
Feeling the squeeze: How borrowers in the care sector will be affected by the climate in the lending market and what can be done about this

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Abstract

Penned by a legal advisor to both borrowers and banks, this paper is written from the perspective of an adviser to care sector borrowers. It gives an insight into issues that are likely to touch and concern a care sector borrower entering into funding arrangements. Such borrowers frequently enter into funding arrangements to finance growth, for example by way of acquisitions and development. Comment is offered on lenders' perceptions of the care sector and its borrowers, the impact that the credit squeeze is expected to have on arrangements between lenders and care sector borrowers and what can be done to protect these borrowers' businesses from any adverse terms being passed on to them by a bank itself feeling the negative impact of the credit squeeze. Presented with a flavour of reform favourable to borrowers but within the reality of the lending market, 'hotspots' for borrowers to address are identified. These hotspots include, for example, restrictions and prohibitions that are frequently included in banking documentation as well as security arrangements that form 'part of the package'. The hotspots are examined and their potential impact on borrowers explained. Suggestions are made for dealing with the hotspots in a sensible way in order to protect the borrowers' present and future position.

Keywords

lending, borrowing, loans, bank, repayment, terms, security

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THE PRESENT IRONY

It is ironic that funding within the care sector — which is itself dedicated to providing care to those who are needy — is likely to be affected by the vagaries of the money markets. The irony lies in the commitment of the care sector to helping vulnerable people while the sector in its finance arrangements is vulnerable to decisions made at high levels in money markets, without any reference to the needs of the people the care sector helps.

‘Lenders’ darling’

This irony is stretched further: although founded on the needs of vulnerable people, the care sector is a successful and attractive proposition for those in the commercial business of lending — like a ‘lenders’ darling’. This is because there is an established and growing need for care services and care service providers often have property as well as cash flow within the business. For a lender, established growth combined with two ‘bankable’ features — property and cash flow — make the sector attractive. In the most basic terms, lenders expect demand for care services to continue to increase; they consider that the business including its property can secure lenders’ funds (so that, if worst came to worst, lenders could resort to selling the property to procure repayment of loans), while the borrower’s cash flow can cover the cost of funds. Property as security is inherently appealing to lenders while the cash flow is considered reliable not least because of the underlying growth in the care sector. Lending into this sector is therefore widely regarded as ‘good business’ and the popularity of the care sector among lenders continues to grow.

HOW MIGHT THE MONEY MARKETS AFFECT THE CARE SECTOR?

How is it that, despite the popularity of the care sector as a general lending proposition, the money markets might negatively affect lending (and therefore potentially growth and expansion too) in the care sector? Recent events in the money markets are influencing the attitude of lenders across the board. In the simplest of terms, it is thought inevitable that lenders will respond to the pressures in the money markets by exerting their own credit pressures on borrowers — ie a ‘squeeze’. It is expected that lenders will be more ‘credit conscious’ and conservative in lending arrangements to protect themselves from risk. The *Financial Times* reported that ‘A large majority of lenders also expected to tighten price and non-price terms on loans to the corporate sector’.¹ This means that, along with other corporates, those in the care sector will ‘feel the squeeze’ in borrowing arrangements.

How will the squeeze be felt?

It is widely anticipated that, as the *Financial Times* reported, this will be felt via the imposition by lenders of ‘tighter price and non-price terms on loans’.

Lenders’ response to the ‘squeeze’

Harsh lending arrangements

A 'double whammy'?

The terms and conditions imposed by some lenders when entering into arrangements with care sector borrowers are relatively harsh and can have long-term adverse implications for the borrower. It has been suggested previously that the culture of the care sector — being a commitment to the needs of individuals — is at odds with the attitude and experience needed 'to drive a commercial bargain' so far as borrowing goes. This may well be the case as the care sector seems to have a natural modesty in presenting itself as a commercial opportunity for lenders. This modesty may be followed through into a tendency by some care service providers to accept terms from lenders at face value. A 'blanket' approach to acceptance is not necessary and can put the care sector borrower in a difficult position later on (eg via acceptance of restrictions such as those referred to below).

