THE ABCS OF LOANS AND LOAN AGREEMENTS

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ABSTRACT

This article revolves around the fundamentals of loans and loan agreements, offering a comprehensive understanding from all directions, with a particular focus on important clauses of the agreement. The articles begin by outlining the definition of a loan and its types; followed by the meaning of the creation of charge and the difference between often confusing terms and concepts. The core of the discussion revolves around the essentials of the loan agreement and ends with the discussion around promissory notes.

Keywords: Loan, Agreement, Charge.

INTRODUCTION

In the modern financial landscape, there are a plethora of loans in the market to cater to the needs of every type. Unlike in old times, loans are not just for emergencies they now act as catalysts in the process of growth. Loans play a crucial role in the growth of the economy, from industrial to personal; loans enable everyone to achieve their financial goals. Being a crucial ingredient in the recipe of finance it is important to understand the basics of loans, loan agreements, and legal aspects of it.

Loan: As per the Cambridge Dictionary, a loan is "an amount of money that is borrowed, often from a bank, and has to be paid back, usually together with an extra amount of money that you have to pay as a charge for borrowing." A loan has some indispensable components to it like the term of the loan, principal amount, interest rate, and the time of repayment. The principal amount is the amount borrowed which is to be repaid within the fixed term either short or long; along with the increased amount depending on the interest rate after a regular interval of time called the time of repayment.[1]

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[1] Julia Kagan, What Is a Loan, How Does It Work, Types, and Tips on Getting One *(Investopedia, July 31, 2023)* <https://www.investopedia.com/terms/l/loan.asp> accessed 25th January, 2024

A loan is of many types but based on collateral can be divided into Secured Loan and Unsecured Loan.

Unsecured Loan: As the name suggests any loan that is not backed by the collateral is called an unsecured loan. The amount of unsecured loans is less as compared to the amount of secured loans due to the involvement of substantial risk. Interest rates are quite high in comparison.[2]

Secured Loan: Any loan which is secured by the collateral is called a secured loan. It is called secured because whenever the borrower defaults on the payment; the lender can sell the collateral to secure his amount. It is the most common type of loan as the lender has surety of the repayment. Loan agreements are unavoidable in secured loans to drop future uncertainties and ease for both parties.[3]

HYPOTHECATION, PLEDGE, AND MORTGAGE

Whenever an asset is used as collateral against a loan it is called 'creation of charge'. The charge can be created in various forms in which hypothecation, pledges, and mortgage are most common and often used interchangeably. However, there is a huge difference between them.

Hypothecation: Under Section 2 (n)[4] of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFESI) Act, Hypothecation is defined as "a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance, and includes floating charge and crystallization into fixed charge on movable property"

Pledge: Under Section 172[5] of the Indian Contract Act, a Pledge is defined as "The bailment of goods as a security for the payment of a debt or performance of a promise".

Mortgage: Under Section 58[6] of the Transfer of Property Act 1882, a Mortgage is defined as "the transfer of an interest in specific immovable property for the purpose of securing payment of money advanced by way of loan".

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[2] *Ibid*
[3] *Ibid*
[4] SARFAESI Act 2002, sec 2(n)
[5] Indian Contract Act 1872, sec 172
[6] Transfer of property act 1882, sec 58

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The following are the major differences among them:

One of the major differences among them is that of the type of property on which it is created. Hypothecation and Pledge are always created against the movable property. However, a Mortgage can be created against an immovable property only.

Another difference is in the possession of property that in the case of the Pledge rests with the lender and in the case of Mortgage and Hypothecation rests with the borrower itself.

What is a loan agreement?

The loan agreement is a contract for lending money from a lender to the borrower with a guarantee to pay back the amount. Also outlines responsibilities, interest rates, an event of default, details of the collateral (if any), and other necessary information.

Loan agreements can be prepared by any party but generally, it is prepared by the lender to ensure the repayment of the loan amount.[7]

Syndicate Loan Agreement: Numerous times the borrower is a huge corporation, institution, or government that needs a loan for its enormous project the amount of which is so high that even the banks are not able to sanction it. For the economic development and the good of banks and financial and non-financial institutions also, these kinds of projects are important. To deal with this kind of situation syndicate loans are issued by the group of lenders. In simple words, syndicate loans are a type of financing in which a group of lenders comes together to sanction a loan to the borrower. It is needed in projects that involve massive amounts of capital. The group of lenders who come together is called a syndicate.[8]

The main purpose of this loan is to distribute the burden of risk among lenders, as the loan amount is so high that even if the lender can issue it alone, it is not the right choice to do so.

Syndicate loan generally involves three parties that are borrower, the arranger, and the lenders. An arranger, as the name suggests, is the person who arranges the loan amount for the borrower.

