does not need to access all the funds for the entire term of the loan. With a revolving line of credit, the borrower can accrue smaller amounts of interest by repaying amounts of the loan principal that it ceases to need during the life of the agreement.¹³

BULLET PRINCIPAL REPAYMENT VERSUS AMORTIZING LOAN

While interest payments usually are due on regularly scheduled dates set forth in the loan agreement (Interest Payment Dates), the principal of the loan is payable either in a single lump sum (known as bullet repayment) upon the final maturity of the loan or in installments (often called amortizations) according to a schedule set forth in the agreement or set out in a grid attached to the promissory note.

FIXED VERSUS FLOATING RATE LOAN

A fixed rate loan has a uniform interest rate, established at the commencement of the loan, which stays in effect throughout the life of the loan. Floating interest rates are reset at specified intervals, usually by reference to a market indicator in the domestic (or sometimes even international) borrowing market.

¹³ Often, the borrower will be responsible to pay a commitment fee on the unused portion of the line of credit. (See "Fees.")

Standard Loan Agreement Provisions

The remainder of this guidebook assumes that a borrower wishes to obtain a single-disbursement, bullet-repayment, term loan from a local bank without any form of credit enhancement. In some sections, however, additional information regarding other types of loans may be included.

Introductory Provisions

Recitals

The recitals (frequently introduced with the word “Whereas”) found at the beginning of a loan agreement describe in plain language the general business understanding between the parties to the agreement. The borrower should always confirm that these statements reflect its understanding of the background to, and operation of, the loan.

Definitions

Before reviewing the operative provisions of a loan agreement, a borrower should make sure it understands the meanings of terms used in the agreement. Definitions for these terms usually are provided in one section of the agreement called Definitions, but they are sometimes interspersed throughout the agreement. Defined terms are included in loan agreements for two reasons: (i) once a defined term has been created, the drafter can use it throughout the agreement without repeating the underlying definition; and (ii) the creation of a defined term ensures consistency in the use of the concept throughout the document (consistency that might be lost if the drafter attempted to restate the concept in full or in part at each relevant place in the text).

Defined terms contribute to the goals of drafting economy and consistency. They can, however, impede reading comprehension. No convention of contract drafting requires that a defined term be given its common sense meaning. The drafter is free to take an everyday word

and give it an idiosyncratic or counter-intuitive meaning. Thus, readers should not assume that they understand the meanings of defined terms without checking the actual definitions.

Financial Terms

Commitment to Lend

PURPOSE OF CLAUSE

The commitments clause of a loan agreement confirms the lender's agreement to lend up to a specified amount of money to the borrower on the terms, and subject to the conditions, subsequently set forth in the loan agreement. The borrower should understand that the lender's commitment to lend does not obligate the borrower to borrow the available funds (though the borrower may be required to pay a commitment fee on any undrawn balances available under the loan agreement, as described in "Fees"). The obligation to borrow typically arises when the borrower formally notifies the lender that the borrower intends to borrow pursuant to the loan agreement. This notification frequently occurs several days before the actual borrowing, so the lender will have enough time to complete all of the internal processes required for a lending.

ISSUES TO CONSIDER

Most loan agreements contain conditions to effectiveness and lending (sometimes also called conditions precedent). These are conditions that must be satisfied before the agreement creates a legally binding obligation on the lender (effectiveness) and before the lender is obligated to disburse the committed funds.¹⁴ Such conditions often include a requirement that the borrower (i) confirm that the representations and warranties contained in the agreement are correct, (ii) confirm that no default (or a circumstance that could ripen into a default) under the agreement has occurred and is continuing, (iii) provide the resolutions of its board of directors (or equivalent authority) authorizing the transaction and copies of all other corporate and governmental approvals, and (iv) provide the legal opinion of its counsel.¹⁵ Such

¹⁴ Although the most onerous conditions precedent are usually on the borrower, sometimes loan agreements will include conditions precedent that obligate the lender to comply with certain conditions or provide the borrower with certain documentation.

¹⁵ Adherence to the practice of requiring a legal opinion varies among civil law jurisdictions.

a legal opinion usually deals with each of the subjects addressed by the representations and warranties made by the borrower to the extent that they involve matters of law, as opposed to pure questions of fact. Conditions specific to a particular borrower or transaction, such as the securing of a specific license for business operations, certain equity investments being completed, or contracts executed, also may be included.

In a loan that contemplates multiple disbursements (sometimes called multiple draw-downs), these conditions must be satisfied before *each* disbursement, not just after the first disbursement. To avoid surprises (such as the lender's refusal to disburse the loan amount) at the time of disbursement, the borrower should do the following at the outset:

- Ensure that its representations and warranties as set out in the agreement (see “Representations and Warranties”) are and will be accurate, because the borrower almost certainly will be asked to reaffirm the accuracy of those representations and warranties at the time of each drawdown.
- Verify that all governmental, corporate, and third-party approvals have been obtained or are obtainable by the time the borrower wishes to receive the funds.
- Agree, before the loan agreement is signed, on the precise language of any legal opinions or certificates the borrower will be required to deliver as a condition to borrowing. Merely describing these documents as being “satisfactory in form and substance” to the lender may give the lender an opportunity to escape from its lending commitment if it subsequently loses enthusiasm for the transaction.

Disbursements

PURPOSE OF CLAUSE

The disbursement clause sets forth the manner in which loan funds will be provided to the borrower. The clause assures the borrower that if specified conditions are met, the funds committed by the lender will be credited by a specific day and time to the account specified by the borrower. This clause also specifies the period for, and number of, disbursements.

