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Common clauses and stipulations in loan agreements

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The aim of this article is to explain some common clauses and stipulations in loan agreements underlying financial transactions. Without prejudice to common characteristics of the clauses as described below, the parties should check the wording of each particular clause before concluding a contract. In addition, the clauses may lead to different legal consequences under each underlying jurisdiction.

The cross-collateral clause. Under a cross-collateral clause, the lender is entitled to seize any or all collaterals provided for different loans with the same lender even if only one loan goes into default. This has a powerful effect because the lender holds the collateral until the borrower pays off all of his loans and other debts with that lender. This clause is usually a part of the security agreement rather than the loan agreement. If the borrower accepts the provision of the cross-collateral clause, the borrower should restrict its effect only to previous and existing debts. As the maximum amount of the principal must be precisely stipulated in a lien agreement under the Slovak law, in our opinion, a lien may not serve as a cross-collateral for future loans in the amount exceeding the stipulated maximum amount. Provisions under which the collateral should secure even "any other future amounts owed" are questionable and should be avoided.

The cross-default clause is one of the most common clauses to be found in loan contracts. It is generally applied when the lender provides multiple loans to the borrower or its subsidiaries. The clause entitles the lender to accelerate all loans, even if the borrower defaults only on one of the loans. The defaulting borrower may thus cause a domino effect in respect of all his loans. The clause protects the interests of the lender, enabling the lender to take action before the borrower defaults on other debt obligations. The clause is suitable in cases involving the project financing where the borrower usually enters into a set of financing and security contracts. Depending on the wording of the clause, the cross default may also apply to the loans obtained by affiliated companies. It is necessary to note that the clause does not activate automatically. Because of the expenses connected with the collection on the debt, the lender is likely to cooperate with the borrower and look for some mutually beneficial solution. If the borrower is in a position to negotiate the wording of the clause, the borrower should focus on the limitation of the lender´s acceleration right only to substantial and clearly defined default cases. In insignificant default cases, the borrower should at least be granted a reasonable period of grace.

The negative pledge clause prohibits the borrower from creating any security interest over specified borrower´s assets. The clause, however, does not stop a third party from creating a security interest. It just imposes a negative obligation on the borrower. Therefore, the primary remedy for breach of the clause is damages, even though such a claim is rare and of little practical benefit to the lender. In unsecured transactions, the clause protects the lender from favoring subsequent creditors by creating a priority right of those creditors to the borrower´s assets. In secured transactions, this clause often creates an event of default if the borrower uses the same assets as collateral to other creditors´ benefit. However, under the Slovak law a property that is a subject of a first-order lien may be sold by the creditor without approval of other creditors holding subordinated liens.

The parri passu clause is a well-known instrument, used especially in cross-border transactions. Under this clause, the borrower undertakes to ensure that the loan obligations will always rank equally with all of the borrower´s other unsecured obligations. This should secure the equal ranking of debts, especially when a law of another jurisdiction would otherwise prefer the repayment of other debts without the lender´s consent and thus lead involuntarily to a subordination of the loan debt. However, an automatic subordination is inadmissible under the Slovak law and all creditors must be treated equally unless the particular creditor consents to debt subordination. There is an ongoing debate about different interpretations of this standard clause. In any case, we advise careful preparation and review of the wording in such a clause. All vague and ambiguous stipulations should be avoided and the terms used (including the term rank) should be clearly defined.

The change of control clauses are used to satisfy the lender that the borrower's company remains in the hands of a parent company with good rating. A typical clause reads that in the case of the acquisition of over 50% of the share capital of the borrower's company by a third party, a change of control is deemed to have occurred. The change of control usually creates an event of default, unless the lender consented to the change of control in advance. It is not uncommon that the lenders are not willing to accept any change of the lender´s shareholders structure. An event of default may in such cases be invoked by any shareholder leaving the lender`s company. If the acquiring third party is a good rating company (and if the clause's wording makes it possible) the lender should not unreasonably withhold consent to the change of control. We advise that inter-company exceptions are listed in advance. It is necessary to note that all potential acquirers need to carefully review change of control clauses as part of any due diligence on a company that is to be acquired.

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