

PROBLEMS IN COMMERCIAL LENDING DOCUMENTS

We suggest you look closely at the commercial lending documents banks use.

Those documents are prepared by the bank, for the bank, and naturally favour the bank. They aim to protect the bank in all situations one might encounter in that type of lending.

When reading the documents, know that the bank is entitled to strictly enforce the documents according to their terms and is not required to take a commercial approach in exercising its rights (though the law is evolving on that). If you feel your goodwill with the bank may reduce if you ask for changes, weigh up the risks of keeping silent.

Types of documents

A bank will have its own set of standard documents. These would include:

Letter of Offer: An offer of finance that you may accept, to form a contract between you and the bank. It is a binding document (once accepted), but the format is less intimidating to some borrowers than a full Loan Agreement.

Loan Agreement/Facility Agreement: A contract between you and the bank for the finance facilities.

Standard Terms Booklet: A Letter of Offer or Loan Agreement may be kept short by setting out only the variables and key terms of the deal, and then going on to bring into the contract a separate booklet of "standard terms".

Mortgage Debenture: A security a company grants over the whole of its assets (present and future). On an event of default, the bank may appoint a receiver and/or an administrator over the company. In addition, the bank has the usual powers of a security holder to take possession of and sell the assets concerned, and set off the sale proceeds against the debt yet to be repaid.

Bill of Sale: A security any person may grant over specific assets (like plant), now usually only granted by individuals.

Pledge: A security over goods.

Mortgage/Charge: You can grant a mortgage (or charge) over most kinds of assets; land, shares,

debts, ships, aircraft, motor vehicles, insurance policies, patents and trade marks are examples.

Guarantee: A contract for a guarantor to become liable to the bank on account of your liability to the bank. You remain primarily responsible to the bank for the finance, but the bank can now have recourse to the guarantor as well. A guarantor may be asked to support its guarantee by also granting the bank a security over the guarantor's assets. And see our paper, [Tailor Your Guarantee](#).

Priority Deed: A contract between your secured creditors as to how their securities will rank between themselves.

Subordination Agreement: A contract between the bank and another creditor of yours so that the creditor's debt ranks after the bank's debt and cannot be paid off until after the bank is paid in full.

Tripartite Deed: A contract between you, the bank and a builder such that the bank can take over the building works being funded by the bank, if you default under the building contract. This kind of document can be adapted for your other important contracts, such as a valuable patent licence.

Other documents: You may see an account operating authority (to empower named people to operate your account with the bank), payment direction (how you want the funds disbursed), authority to complete (enabling the bank to date and fill in blanks in other documents), minutes of meeting of directors of the borrower (to assure the bank that those directors approved the transaction).

You may find in them problems like these.

The parameters of the finance facility

- in reality two or more of you are borrowing, but not all are named
- you borrow as a trustee, but are not stated to be so
- you borrow as a trustee, but are personally liable if the trust assets are insufficient to repay the funds

- the bank's offer is only "indicative", not a binding commitment
- facility limits (maximums) are too low when bank letters of credit or bank guarantees are deducted at face value from amounts that you can borrow
- facility limits on an overdraft are high, but with low limits on cash advances or bill acceptance and discount facilities (which are cheaper to use)
- the interest rate used already includes a good margin over the bank's cost of funds, even before the bank adds a more obvious margin to that
- interest at higher (default) rates accrues immediately on a late repayment, with no days of grace
- borrowings must be in tranches that are too high (for example, in multiples of \$10,000 each) so you cannot borrow only a little at a time
- borrowings of advances or against bills of exchange do not offer a full range of interest periods from which you can choose (30/60/90/120/180 days) to take advantage of different interest rates in the money market
- you can only use the funds for inflexible, limited purposes
- the documents do not promise you the availability of derivatives (interest rate swaps and the like) that you want
- the facility is repayable on demand by the bank (an overdraft customarily is)
- the scheduled termination date is too soon (allowing the bank to ask for a fresh approval fee when the facility must be renewed)
- the scheduled termination date is so soon you may not have time to get value for the approval or establishment fee, or stamp duty, you paid
- the bank can review the facility (reduce the finance limit, increase the interest margin, increase fees and vary other terms and conditions) even if your creditworthiness does not change
- the bank can review the facility at any time and frequency the bank chooses

Repayments

- scheduled repayments of principal are not realistic against your expected free cash flow, particularly in a seasonal business
- the bank can vary the instalments or times for payments of interest or principal
- repayments of principal must be in tranches that are too high (for example, in multiples of \$10,000 each) so you cannot repay only a little at a time
- you may not repay the facility early, or must give advance notice of an intention to repay early, or must pay a penalty (called *break costs*) to repay early
- you cannot redraw monies repaid early
- the bank may apply your repayments against principal, interest or costs or between different facilities as the bank chooses, despite your reason for paying
- you may not set off or counterclaim from a scheduled repayment a debt the bank owes you, nor may you make a repayment under protest
- you must top up (called *gross up*) any deduction or withholding for taxes you make to comply with the law (such as interest withholding tax from repayments to a non-resident bank)
- the bank has too much latitude in fixing the Australian dollar equivalent of foreign currency payments and receipts (and may make a margin call against currency fluctuations at the bank's choosing)
- the bank may credit your repayment to a suspense account and not credit your account, as and for so long as the bank chooses

Fees

- an approval or establishment fee is not refundable to any extent if the bank reduces or terminates the facility early after a review of your creditworthiness

- a line fee or other fee is scaled against the facility limit/amount owing/amount not borrowed as at set dates (say at the end of each calendar quarter), with no adjustment for daily changes that occur between the set dates
- a line fee or other fee paid in advance is not refundable to any extent if the facility terminates early