ISSUES TO CONSIDER

Knowing precisely when and where funds will be credited to the borrower's account may be very important to the borrower. If funds will be needed on a specific day to make a payment on some other obligation or, when a borrowing MFI is using the loan proceeds

to fund its microfinance loan portfolio, to be on lent, a delay in receiving the funds may place the borrower in breach of its other commitments.

DRAFTING TIPS AND VARIATIONS

When negotiating disbursement provisions, the borrower should be aware of the following issues.

Single versus multiple disbursements. A single disbursement may not be suitable (or advisable from a financial perspective) if the borrower will need the money in installments over time. Under these circumstances, forcing the borrower to borrow the full amount of the loan at the outset will increase the likelihood that the unused portion of disbursed funds will be placed on deposit at a lower interest rate than that applicable to the loan. It may therefore be in the borrower's financial interest to stagger loan disbursements to meet its anticipated need for funds, even if this entails paying a commitment fee on the unused portion of the loan, because commitment fees are typically lower than the interest rate charged on the outstanding principal amount of the loan.

Availability of funds. These clauses frequently describe the type of funds the borrower will receive at the time of disbursement. The typical options are as follows:

- immediately available funds (i.e., the borrower will have access to the money immediately upon crediting to its account)
- same-day funds (i.e., the borrower will receive the funds the day, but not the instant, they are credited to its account)
- next-day funds (i.e., the borrower can use the money only the day after it is credited to the borrower's account)

Repayment of Loan Principal

PURPOSE OF CLAUSE

The repayment provision sets forth the manner in which the borrower will be required to repay the loan principal. A term loan specifies when principal and any remaining unpaid interest are due and may define the maturity date (the date on which the principal and any remaining unpaid interest is due and the loan obligation terminates). In contrast, a demand

loan states that principal is due upon lender demand. Some agreements, such as overdraft facilities, may have a maximum duration and also be payable on demand.

ISSUES TO CONSIDER

Even in amortizing loans (loans that provide for repayment of principal in installments), borrowers often ask for a grace period on principal repayments. In this context, a grace period is a period during which the borrower will be obligated to make only interest payments on the loan, but no installments of principal will be due. Thus, a loan described as “five years, including three of grace” means that, even though interest may begin to be payable immediately, the principal will be due in installments payable only during the final two years before the loan’s maturity date.

DRAFTING TIPS AND VARIATIONS

Repayment clauses vary according to the loan structure (e.g., demand, term, amortizing). For a demand loan, the borrower should ensure the agreement includes a provision stating that the lender must give the borrower a set number of days of advance notice before payment is due. For both a demand loan and term loan, the borrower may want to include in the contract a provision that grants the borrower an opportunity to cure in the event the borrower is unable to meet the payment deadline. The opportunity to cure, or cure period, gives the borrower some extra time to make the payment without the risk of triggering default provisions of the loan agreement. The cure period is also sometimes called a grace period but differs in meaning from the grace period mentioned in the earlier discussion of amortizing loans. It is essential to remember that failure to pay either principal or interest when due (even if within the cure period) may trigger cross-default or cross-acceleration clauses of other loan agreements. (See “Events of Default.”)

Voluntary Prepayment of Loan Principal

PURPOSE OF CLAUSE

This clause, sometimes also called the early repayment clause, governs whether the borrower may prepay the loan at its own discretion. In many jurisdictions, unless the agreement explicitly allows prepayment, loans may *not* be prepaid. Sometimes the terms of the

agreement expressly prohibit prepayment. It is normally desirable for the borrower to negotiate the right to prepay a loan. It is not unusual, however, for a lender to require the borrower to pay a fee in exchange for the borrower's right to prepay.

ISSUES TO CONSIDER

Unless a borrower has negotiated the right to prepay a loan, the borrower may find itself having to pay interest on the loan even when it can repay the loan in full or refinance the loan with new, cheaper, or otherwise more borrower-friendly financing.

In negotiating the prepayment clause, borrowers should keep two objectives in mind: flexibility (i.e., the ability to prepay the loan balance, preferably without the need to first obtain the lender's permission) and predictability (i.e., in the event the borrower must pay a prepayment penalty, it should be at a fixed rate and have a clear cap to protect the borrower from unanticipated costs or fees).

Where a loan is secured, the borrower should ensure prepayment terms provide for the release of pledged assets related to any such prepayment. If the loan agreement does not address this point, then the lien on the borrower's pledged assets might not be released until the originally scheduled expiration of the loan, despite the borrower's having prepaid all or part of the loan.

DRAFTING TIPS AND VARIATIONS

Lenders invest time and incur administrative expenses in arranging their loans, and as a result, they often take the position that the borrower should pay a fee (a prepayment premium or simply penalty fee) if the borrower elects to prepay a loan before its scheduled maturity. Also, under a fixed-rate loan, the borrower may be required to compensate the lender for the lost profit resulting from a prepayment of principal if market interest rates have declined since the loan was originally extended. Even where the interest rate is reset for each interest period, a prepayment *within* an interest period may result in a loss for the lender if the interest rates have decreased. (These types of expenses or costs of the lender are often referred to as break funding costs.) For this reason, lenders tend to require prepayments to be made only on specified interest payment dates.

Prepayment fee clauses can specify the exact amount of the fee or can provide for a range of fees or a method of calculating the fee the borrower will incur upon prepayment.

For example, the fee might be a percentage of the prepaid amount of the loaned principal, or the prepayment clause could simply state that the party prepaying will have to pay all costs and expenses resulting from the prepayment. Borrowers should clearly define or cap the amount of the prepayment fee in the loan agreement to ensure the figure will be as predictable as possible. For example, a borrower-friendly clause might provide: “The Borrower shall pay a penalty fee of 1.00% of the amount prepaid to the Lender. The Borrower shall not incur any other penalty or expenses.” By contrast, a clause that states “the Borrower bears any costs and expenses incurred by the lender as a result of the prepayment” is far less attractive to the borrower, because there is no predictable maximum cost.