Adverse money market influence

If the lending market changes as predicted and 'tighter' terms are accepted by care sector borrowers without question, the care sector effectively could be dealt a 'double whammy' on its borrowing terms: the first whammy being accepting terms of borrowing with insufficient negotiation (as a result of a natural modesty) and the second whammy being the imposition of even harsher terms as the money market influence exerts itself.

The care sector, of all sectors, has a moral entitlement to protection against uncompromising borrowing terms, fortunately there is much that can be done to facilitate this. Below are a number of pointers to set care sector borrowers in the right direction. It all comes down to the small print — the small print of the lending documents the borrowing business enters into because this is where price and non-price terms are set out.

WHAT CAN A CARE SECTOR BORROWER DO TO PROTECT ITS BUSINESS IN A SQUEEZE?

- Look at the small print.
- Find the terms that could adversely affect the borrower's business.
- Negotiate these terms into wording that is acceptable.

Security often required from borrowers

There will be a lot of small print because the lender will want to 'secure' its lend to the business. To secure a lend, typically a debenture over the company's assets, and/or a legal charge over property (whether owned by a director, say, or the business), and/or a personal guarantee (which itself may be secured against the director's personal property) and sometimes other documents such as assignments will be required. (These documents together are referred to as the 'security documentation' and for the present purposes the most commonly used securities are referenced.)

Borrowers can be surprised by the amount of paperwork involved. From the lender's point of view, it is their money being used and, once spent, how is it to get its money back if the borrower does not repay it? This is of course a fair question,

answered by the security documentation put in place to help the lender to do this.

The lender has various rights, through the security documentation, for example:

What this security gives the lenders

- to sell a property and use the proceeds of the sale to repay itself;
- perhaps to take over the running of a home and use generated income to repay itself;
- to have access to funds on account (for example, by having a deed of charge over the funds) which can be used to repay the loan.

There are many different routes that can be taken to secure a lend. Invariably, where there is property this will be the lender's first port of call and this will be reflected in the security documentation. All such security options need to be documented and it is the security as well as the loan itself that creates the paperwork — and all that small print to be digested.

WHAT TYPES OF TERMS SHOULD A BORROWER BE ON THE LOOKOUT FOR IN THE SMALL PRINT?

'Hotspots' or potential traps

A lender should look at the usual 'hotspots' in the documents. These are the terms that frequently cause borrowers concern. Please see a number of examples below (under 'Restrictions on early repayment' and 'Prohibitions'). These are a sample only of the hotspots to be addressed. All of these hotspots can be significantly 'softened' by negotiation so that they become quite acceptable for the borrower and their 'stings' removed.

CAN BORROWERS REALLY NEGOTIATE?

Banks want to lend to the care sector so borrowers can request 'tailoring', ie better terms

Yes. Lenders are used to negotiating changes to their documents in order to complete a lending transaction. There are a number of different techniques and approaches that can be taken. The results will be more or less the same — a 'tailored' set of paperwork that is palatable to both lender and borrower. This process of negotiation will be increasingly important in the current market conditions and take place against what could be a hardening backdrop as lenders feel the pressure of the money markets.

WHAT SHOULD A BORROWER NEGOTIATE?

It may well be the case that it will be increasingly important to deal with certain aspects of documentation so that it is not harshly interpreted later on — especially if economic conditions become more challenging. Examples of such provisions are those which have the effect of restricting growth and/or expansion (please see the 'Restrictions on early repayment' and 'Prohibitions' sections below), and/or, in the case of a breach scenario, preclude the opportunity of remedying any problems which might otherwise result in a breach of any other of the borrower's funding

arrangements (the consequences of which are indicated below). This paper will now look at a few specific ‘hotspots’ in more detail.

‘Hotspots’ in long term lends

Restrictions on early repayment

At the time of entering into arrangements, a borrower may feel that a prospect of early repayment is so remote that it need not concern itself with these provisions. This is an understandable approach for a short-term lend of one or two years; however, where the term of the loan is up to 20 years, as is frequently the case in care sector lends, the possibility of early repayment should be allowed for the borrower. Some of the reasons why a borrower might want early repayment include:

- some time down the road, another lender offers sufficiently competitive rates that the borrower wishes to enter into arrangements with the new lender;
- borrowers perceive that they are ‘not being looked after’ by their current bank;
- a borrower may wish to expand by way of acquisition and is either not getting the support from its current bank that it would like, or wishes to change existing funding arrangements as part and parcel of new funding arrangements.