Costs and expenses

- your liability for the bank's documentation legal costs is unlimited
- the bank may debit your account with costs, without prior notice or substantiation
- external costs to the bank are debited against you in full, with no reduction for GST input tax credits claimable by the bank from those costs
- the bank is not obliged to lawfully minimize the costs it incurs and can recover from you
- you must pay an hourly remuneration to the bank, if the bank takes operational control of your assets after an event of default
- if a change in law reduces the bank's yield on your facilities, the bank can recover from you the shortfall and the bank is not obliged to attempt to minimize the reduction, or allow you to terminate the facility without incurring a penalty

Warranties

- you warrant that all information (oral or written) you give to the bank before or during the facility is and will remain complete, true, reasonable and not misleading even if the information was given casually or has no real bearing on your creditworthiness
- you warrant that your annual financial statements are more than compliant with applicable law and accounting standards (which for companies only require annual financial statements give a "true and fair view")
- the bank excludes liability for any representation or promise made by the bank to you during negotiations but not expressly stated in the documents

Security

- the bank may call on you for additional security even if your creditworthiness does not change
- the bank may call on you for top up security if its own informal estimate of the value of the security falls below the bank's original estimate of its value
- the bank is not obliged to release any security (or even reduce the interest rate) if the value of the security comes to exceed the original loan to security ratio
- you are not entitled to replace securities with new securities or cash deposits of at least equal value
- you are not entitled to replace guarantors with new guarantors of at least equal available assets
- you are a company and must cause a new subsidiary (even a partly-owned one) or a new shareholder to become a guarantor
- the bank is free to agree with another secured creditor to vary the priority of their securities without your consent
- the bank can call for revaluations of the security (at your cost) as it chooses
- the bank can use any valuation methodology it chooses
- you are not entitled to see a valuation you pay for

Negative pledge

- you must not borrow from another financier in any circumstances
- you must not grant any security to a third party, with no exception for charges (such as for land tax) that arise by operation of law
- the limits on your financial transactions (trading in capital assets, making loans, paying dividends) are unrealistic

Financial ratios

- you must satisfy specified financial ratios at all times during the year, not only at the end of each calendar quarter or end of the financial year
- financial ratios employ terminology different to the accounting standards
- financial ratios do not allow for seasonal changes in your business

Information to be provided

- you must give the bank monthly or other periodic financial reports that serve no real purpose
- in reality your financial reports cannot be prepared in the time allowed for
- your annual financial statements must be audited though you are not required by law to have an auditor
- you must notify the bank of any adverse change in your financial condition (whatever that means)
- you must give the bank copies of all your government filings or communications to shareholders, when that serves no real purpose
- your employee or officer must periodically certify to the bank your full compliance with the documents (so the bank can sue that individual personally for misleading or deceptive conduct if need be)

General covenants

- you must insure against risks or for amounts that are not available in the market at reasonable cost
- you must give the bank any information the bank may ask for (completely open-ended)
- you must comply with covenants that are so vague you don't know what they mean (such as to conduct your business "in a proper and efficient manner" or, in case of a farm, "in accordance with best husbandry practices in the locality")
- you must comply with covenants that have no real bearing on your creditworthiness (such as to comply with *all* laws applicable to you, not pass *any* special resolution of

the company, nor in *any* way amend your company constitution or your trust deed)

Events of Default

- an event of default includes contingent events that may never eventuate (things that "with the giving of notice and/or by lapse of time and/or fulfilment of any other condition would constitute an [actual] event of default")
- an event of default may have no real bearing on your creditworthiness, such as:
 - a late repayment is immediately an event of default, with no days of grace
 - any* breach by you of the bank documents
 - any* warranty you gave is or becomes in any respect untrue or misleading
 - a borrower or guarantor company has a change in control or change in directors
- the bank may act on a subjective opinion that you have suffered an adverse change in your financial condition

Other problems

- the documents do not expressly make applicable the (otherwise voluntary) *Code of Banking Practice* (created for the benefit of consumers and for small business, and, if applicable, imposes minimum standards of good behaviour on the bank)
- a bank officer's certificate as to the total debt or any other matter is *conclusive* against you
- the bank is not obliged to diligently process your building work progress payments in time to comply with the building contract
- you are a trustee and may not distribute income to beneficiaries, resulting in the trust paying punitive rates of income tax
- the bank may set off (or combine) two or more of your accounts, without prior notice
- the bank in ascertaining the debt owing and the interest payable will not net off a credit balance in another account of yours

- you appoint the bank as your attorney with broad powers, effective immediately and not only on an event of default
- the bank may assign (sell) your debt to another person, without your consent
- an assignment by the bank of your debt is free of any equities (counterclaims) you may have against the bank (so you have to pay the assignee in full, despite having a claim against the original bank)
- you “consent” to being marketed to by the bank’s financial products subsidiaries
- the bank may rely on an oral communication from you, without confirming it in writing
- the bank may serve notice on you at an old address
- the bank may serve notice on only one of two or more borrowers
- the bank’s facsimile or email notice is “served” on you on the day it is sent (at any time of day) and even if you never acknowledged receipt.

All documents

Some problems may appear in more than one document and those documents may express the same problem in different words. However, if the Letter of Offer/Loan Agreement expressly overrides any contrary rule in the other transaction documents (it usually does), ask for it to expressly remedy the problems you have identified.

This paper looks only at contract issues. Statutes such as the *Privacy Act* and the *Trade Practices Act* are relevant to knowing the parties’ full rights and duties.

A joint publication of Adam Gamble (partner) (mobile 0439 384 298; agamble@crawfordlegal.com.au) and Mark Sallis (barrister) (mobile 0438 834 430; msallis@senet.com.au).