A prepayment clause that merely requires the borrower to provide advance notice of prepayment to the lender is more favorable to the borrower than one that requires the borrower first to obtain from the lender written permission to prepay. If the borrower need provide only advance notice of prepayment, then the lender will not be able to refuse prepayment as long as the terms of the prepayment clause are followed. By contrast, if the borrower must first obtain the lender’s written permission, the lender may withhold permission.

Fixed Interest Rate

In fixed rate loans, the rate at which interest accrues while principal is outstanding during the life of the loan is fixed when the loan is made and set out in the loan agreement. Although it is simpler to document and calculate interest payment amounts for a fixed rate loan, than for a floating rate loan, a fixed rate loan exposes the borrower to the risk that it may be locked into an above-market cost of borrowing in the event interest rates subsequently decrease. Conversely, because the lender is not protected against an increase in the rates at which it can raise and lend funds (making loans made previously at lower rates more costly), the fixed interest rate offered by lenders tends to be higher than the floating rate applicable at any given time.

Floating Interest Rate

PURPOSE OF CLAUSE

In floating rate loans, the interest rate has two components: (i) a base rate that refers to some market index, such as the prime rate or an interbank rate, and (ii) a margin or spread over the base rate that reflects the borrower’s perceived creditworthiness. Interest gener-

ally is paid for specific periods (e.g., monthly, quarterly, etc.), and loan agreements generally require the borrower to pay interest accrued during that period on the first or last day of that period.

ISSUES TO CONSIDER

The borrower needs to understand the structure of the base rate. Some rates, such as the prime rate in the United States, already incorporate an element of profit for the bank. As a result, creditworthy borrowers in the U. S. market can frequently borrow at the prime rate *minus* a margin. Other rates—the Moscow Interbank Offered Rate, for example—are so-called cost of funds rates; they represent (more or less) the cost of funds to the lender itself. In cost of funds rates, the bank's profit comes through the margin *over* the base rate. Margin size reflects the lender's perception of the borrower's creditworthiness and takes into account any credit enhancements incorporated into the loan.

DRAFTING TIPS AND VARIATIONS

A borrower can take certain measures to reduce the size of the margin or spread on its loans. All other things being equal, a loan with a shorter term (for example, two years rather than five years) should present less risk to the lender and thus attract a lower margin. Amortizing loans, particularly if they do not include grace periods, shorten the average weighted life of the loan and, based on a similar logic, reduce the risk to the lender. Secured loans or loans benefiting from credit enhancements (such as a letter of credit or a third-party guarantee) also should enjoy pricing favorable to the borrower.

Interest on Late Payments

PURPOSE OF CLAUSE

Many loans specify that the interest rate on *overdue* payments of principal or interest will be higher than the normal rate applicable to the loan. The purpose of this increase is to compensate the lender for the additional risk and administrative expense involved in a loan that is now, by definition, in default. The interest rate increase also is designed to give the borrower an added financial incentive to cure the payment default.

ISSUES TO CONSIDER

Overdue or penalty interest rate provisions can be controversial. Under the laws of some countries, the charging of interest on overdue interest or compound interest is contrary to public policy and therefore unenforceable. In addition, the size of the penalty margin is a subject of frequent negotiation. The market standard is 1 percent or 2 percent above the normally applicable interest rate (including the normal margin), but lenders sometimes ask for much more. This clause often will contain a provision that the penalty interest rate applies only to the extent permitted by applicable law.

DRAFTING TIPS AND VARIATIONS

The penalty rate of interest should accrue only on the overdue amounts. Amounts not yet due under the loan should continue to bear interest at the normal rate. Beware of loan agreements that attempt to raise the interest rate on the *entire* loan following a single missed payment, because this approach is not customary.

Fees

PURPOSE OF CLAUSE

This provision gives the lender additional compensation for arranging and maintaining the loan. Potential fees include arrangement, commitment, prepayment, and facility fees.

ISSUES TO CONSIDER

Lenders have never lacked ingenuity on the subject of fees. Fees may come in several guises:

- Arrangement fees or facility fees are flat fees (that is, they are calculated as a percentage of the bank's total loan commitment) designed to compensate the bank for the time and expense of arranging the loan. They usually are payable upfront and may be paid using a portion of the proceeds from the first drawdown under the loan, thereby effectively reducing the amount actually disbursed to the borrower's bank account from the first drawdown.

- Commitment fees compensate the bank for its agreement to stand ready to lend money to the borrower. Accordingly, commitment fees are calculated on the unused (i.e., undrawn) portion of the bank's loan commitment.

DRAFTING TIPS AND VARIATIONS

One reason banks like to receive fees is that, unlike interest payments, fees can be taken into the bank's income up-front rather than be spread out over the life of the loan. There is a relationship between the fees payable under a loan and the interest rate applicable to the loan—the higher the fees, the lower the interest rate, and vice versa. Some borrowers prefer to compensate lenders through fees to establish a lower (but more visible) interest rate on their credits, and thus use this lower rate to negotiate more beneficial terms in future borrowings. Note, however, that up-front fees paid to lenders cannot be recouped even if the loan is prepaid or accelerated shortly after it is drawn. (See “Events of Default” for more on acceleration.) The fee amount may be calculated in various ways, for example, as a percentage of unpaid loan principal or the size of the loan.

Expense Reimbursement

PURPOSE OF CLAUSE

The expense reimbursement clause sets forth the borrower's obligation to reimburse the lender for expenses incurred in connection with (i) negotiating and documenting the loan, (ii) amending the loan agreement or obtaining necessary waivers, and (iii) applying any expenses the lender subsequently incurs in enforcing its rights against the borrower (e.g., collections, litigation, or settlement negotiations).

