

LOAN AGREEMENT DRAFTING NOTES

THE "LOAN" AND "PURPOSE" CLAUSES

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INTRODUCTION

A loan agreement is an agreement whereby a lender, in many cases a bank, agrees to provide a loan to a borrower. Lenders extends to the borrower an amount of money, while the borrower commits to repay the borrowed monies at the specified time or times and pay the interest accrued over the principal amount.

Loan agreements can be documented in relatively simple documents that provide only the essential terms, such as the borrowed amount, the maturity and the interest rate. However, most loan agreements are more elaborate and complex documents whose terms depend on, among other things, the purpose of the loan, the amounts borrowed, the creditworthiness of the borrower, and the existence or not of collateral.

Several international models of loan agreements may serve as the basis for drafting loan agreements. The Loan Market Association ("LMA") model is designed to provide standardised documentation for various types of loan transactions. Widely adopted in the European syndicated loan market, it serves as a common framework for financial transactions across multiple jurisdictions. Another relevant international model is the Loan Syndications and Trading Association ("LSTA") model, which is extensively employed in the United States. Specifically designed for syndicated loan transactions, it is recognised as a key standard in the U.S. loan market.¹

¹ See *The ACT Borrower's Guide to the LMA's Investment Grade Agreements* (KATHRINE MELONI, Slaughter and May, 6th edition) and *The LSTA Complete Credit Agreement Guide* (BELLUCCI AND MCCLUSKEY, Milbank, 2nd edition, McGraw-Hill, 2017).

In this paper we review the "loan and purpose of the loan" clause of a typical international commercial loan agreement.

This is the first of a series of articles reviewing the key terms of international loan agreements. Subsequent papers will cover:

- utilisation of the loan and conditions precedent;
- interest, interest rates and market disruption;
- representations and warranties;
- positive and negative covenants;
- financial covenants;
- events of default and acceleration;
- assignment and transfer;
- remedies and waivers; and
- governing law and dispute resolution.

1. THE "LOAN" CLAUSE

There are three basic types of loan agreements depending on how the loan is advanced to the borrower:

- (a) term loans, where the lender advances the loan in its entirety upon satisfaction of the conditions precedent;
- (b) loan facilities, where the lender agrees to provide a maximum amount of credit to the borrower (the facility), which the borrower can draw as needed; and
- (c) revolving loan facilities, where the borrower can draw funds up to the facility limit, repay the utilised amounts, and draw again as needed.

Loans can have a repayment schedule of more than five years (long-term loans), a term between one and five years (medium-term loans) or a term of less than one year (short term loans).

Bridge loans are a typical form of short-term loans, which serve to "bridge" the gap between the purchase of the asset and the obtention of funds from another source, such as the sale of another asset, an equity investor or a longer term financing. Bridge loans are often used in real estate transactions or acquisition finance to provide quick access to capital while longer-term finance is being negotiated. Bridge facilities may include a "term-out" option, under which, if the borrower does not draw the facility by an agreed date, the loan will be automatically converted into a longer-term loan, typically at a higher margin, giving the lender an increased return commensurate with risk of extending the term, while the borrower obtains the certainty that funding will be available.²

Loans and loan facilities may be secured or unsecured, depending on the presence or absence of collateral arrangements.

Loans can be bilateral or syndicated. A bilateral loan is made by a single lender to the borrower. A syndicated loan is made by several lenders acting together under the same loan agreement, with an agent, who may be one of the lenders or a third party, administering the loan on behalf of the syndicate. Syndication allows lenders to share the credit risk and provide larger loan amounts than a single lender would wish to commit. The LMA and LSTA models are primarily designed for syndicated transactions but can be easily adapted to bilateral loans by deleting the provisions that do not fit and changing those that assume multiple lenders. However, in some cases, it may be advisable to keep the syndicated loan wordings because the single lender may wish to syndicate the loan at some point in the future. Agency provisions *per se* and other provisions typical of syndicated loans do not affect bilateral loans, they simply do not apply but make the document more complex.

Lenders may extend committed or uncommitted facilities. Under committed facilities, lenders are bound to advance funds up to the agreed limit with the borrower paying a commitment fee on the undrawn portion of the facility. Under uncommitted facilities, lenders are not obligated to extend the loan and may refuse drawdown requests or cancel the facility; costs for borrowers are lower and are not subject to the same capital requirements for banks. Committed facilities are typical in project and

² Bridge financings commonly include a "term-out" option allowing the borrower to convert the bridge into a longer-dated loan if the expected take-out (equity issuance, bond offering or asset sale) does not materialise. See JAMES GREENE AND ANNA SOROKA, [*Bridge Financings in European Acquisition Finance*](#) (client briefing), (Clifford Chance, 2022).

acquisition finance, while uncommitted lines are more suited for working-capital and overdraft arrangements.³

SUGGESTED CLAUSE

Loan

The Lender agrees to advance to the Borrower, subject to the terms and conditions of this Agreement, a [term loan / loan facility / revolving loan facility] in the aggregate principal amount of [Loan Amount], to be advanced [in a single drawing on the Utilisation Date / in one or more drawings during the Availability Period]. [FOR REVOLVING FACILITIES: The Borrower may draw, repay and redraw amounts under the facility, provided that the aggregate principal amount outstanding at any time shall not exceed the Facility Amount.]

2. THE "PURPOSE" CLAUSE

In general, the loan agreement will indicate the purpose of the loan, that is, where the borrower will apply the amounts borrowed. This is because the lender has agreed to provide money for a specific purpose, and if the borrower uses it for anything different, the loan's risk profile may increase.