Restrictions that might be seen in relation to early repayment and prior to negotiation include the following.

- The imposition of a long notice period for repayment.
- Restriction as to when such notice of repayment can be given so that notice can be given only on certain days. This means that, if a borrower only has defined ‘windows’ for giving notice of repayment and it misses a window, it can take months for the next ‘window’ to come around, during which time the business could be tied into arrangements which do not suit it for financial as well as practicable reasons.
- An additional payment being required by the borrower to the lender in the event of early repayment. This is sometimes required by reference to timescales, for example, the earlier the repayment in the term of the loan, the more expensive an exercise this is for the borrower.

Loans with options

Particular care is urged where a borrower enters into a loan which has different ‘options’ built in, such as fixed or floating rate options; a borrower may be able to change its option as the loan progresses over its term. Usually, a fixed rate loan will attract ‘break costs’ if repaid early. These ‘break costs’ are frequently in addition to other restrictions and costs referred to above and tend to be referable to transactions the bank has entered into to secure the borrower’s fixed rate option. These costs can be expensive and justifiably passed on under the terms of the documents — proceed with care.

Improvements could include: tailored repayment provisions that are workable for the borrower and clarity on break costs.

Prohibitions applicable to all lendings

Prohibitions

All lending arrangements will contain restrictions on what the borrower can and cannot do during the term of the lend. This is because the lender seeks to minimise its risk of losing its money by making sure that the borrower will not do anything that might adversely impact its reliability as a borrower. Things that a lender will be concerned about include the risk that a borrower over-stretches itself, for example, by entering into additional funding arrangements with other lenders; or changes tack and concentrates on less-profitable business activities; or disposes of a part of its business or an asset or assets upon which the lender will rely should it need to call in its security in the event of a non-repayment of the loan. In principle this is all fair enough; however, in practice, it is often the case that the translation of the lender's concerns into the small print results in tightly worded and absolute prohibitions on the borrower.

The types of prohibitions regularly seen prior to negotiation include prohibitions against the following.

Entering into any other funding arrangements

This often goes hand in hand with a flat prohibition against the giving of security, guarantees etc (the latter is called a *negative pledge* — a pledge to keep assets 'clear' of security). The borrower is therefore prevented from entering into any other funding arrangements with any other lender as not only can it not enter into funding arrangements, it cannot offer any security either, even if the security is surplus to its current lender's requirements.

Selling or disposing in any way of any assets

This prohibition can be worded so that no asset disposal is allowed even if the asset is not relevant to the bank for its security purposes. If a borrower wished to sell an asset or part of its business, it could be prevented from doing this.

Changing of business or control

In addition to the general meaning of a prohibition of this nature, this could mean that, were a borrower approached by an investor, it would not be allowed to proceed with the proposal. As can be seen, prohibitions such as these can put the borrower between a rock and a hard place — if it 'keeps to the letter' in the documents, it cannot fulfil its own business wishes. If breached (with the consequences of a breach as referenced earlier), such restrictions usually trigger an event of default which results in default rates being charged and quite possibly the loan being called in as well.

Additionally, in certain cases, such defaults can trigger a default of the borrower spilling over into other arrangements that the

One type of isolated default can lead to a default with other entities too

borrower might have with separate entities (this can happen by the implementation of a 'cross default' clause which allows default in one finance document to cross over into another (sometimes unrelated) finance document, thereby putting that document into default also). As markets squeeze, the risk of a lender calling a cross default increases.

Improvements could include: allowance of arrangements with other funders and removal of the negative pledge or its impact being confined to certain assets; restrictions on asset disposal sensibly only affecting certain assets and/or being restricted by reference to loan to security cover lending ratios and/or being subject to provisions such as the lender not being adversely affected; allowance to change control etc, for example, on notice and provided that the lender is not adversely affected.

Security being allowed to stay in place beyond required duration

Disproportionate security to the borrower's advantage

Strategically, this is one of the most important features in financing arrangements because of the potential impact this could have on a business. If a business has given a lender 'blanket security' over a long lending term, the time may well come when, for example, the lender has the benefit of the original security over a reducing loan; or there is 'headroom' in the lender's security because the asset securing the lender's loan has gone up in value so significantly. The lender may also still be secured by personal guarantees. If at this stage the borrower wishes to enter into new funding arrangements and wishes to use security, which has become redundant to the existing lender's needs, the release of such security can be most problematical unless there is provision in the lending documents dealing with this scenario.