The lender's expense reimbursement may cover travel, printing, photocopying, telecommunications, advertising, certain taxes, and legal and accounting fees.

ISSUES TO CONSIDER

The main risk to the borrower in connection to this provision is that it may incur significant costs if the Expense Reimbursement clause is not carefully drafted. The borrower should seek to place a cap on the amount of expenses it is required to reimburse. It also may consider negotiating a lump-sum payment in specified circumstances, as opposed to actual

expenses incurred. Borrowers also should attempt to include provisions that require that fees and expenses be “reasonable” and “documented” before being eligible for reimbursement.

DRAFTING TIPS AND VARIATIONS

In some jurisdictions, a party’s expenses incurred in enforcing a contract through litigation are not automatically recoverable, even if that party wins the lawsuit. This explains a lender’s desire to have the loan agreement contain a separate commitment by the borrower to pay such enforcement expenses.

Performance Commitments

Representations and Warranties

PURPOSE OF CLAUSE

Representations and warranties assure lenders that the legal, financial, and regulatory affairs of borrowers are in order before the loan is disbursed. Lenders may request whatever representations and warranties they feel are appropriate and necessary.

SAMPLE LANGUAGE

The following are examples (for illustrative purposes only) of typical representations and warranties included in a loan agreement:

- *Organization.* Borrower represents that it has been formed as a company in accordance with applicable laws, and that it has authority to own its assets, conduct its business, and enter into agreements.
- *Authorization.* Borrower represents that it, as an organization, has done everything necessary to make sure it has corporate authority to consummate the agreement and to perform its obligations thereunder.
- *Legal, Valid, and Binding.* Borrower agrees that the agreement is a legal and binding agreement, enforceable against it.
- *Government Authorizations.* Borrower states that it has done everything it must do to gain any government authorizations for the loan’s validity or enforceability.
- *No Default.* Borrower attests that there are no current defaults on any of its debts.

- *Consent.* Borrower states that it is not obligated to gain the consent of any of its creditors in order to consummate and perform its obligations under the loan and that neither the consummation nor the performance of obligations under the loan will constitute a breach of any agreement, order, law, regulation, or organizational document.
- *No Actions.* Borrower states that there are no court actions threatened or pending against it that will inhibit the loan's validity and enforceability or the borrower's ability to perform its obligations under the loan.
- *Financial Statements.* Borrower attests to the accuracy of its financial statements and that they conform to generally accepted accounting principles. Borrower also states that the financial statements have been certified by independent accountants.
- *Material Adverse Change.* Borrower states that its financial condition has not changed in any material or adverse way since some date the parties have agreed to use as a reference point.
- *Taxes.* Borrower agrees that the execution of the agreement will not be subject to any tax or other charge (e.g., transfer tax, stamp duty, registration) imposed by a governmental authority.

ISSUES TO CONSIDER

Representations and warranties are designed to assure the lender that each of the factual and legal predicates to its investment decision is correct at the time the loan agreement is signed and will be correct at the time of each disbursement under the loan. If any representation or warranty proves to be inaccurate before the loan is disbursed, the lender may withhold that disbursement. If the inaccuracy is discovered after disbursement, the bank has a basis for declaring the loan in default and demanding payment of the unpaid balance of the loan (referred to as accelerating the loan, and further discussed in "Events of Default" below).

For MFIs operating in uncertain or unclear legal environments, giving unqualified representations and warranties about their organization or government authorizations may be fraught with difficulties. In these situations, local counsel can, and likely will, play an important role in explaining to the lender and lender's counsel the legal form of the MFI and its capacity and authority to conduct microfinance, borrow, and/or lend the proceeds. If borrower's counsel cannot address this issue to the satisfaction of the lender, then it is unlikely the loan transaction will be completed. Accordingly, these issues should be addressed early on in the negotiation process, even at the term sheet stage, so as to save each party time and expense should these issues prove insurmountable.

DRAFTING TIPS AND VARIATIONS

The borrower should carefully review each representation and warranty before the loan agreement is signed.

Authorizations. If an extensive list of governmental authorizations is required to make a representation accurate, it may be more convenient for the borrower to list them in an exhibit (or schedule) to the loan agreement.

Requirements. If there are requirements that can be accomplished only *after* the loan agreement is signed (e.g., registering the agreement itself with the exchange control authorities in the borrower's jurisdiction), those requirements should be explicitly identified as not falling within the language of the relevant representation, and the borrower should add a covenant to the agreement promising to complete the post-signing requirements promptly. (See "Covenants.")

Qualifiers. The borrower should include "to the best of the borrower's knowledge" and "materiality" qualifiers where necessary, particularly as to representations regarding the absence of threatened lawsuits and other contingencies.

Liens. The negative pledge representation in an unsecured loan often requires disclosure of all existing liens to assure the unsecured lender that sufficient unencumbered assets remain to support the loan. As noted, borrowers that have previously pledged a significant amount of their assets to secured lenders may be limited in their ability to borrow on an unsecured basis. If an extensive list of existing liens is required to make a representation accurate, the borrower should list them in a schedule to the loan agreement. Because borrowers often must describe relevant liens to make this representation, the lender will automatically know that the borrower has granted other liens to other lenders. Thus, this representation is not only burdensome from a disclosure standpoint, but it also serves to reduce borrower's flexibility in negotiating the security package applicable to the particular loan agreement at hand.

Financial statements. The borrower should avoid representing that the financial statements are "accurate." Instead, a statement that the financials have been certified as "fairly presenting" the financial condition of the borrower provides flexibility.