The purpose of the loan will determine the type of financing, the structure and mechanics of the loan and collateral provided by the borrower which can broadly be characterised as follows:

- (a) **corporate finance**, which includes loans advanced to corporations to finance their regular operations or to refinance existing debt;

³ On the distinction between committed and uncommitted facilities, see PHILIP WOOD, *Law and Practice of International Finance* (Sweet & Maxwell, 2008).

- (b) **asset-based finance**, where the borrower gives assets as collateral, such as property, account receivables, inventory, or equipment;
- (c) **project finance**, which includes loans advanced to finance specific projects, such as infrastructures and other government-backed projects under public/private partnership schemes ("PPP"), design, build, finance and operate ("DBFO"), etc. These schemes are used for the construction of roads, hospitals, power plants, etc. Private projects may also resort to project finance structures which aim to limit the liability of the project sponsor to the project's assets owned by the project company (a special purpose vehicle incorporated to develop the project). Privately led projects include oil and gas, wind and solar farms, mining, real estate development, etc.;⁴ and
- (d) **leveraged buy-outs ("LBO") and acquisition finance**, where a company uses debt to purchase another company and the financing is secured with, among other things, a pledge of the acquired company's shares. The acquiring company takes on significant debt to finance the transaction secured by the acquired asset, hence the use of the term "leveraged".

In more recent times, we have seen a rise in green loans where proceeds must be applied to eligible environmental projects directly affecting the purpose clause. Some corporate loans may also be linked to sustainability criteria, where the margin is adjusted up or down against agreed sustainability performance targets, following recognised standards like the Green Climate Fund ("GCF") guidelines and International Capital Market Association's ("ICMA") Green Bond Principles ("GBP").

Stating the purpose of the loan may be necessary for the lender to control how the loan will be spent and ensure it will not be used for reckless or unlawful reasons. The goal is also related to the internal credit assessments and approvals to be obtained by the lenders.

In this regard, the purpose of the loan is relevant in assessing the risk of the transaction. The lender needs to know whether the borrower intends to use the borrowed amounts for, for example,

⁴ See G. VINTER, G. PRICE & D. LEE, *Project Finance: A Legal Guide* (Sweet & Maxwell, 4th ed., 2013).

acquiring equipment or shares in a company, refinancing an existing debt, or simply for treasury support, as each of these purposes may entail a different risk.

For these reasons, the borrower must ensure that the purpose stated in the agreement corresponds exactly to the intended purpose. Therefore, if the borrower wishes to use the loan for general purposes, such as working capital, in addition to the specific needs that lead it to seek the financing, it must ensure that this is stated in the agreement, so that the use of funds is not called into question in the future.

The use of funds for a purpose other than the agreed one will constitute a breach of contract, which may, depending on the loan terms, constitute an event of default entitling the lender to cancel undrawn facilities, accelerate the loan and enforce the security given by the borrower under the security documents.

Although the purpose of the loan or facility is not generally a legal requirement, the purpose of the borrowed amounts may not be irrelevant to the lender's decision to enter into the contract, as the risk assumed depends on how the loan will be used.

The purpose clause serves also to monitor compliance with local and international anti-money laundering ("AML"), anti-corruption and sanctions regimes, as banks are required to carry out diligent investigations on the borrower's conduct, activity and operations under the EU AML directives, international standards and local banking laws.⁵

It is equally important to note that, although the borrower undertakes to apply the loan for the stated purpose, the lender is generally not obliged to monitor how the funds are used by the borrower. This position, reflected in the suggested clause at the end of this article, reduces the lender's operational obligations and its exposure to claims that it had an obligation to scrutinise the borrower's application of the proceeds. The compliance risk lays mostly with the borrower.

⁵ Following the invasion of Ukraine in February 2022, lenders have expanded sanctions-related representations, covenants and events of default in loan documentation. See AIRLIE GOODMAN, CRAIG HOLBURD and RUTH MALONE, *The Ukraine Crisis: Contractual Consequences under English Law for Facility Agreements and Financial Contracts*, (Mayer Brown, 2023).

3. CONCLUSION

The loan clause, which specifies the amount of the loan, together with the obligation to repay it, constitute the essence of the loan agreement. In turn, the purpose clause puts limits on what the borrower can do with the borrowed amounts. Other clauses in typical commercial loan agreements (i.e. the conditions precedent, the representations and warranties, the covenants, the events of default) are directly or indirectly linked to the type of loan and the purpose clause, insofar as they reflect the borrower's and the transaction's risk profile and can justify the various constraints imposed on the borrower.

In the last decade, the importance of the purpose clause, historically seen as less important, has increased significantly. Sanctions, anti-money laundering and anti-corruption regimes and green and sustainability-linked financing are changing lenders and legal advisors approach to the purpose clause.

SUGGESTED CLAUSE

Purpose

The Borrower agrees that it will use all amounts advanced to it strictly for the purposes set out in this clause and that it will not use the whole or any part of any advances made to it in contravention of any applicable law.

The Borrower shall not, directly or indirectly, apply any proceeds of the Loan, nor lend, contribute or otherwise make them available to any subsidiary, affiliate or other person, (i) for the benefit of any person who is the target of economic or financial sanctions imposed by the United Nations, the European Union, the United Kingdom or the United States, or any other sanctions regime applicable to the Borrower or the Lender, or (ii) in any manner that would result in a breach by the Borrower or the Lender of applicable anti-money laundering, anti-corruption or sanctions laws.

Without prejudice to the obligations of the Borrower to apply the Loan for the purpose specified in this clause, the Lender shall not be under any obligation to concern itself with the application of the Loan.

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