Improvements could include: 'release mechanisms' being pre-agreed so that certain security features such as personal guarantees will be released on the meeting of stated conditions; security requirements generally being subject to a loan to value requirement which cuts both ways and allows security to be released.

Unworkable financial covenants

Financial covenants are relatively easy for a bank to assess. If they are breached, this can be a straightforward matter because the breach is defined by a mathematical calculation. Breach of a covenant is a clear default. The wording of covenants should be carefully considered.

Improvements could include: inclusions and exclusions looked at closely and negotiated as appropriate, which can significantly impact the calculation in favour of the borrower.

Hidden default costs include compound interest

Strict interpretation of terms, which are unforgiving to the borrower

Throughout the loan and security documentation, unless negotiated, the lender will generally have the right to call defaults absolutely. This means that, in the event of default, the lender may be able to call a default without allowing the borrower to remedy. Certain default scenarios will trigger compound interest obligations on the borrower. Compound interest is a hefty price to pay at any time and should be carefully considered before being agreed.

Improvements could include: remedy periods and mechanisms agreed so that the borrower is not immediately plunged into a default scenario. Additionally, where possible, the lender should be obliged to act reasonably and give notices.

Unqualified rights of the lender

Throughout the loan and security documentation, the lender will also have the right to give or not give its approval, consent and consideration. This means that, unless its actions are qualified, the lender may delay or prevent the borrower from doing something that is important to the borrower by not giving necessary approval or consent or exercising its consideration reasonably etc.

Improvements could include: qualifying the rights of the lender so that its actions and decisions have a degree of objectivity.

Better all round

HOW ARE BETTER TERMS SUCCESSFULLY NEGOTIATED?

A reasonable approach, which recognises the lender's needs, is likely to get a better result for both the borrower and the lender. This is not something to be worried about as seasoned lenders in the care sector have knowledge and are flexible in their approach — a number of lenders have large and committed teams servicing the care sector. These teams understand the needs of the care sector's characteristics and such experts will not only negotiate positively but also take an innovative approach as the care sector itself responds creatively to its financing needs.

Timing is key

WHEN IS THE BEST TIME FOR THE BORROWER TO RAISE ANY ISSUES WITH PROPOSED LENDING TERMS?

As early as possible and before the borrower has committed to the deal, ie signed the papers. The borrower's negotiating position is strongest after the lend is 'credit approved' (ie once the bank's internal credit checks have approved the lend) and before signing. In return for its lending, the bank makes money on the fees as well as interest rates and 'add ons' (such as hedging supporting a fixed rate lend). Basically, the bank will want to do the deal for all its own commercial reasons — this 'want' translates into flexibility of terms and the cost of borrowing.

Is it ever 'too late'?

IS THERE ANYTHING THAT CAN BE DONE TO PROTECT THE BORROWER IF DOCUMENTS ARE ALREADY SIGNED UP?

Yes. A lending arrangement is a contractual arrangement. Like all contracts, if both parties agree, these can be changed — either substantively or in a minor way — for specific things to be allowed. To be successful in changing committed terms, a borrower needs to understand what rights it has under the documents and how it is performing in relation to the documents. This is because the negotiating strength of a borrower in this situation will be affected by the lender's perception of it. A lender will try hard to keep a borrower happy if it values that business and knows the borrower could take its business elsewhere. This is where the care sector comes into its own. As a 'lender's darling' a care sector borrower has the advantage of a positive attitude from the lenders. This attitude, together with good performance under existing terms, can be translated via negotiation into happier arrangements all round.

CONCLUSION

The borrowing market generally could be facing a challenging period. The care sector will not be exempt from these challenges. By looking closely at the terms being agreed, and negotiating improvements where appropriate, a care sector borrower will be able to protect itself against harsh provisions having an adverse impact on its business. The favourable perception of lenders to the care sector will help the negotiation process and attention to the small print will help borrowers weather the expected squeeze.

Reference

1. Giles, C. (2007) 'Bank fears squeeze on companies', *Financial Times*, 27th September, p.1.