Evergreen clauses. Sometimes loan agreements contain a provision that states that the representations and warranties made therein are "deemed repeated periodically on a continuing basis throughout the life of the agreement." These provisions are called evergreen warranties. As a general matter, evergreen warranties are objectionable. If the lender wants

an ongoing assurance about a particular matter, it should require the borrower to cover the point in a covenant (which will have the benefit, from the borrower's perspective, of a cure period before it becomes an event of default).

Covenants

PURPOSE OF CLAUSE

Covenants are promises the borrower makes to the lender about what its conduct and financial situation will continue to be after the loan is disbursed. Covenants are designed to satisfy the lender that the borrower will be able to repay the loan when due and to ensure that the lender will not be disadvantaged *vis-à-vis* the borrower's other creditors in the event the borrower runs into financial trouble. Covenants can be either affirmative (promises to do certain things) or negative (promises to refrain from taking actions the lender believes could undermine the ability of the borrower to repay the loan). Examples of affirmative covenants are promises to deliver financial statements to the lender regularly, to pay taxes, and to take the necessary steps to maintain the borrower's legal existence. Some common negative covenants are promises not to incur additional indebtedness, not to pledge the borrower's assets (a negative pledge, described above), and not to declare dividends to a corporate parent or make distributions to its equity holders.¹⁶

SAMPLE LANGUAGE

Although a lender may propose other specific covenants,¹⁷ some common provisions (for illustrative purposes only) are as follows:

- *Use of proceeds.* Borrower promises to use the loaned funds for working capital.

¹⁶ Financial covenants may include, for example, that the borrower maintain a portfolio at risk over 30 days of not more than a certain proportion of its portfolio, a certain debt-to-equity ratio, profitability (commonly stated in microfinance as operational sustainability or financial sustainability, but such terms should be defined in the agreement because methods of calculation vary). See "Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance" (CGAP, September 2003) (p. 10 defines operational self-sufficiency and financial self-sufficiency).

¹⁷ In many jurisdictions, there is growing concern that a borrower might use loaned funds for an illicit or illegal purpose. In many cases, there will be relevant legislation in place that could subject a lender to criminal sanctions or other severe adverse consequences if loaned funds are used illegally. (Use of loaned funds to finance terrorism is a particularly widespread example.) To limit its exposure to such sanctions, lenders often include covenants specifically listing illegal or illicit purposes that the borrower promises not to commit using borrowed funds.]

- *Governmental Authorization.* Borrower agrees to keep in full force any authorizations required for the continued validity and enforceability of the loan agreement.
- *Financial Statements.* Borrower promises to provide the lender with annual financial statements that are accurate and prepared in accordance with generally accepted accounting principles of a specified jurisdiction. The borrower agrees that the statements will be accompanied by a certification from an independent accountant and a statement attesting to the absence of an event of default during the term of reporting.
- *Inspection Rights.* Borrower agrees that representatives of the lender will be able to examine its property and records.
- *Notices of Default.* Borrower promises to inform the bank of any event of default or other condition that will materially affect its ability to perform its loan obligations.
- *Restrictions on Liens (Negative Pledge).* Borrower agrees to not establish any liens against its present or future property unless the borrower's obligations to the bank is also be secured by that property.
- *Restrictions on Incurrence of Indebtedness.* Borrower agrees not to incur additional indebtedness in excess of an agreed upon amount.
- *Payment of Taxes.* Borrower promises to pay any taxes assessed when due.
- *Asset Disposal.* Borrower promises not to sell, lease, or otherwise dispose of any of its revenues or assets through any type of direct or indirect transaction.
- *Limitation on Fundamental Changes.* Borrower promises not to enter into any business combination, liquidation, dissolution, or transfer of assets except in certain circumstances that the borrower and lender agree to except.
- *Pari Passu:* The note ranks at least pari passu with all other outstanding unsecured and unsubordinated obligations of the issuer, existing and future, except for those preferred by mandatory provisions of law or otherwise agreed in writing between the parties.

ISSUES TO CONSIDER

The borrower's principal objective in negotiating the covenants section of a loan agreement is to preserve flexibility. Covenants that restrict the borrower from engaging in its normal business activities (such as prohibitions on incurring liens or additional indebtedness in any circumstances) may either (i) place the borrower in default under the loan agreement or (ii) force the borrower to seek an amendment or waiver under the loan

agreement. A borrower's request for an amendment or waiver is sometimes treated by the lender as an opportunity to obtain additional compensation or reciprocal concessions from the borrower and often is not approved.¹⁸

The negative pledge covenant, under which a borrower promises not to pledge its assets against other liabilities, can be particularly onerous because it can prevent the borrower from future borrowing or, at a minimum, limit the borrower's ability to improve the financial terms of future borrowings. For example, a borrower would not be able to pledge assets at the request of a prospective lender if the borrower has agreed not to pledge those assets under the terms of a preexisting agreement. A borrower should not agree to overly restrictive negative pledge clauses. For each lending arrangement to which it is a party, the borrower must consider what flexibility it may need to engage in future borrowing.¹⁹

Borrowers should note that lenders take financial covenants, including any requirement to provide monthly financial statements and other documentation, *very seriously*. In negotiating covenants, an MFI borrower should consider carefully whether it will be able to meet the covenants established in the loan agreement. Equally important, an MFI borrower should implement an internal monitoring mechanism or procedure to ensure that the financial covenants are being met. Not only does a monitoring mechanism provide an MFI borrower with a measure of confidence in reporting to the lender, but it also serves as an early warning system to prompt the MFI borrower to approach the lender regarding any expected breach of covenant to work matters out with the lender amicably.

¹⁸ Within some civil law jurisdictions, certain kinds of covenants (e.g., negative covenants preventing corporate restructuring) require prior shareholder approval. The borrower should carefully review the scope of the covenants with the support of legal counsel to ensure proper corporate approvals are sought before executing binding loan documents. Transformations typically raise complicated legal issues that might be affected by many different aspects of the transforming entity's outstanding legal agreements, including its commercial loan agreements. While a full discussion of this topic falls beyond the scope of this Guidebook, organizations that are considering a transformation will want to consult local legal counsel about the possible ramifications that loan agreement terms may have on their transformation plans.

¹⁹ MFIs that are contemplating transforming during the life of the loan from credit-only, unregulated institutions into deposit-taking, regulated financial intermediaries also should pay close attention to covenants, such as the asset disposal and limitation on fundamental changes (or any other covenant that may be affected by a change in the legal form or transfer of a substantial amount of the MFI's loan portfolio). In some cases, the transforming MFI may be able to negotiate up-front the lender's approval to permit a reorganization or transfer of assets, provided it is to affect a transformation into a regulated, financial intermediary. However, it is more common for the transforming MFI to solicit the formal approval (consent or waiver) of the lender at the time the transformation is to take place.

DRAFTING TIPS AND VARIATIONS

Each covenant should be reviewed carefully by the borrower before the loan agreement is signed.

Inspection rights. The right of the lender's representative to inspect the property and the records of the borrower should be during normal business hours, and with advance notice, and be subject to the confidentiality provision, as described below.

Notices of default. Sometimes the borrower's failure to give the lender notice of a default will result in the borrower losing any cure period for that default. This provision may also be drafted to require that the borrower deliver, at set times, a certificate to the lender confirming that no event of default has occurred.

Negative pledges or restrictions on liens. The covenant not to create a lien on the borrower's assets in favor of another creditor, or negative pledge, can come in several forms. The most restrictive negative pledge undertaking completely prohibits the incurrance of secured indebtedness. It is possible, however, to draft more borrower-friendly negative pledge clauses. A typical clause makes exceptions for a list of permitted liens that allow the borrower to carry on its day-to-day business activities. These also may be referred to as a basket of permitted liens or carve-outs. Another way of providing both flexibility to the borrower and reassurance to the lender is to set limits on amounts that can be pledged under future loan agreements.

Asset disposal. The purpose of the asset disposal clause is to restrict the sale, lease, or disposal of the borrower's assets or business. It is also the vehicle through which the lender restricts the borrower from transferring funds up the corporate chain to its parent company or equity holders. This clause often is broken down into several provisions that address more specific limitations, such as restrictions on fundamental changes (see below), capital expenditures, investments, transactions with affiliates, sale and leaseback, and dividend payments and distributions. As with the negative pledge, the borrower should negotiate exceptions to these restrictions to retain as much flexibility as possible for conducting its normal operations.

Limitations on Fundamental Changes. This covenant forbids the borrower from combining with another entity (unless the borrower itself is the surviving entity) or from taking actions that would result in its liquidation or winding up. The lender wants to be sure that the borrower will continue to be substantially the same entity with which the lender entered into the loan agreement. Certain exceptions allow mergers of a subsidiary into the borrower.

Events of Default

PURPOSE OF CLAUSE

This provision specifies the circumstances that entitle the lender to pursue its various remedies for default, such as acceleration (where a lender demands immediate repayment of the entire principal and interest amounts outstanding), set-off (when a lender obtains the money owed to it from an alternative source, such as a cash collateral account meant to serve as security for a loan), or litigation. The events listed in this section alert the lender to a deteriorating situation and give the lender the ability to take timely remedial actions. As noted, defaults under one loan agreement also can trigger cross-default provisions that will cause defaults under other indebtedness. Although a default releases the lender from its obligations under the loan agreement and allows it to take advantage of specified remedies, the lender's objective in drafting this clause is typically to ensure its ability to bring the borrower to the negotiating table as early as possible if problems develop. Accordingly, lenders often try to define events of default as broadly as possible, while borrowers aim to minimize the list of events of default and define the events as narrowly as possible.²⁰

SAMPLE LANGUAGE

Typical events of default (for illustrative purposes only) are as follows:

- *Payment Default.* Borrower fails to pay when due any amount of principal or interest.
- *Breach of Nonpayment Covenant.* Borrower fails to perform any covenant or agreement contained in the sections of this agreement pertaining to the use of proceeds, notices of default, liens, and encumbrances or payment of taxes.
- *Breach of Representation or Warranty.* A representation by borrower proves to be untrue, incomplete, or misleading at the time made.

²⁰ Lenders and borrowers generally rely on the event of default provision to enforce the performance of obligations under a loan agreement. Indemnification and "liquidated damages" terms, however, are additional means of enforcement that an MFI might encounter. Indemnification provisions may be used to allocate responsibility for any third-party legal claims arising from performance or breach of a loan agreement. The resulting allocation of risk tends to reflect the parties' assessment of who is in the best position (because of better control or better information) to take responsibility for the conditions and circumstances to which the indemnification applies. Liquidation damages are predetermined penalties that the borrower and lender set as compensation for any future breach of loan agreement covenants, representations, warranties, and other performance obligations. Liquidated damage terms also constitute a form of risk allocation.

- *Cross-default.* Borrower defaults on the payment of or performance under debt owed to another lender such that the default results in the acceleration of the maturity of such debt obligation.
- *Dissolution or Bankruptcy.* Borrower is dissolved or becomes subject to voluntary or involuntary bankruptcy proceedings.
- *Judgment Liabilities.* Aggregate amount (excluding amounts that may be subject to appeal and amounts for which the borrower has set aside reserves) of unsatisfied judgments, decrees, or orders for the payment of money against the borrower exceeds [specified amount].
- *Governmental Authorization or Action.* Governmental authorizations necessary for the continued enforceability and validity of the loan agreement fail to remain valid or become invalid.
- *Change of Control.* Borrower ceases to exist because of a business combination or the sale of a substantial part of its business.
- *Change of Condition.* Borrower has a change in financial condition or business that the lender determines may be reasonably expected to materially and adversely affect the borrower's ability to perform its obligations.
- *Depreciation of Collateral.* Collateral the borrower has posted has depreciated below a certain predetermined threshold value (often set at the initial value of the collateral).
- *Responses to Lender Information Requests for Financial Statements.* Failure to submit any reasonably requested financial, operational, and institution information to the lender within 10 business days.

DRAFTING TIPS AND VARIATIONS

When negotiating the events of default clause, the borrower should be aware of the following issues:

- *Grace period and opportunity to cure.* Borrowers frequently ask that the loan agreement provide for a cure period or a grace period following an event that would, but for the grace period, constitute an immediate event of default. The loan agreement may specify that written notice must be given to the borrower, informing the borrower of the day the grace period began running and of its end date. The advanced notification and grace period may not be of much use if the problem is

that the borrower simply does not have the funds to meet a payment obligation. However, if the event of default is because of an error, a period to cure gives the borrower a chance to correct the error. The borrower may support this request by reminding the lender that an immediately triggered event of default in the loan agreement may entitle lenders under *other* instruments to exercise their rights under cross-default clauses, an event that a lender would not welcome. So, one could argue that extending a grace period to the borrower also benefits the lender. (See “Cross-default.”)

If a lender is prepared to consider cure periods, the cure period applicable to payment defaults (i.e., not meeting a payment obligation) is likely to be short (perhaps two to three days)—just enough time to allow the borrower to correct any mix-up in the payment process. Often, lenders accept cure periods for interest payments, but not principal payments. Defaults other than payment defaults (covenant defaults), on the other hand, are typically given cure periods of 15 to 30 days. The borrower also may ask for the cure period for a covenant default to start only *after* the lender has notified the borrower of the default, which provides the borrower with even more time to cure.

- *Cross-default and cross-acceleration.* If a borrower is in default under one loan agreement, cross-default provisions in other agreements may be triggered. A cross-default clause puts a borrower in default under the terms of one agreement if the borrower defaults on another obligation. This can have a dangerous domino effect, and can result in a borrower’s having to pay back several loans all at once. The reason for these provisions is that if a lender has reason to believe that a borrower may not have sufficient funds to pay back all of its creditors, that lender wants to ensure it is able to get in line at the same time as other creditors, to maximize the chance that its loan is repaid before the borrower runs out of money. A widely used (and more borrower-friendly) approach is to draft the clause as a cross-acceleration rather than a cross-default. Under a cross-acceleration clause, another creditor must actually accelerate its loan before an event of default is triggered under this agreement.
- *De minimis exceptions to cross-defaults.* Borrowers often seek to include in the cross-default clause a *de minimis* provision, specifying that failure to pay or other defaults that permit or cause acceleration of relatively small amounts under the other loan agreements will not trigger a default under the clause. Alternatively,

the borrower may wish to negotiate a threshold amount that would trigger a cross-default.

- *Demand loans and cross-defaults.* As mentioned in the discussion of demand loans, one of the risks of demand loans is that the lender can demand repayment of its money at any time. Thus, the borrower always must be prepared to pay back the sum on short notice. If the lender demands repayment and the borrower cannot make the repayment on time, then not only will the borrower be in default, but its failure to pay may also trigger the cross-default clauses of other loan agreements, which could result in the borrower having to repay multiple loans simultaneously. Demand loans can be particularly dangerous because the timing of the repayment obligations can be unpredictable.

To prevent a simultaneous multiple loan repayment scenario, the borrower must be careful with the wording of the default and cross-default clauses of each of its loan agreements. In any loan agreement, a borrower should pay particularly close attention to both the definition of “default” and the terms of the cross-default or cross-acceleration clause. In most situations, a cross-acceleration clause is more borrower friendly than a cross-default clause. Also helpful is a *de minimis* provision. Even better would be to define “payment default” in such a way as to not apply to amounts demanded back by the lender under a demand loan, though such a definition may be difficult to negotiate.

- *Definition of indebtedness.* The reach of the cross-default provision depends, in large part, on the definition of “indebtedness.” A narrower definition makes it less likely that any adverse developments regarding the borrower’s other obligations will constitute a cross-default under this loan. For example, a narrower definition of “indebtedness” might be limited to indebtedness for borrowed money, whereas a more expansive definition might also include a borrower’s accounts payable. In such a case, a borrower’s failure to make a payment when due to a provider of goods or services might constitute a cross-default under the more expansive definition of “indebtedness,” but not necessarily under the more limited definition.
- *Material adverse change clauses.* Lenders sometimes seek broad protection through the inclusion of a material adverse change (MAC) event of default. Such a clause might provide that an event of default will arise if any MAC shall occur in the condition (financial

or otherwise) of the borrower that gives the lender grounds to believe that the borrower may not, or will be unable to, perform or observe its obligations under the agreement.²¹

Borrowers may resist the inclusion of MAC clauses on the ground that the enumerated events of default should sufficiently protect the lender from circumstances that increase the risk of nonrepayment, and that the subjective nature of the MAC clause in effect turns the loan into a demand note despite the fact that the borrower is paying the fees and pricing for a term loan agreement. If a lender insists on a MAC clause, the borrower may seek to limit the scope of the clause by incorporating standards for determining materiality that are relevant to its particular business circumstances and requiring that the lender make the determination in its reasonable (rather than sole) discretion.

- *Depreciation of collateral.* When a loan is secured with collateral, the loan agreement may require that the collateral be reappraised periodically to ensure it maintains a particular minimum value. If the collateral depreciates below a certain minimum value, it may constitute an event of default or the borrower may be required to provide the lender with additional collateral or assurances. In the microfinance context, agreements governing loans secured by the borrowing MFI's loan portfolio occasionally define as an event of default the increase of the borrowing MFI's portfolio-at-risk ratio above an established threshold value (for example, if the amount of loans overdue more than 30 days were to increase to more than 20% of the overall loan portfolio) such that the loan portfolio and prospects for repayment would appear to be deteriorating significantly. As a general rule, this clause should be drafted with a notice provision that gives the borrower a grace period in which to restore the collateral's value before default is triggered. Borrowers may prefer an infrequent reappraisal period, so as not to be unduly burdened with frequent recalculations.

Remedies

PURPOSE OF CLAUSE

The remedies section sets out the lender's remedies following a default. The most important remedy is the right to accelerate the loan or demand repayment of the entire outstand-

²¹ In civil law jurisdictions, where courts typically employ a high standard for materiality, lenders are less likely to seek MAC clauses. The high standard limits the range of circumstances in which a MAC can constitute an event of default.

ing amount due immediately rather than on the scheduled maturity date. By accelerating payment of the loan when a borrower defaults on a loan, the lender hopes to get its principal (and accrued interest) back immediately. This also positions the lender to pursue other remedies, such as set-off and litigation, for the full amount due under the loan (in contrast to a remedy for only the amount of a missed payment, for example).

Potential Risks. Contrary to the blustery language contained in most loan agreements, lenders do not relish the prospect of having to sue their borrowers in the event of default. Litigation is a last resort: it is expensive, messy, and unpredictable (particularly in countries with unpredictable judicial machinery), and it involves a reputational issue for the lender, because other borrowers may be less likely to borrow from that lender if it is perceived to be quick to declare a default and/or litigate. Lenders usually want the ability to force the borrower to negotiate appropriate measures to protect the lender's interests and to ensure the lender will not be disadvantaged *vis-à-vis* the borrower's other creditors.

The lender is normally free to choose its remedies. For example, it may elect to exercise its right of set-off to recover an overdue payment but not its right to accelerate the maturity of other amounts due.

DRAFTING TIPS AND VARIATIONS

The remedies clause of a standard loan agreement may appear alarming to the borrower, and it is intended to leave that impression. In practice, however, most lenders are cautious in exercising the remedies afforded to them by the loan agreement. Courts in some jurisdictions have held lenders liable for damages to the borrower if the lender was determined to have acted precipitously or in bad faith in pursuing its legal remedies. If a default does occur under a loan agreement, the best advice for the borrower is to talk to the lender (and its other lenders), and to keep talking, until the matter is resolved.

Enforcement

PURPOSE OF CLAUSE

The enforcement provisions of a loan agreement govern how disputes regarding the loan agreement will be handled. Some of the most important enforcement provisions are those that pertain to governing law, submission to jurisdiction, and waiver of right to trial by jury.

DRAFTING TIPS AND VARIATIONS

When drafting the enforcement provision, the borrower should consider the following issues:

- *Submission to jurisdiction or arbitration.* Where there is uncertainty about the independence or honesty of the local judiciary, or there is reason to believe that litigation of disputes might be unnecessarily expensive, a contractual provision for resolution of disputes by arbitration may be an attractive alternative.
- *Waiver of right to trial by jury.* It is common for lenders to seek to require that borrowers and guarantors waive any right they might otherwise have to jury trials. Historically, juries have shown more sympathy to down-on-their-luck debtors than to prosperous bankers.²²

Confidentiality

PURPOSE OF CLAUSE

A confidentiality provision prevents any sensitive information the borrower provides to the lender from being disclosed to other parties. A borrower can suffer serious damage if commercially sensitive information is leaked. The confidentiality clause of the loan agreement is intended to reduce the risk of inadvertent disclosure of sensitive information.

DRAFTING TIPS AND VARIATIONS

The borrower should ensure the confidentiality provision specifies in detail: (i) the information that must be kept confidential, (ii) the parties that may access such information and the circumstances under which they may access it, (iii) the obligation the lender has to monitor the handling of the information and to notify the borrower of potential disclosures in appropriate circumstances, (iv) the circumstances under which previously confidential information is no longer deemed confidential, and (v) the borrower's right to participate in any proceedings that affect the confidentiality

²² Bench trials (i.e., by judge only) are the standard means of adjudicating contractual disputes in civil law jurisdictions. A waiver of trial by jury is, therefore, unnecessary in most civil law jurisdictions.

of such information. The borrower also may wish to include a clause that provides that, in the event of breach of the confidentiality provisions, money damages may be insufficient and that the borrower is entitled to seek other remedies available under local contract laws.

Entire Agreement

PURPOSE OF CLAUSE

Also known as a merger clause, this provision states that the terms appearing in the agreement represent the entire understanding of the lender and borrower and supersede any earlier agreement or understanding. By including a merger clause, the borrower and lender agree that any term sheet, previous or subsequent document, email, or conversation that may exist or occur separate from the loan agreement is not part of the agreement and cannot be enforced against either party unless the substance of those additional communications specifically appears in the agreement.

DRAFTING TIPS AND VARIATIONS

In the agreement, the borrower and lender should require that any change in the terms of the loan agreement be made in writing as an amendment and that both parties must consent to any such amendment as evidenced by their respective signatures. This ensures that any understanding reached subsequent to the signing of the loan agreement becomes properly integrated and enforceable.

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