[7] "Loan Agreements: Everything You Need to Know" <https://www.legalnature.com/guides/everything-you-need-to-know-about-loan-agreements> accessed 25 January, 2024
[8] Troy Segal, "Syndicated Loan: What It Is, How It Works, and Examples" <https://www.investopedia.com/terms/s/syndicatedloan.asp> accessed 26 January, 2024

He is not necessarily part of the group of lenders and is sometimes called the lead banker for sanctioning the comparatively bigger amount.[9]

The syndicated loans can be divided into the following three types:

Underwritten Deal: In this type, the underwriter or the lead banker sanctioned the whole amount of the loan. However, a guarantee from lenders is attached to it that if in the future the underwriter does not provide the entire amount, they will ensure the same.[10]

Best Efforts Syndication Deal: It is just the opposite of the underwritten deal as the underwriter does not take responsibility for the whole amount but for the unsubscribed amount only.[11]

Club Deal: The loan amount for this is generally small with a higher cap of $150 million. Lenders usually have an equal amount of share in this.[12]

SOME OF THE IMPORTANT CLAUSES OF A LOAN AGREEMENT

Every agreement has some important clauses; the following are the most important clauses necessary in every loan agreement:

Effective Date and Term Clause: It usually seems obvious, but it is an important clause to draft at the very beginning. The effective date is the date on which the contract becomes effective for both parties; however, the date of execution can be different. The term is the period till which the contract lasts but usually, the term continues till all the installments have been paid along with the interest.

Facility Clause: It is one of the essential clauses of the agreement. It specifies the amount borrowed and the purpose of the loan along with the conditions precedent and conditions subsequent.

Interest Rate Clause: It is a crucial clause in any loan agreement as it sets out the rate of interest on the loan amount which can either be fixed or floating.

[9] *Ibid*
[10] *Ibid*
[11] *Ibid*
[12] *Ibid*

Fixed-rate loan agreements are those in which the borrower must pay a fixed interest amount irrespective of the economic situation. However, in floating-rate loan agreements the interest rate changes as per the margins added to the benchmark rate.

Apart from the interest rate, it is also essential to add an interest rate for the situation in which the borrower delays the installment or payment; called Default Interest Rate.

Prepayment Clause: It is an important clause as it makes the agreement flexible and allows the borrower to repay the amount early. The borrower can repay the loan early for a variety of reasons including availability of better credit. The prepayment clause has charges attached to it which can be altered in the future by the lender; the provision for the same is also added to it.

Repayment Clause: It is a very essential, yet simple clause that includes the when and how the loan is to be repaid. The loan can be either repaid after a fixed term or lump sum. One must carefully look at his ability to repay before choosing any mode of repayment.

Clause for Collateral: Every secured loan must have this clause as it consists of all the information about the collateral that acts as security against the money borrowed and specifies the rights of the lender and the responsibilities of the borrower. The right of 'set-off' clause is also added in it which allows the lender to borrower's asset at the time of default.

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Events of Default Clause: This clause involves the definition of default which differs according to the type of loan and position of the parties. Some commonly added events are the death of the borrower, insolvency, bankruptcy, or winding up of the borrower. It also consists of the consequences of the default.

Governing Law Clause: This clause is a must for any agreement as it specifies which law is to be followed if legal action is raised against any of the parties by the other party.

Dispute Resolution Clause: It is an important clause to be added to the loan agreement as it specifies whether parties go to the court for the dispute resolution or solve it through mediation, arbitration, or conciliation. This clause is a must to resolve the conflict amicably in the future.

Miscellaneous Clause: This clause is also important. It is always added at the end of the agreement as it carries various sub-clauses in it like notification and amendment clauses.

HOW THE PROMISSORY NOTES ARE DIFFERENT FROM THE LOAN AGREEMENTS?

Where a loan agreement is a full-fledged document or a contract. Promissory notes are just a negotiable instrument. Promissory notes are an instrument that has an unconditional promise to repay a certain amount of money on demand at a fixed future date. Promissory notes are comparatively simple and easy to understand due to the involvement of a lesser sum of money. Promissory notes are also legally enforceable as loan agreements but are less formal and involve a smaller number of clauses.[13]

Promissory notes are generally used by corporations and individuals for lending money from anyone but financial institutions due to lesser and simpler compliances. For example, issuing funds by a parent company to its subsidiaries during tough times or an individual helping a friend in recovering a loss.[14]

CONCLUSION

From the above discussion, the intricacies of the loan were tried to be explained. Loan in simple terms understands as a borrowed amount of money. The loan can be secured or unsecured, single or syndicated. For a better understanding of loan agreements, it is essential to understand the basics of a loan first and the terms associated with it. In the modern financial landscape understanding loans is essential for everyone irrespective of their background.

Agreement is common in day-to-day life but when the agreement is enforced by the law it is called contract. Hence A loan agreement is a contract that outlines the amount borrowed, roles, responsibilities, terms, interest rate, and whatnot.

Loan agreements facilitate the growth of the national economy by allowing businesses, individuals, companies, and governments to invest in expansion, innovation, and the creation of jobs. Loan agreements are not only for huge identities but also for small businesses, students, and home and bike owners.

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[13] "Loan agreements and promissory notes" <https://www.rocketlawyer.com/gb/en/business/raise-capital-for-your-business/legal-guide/loan-agreements-and-promissory-notes#:~:text=Rocket%20Lawyer's%20Loan%20agreement%20should,as%20family%20members%20or%20friends).> accessed 26 January, 2024

[14] *Ibid*

Loan agreements are unavoidable for any vigilant lender to eliminate the risk factors. By outlining a carefully drafted clause, both the lender and the borrower can alleviate potential risk and ensure a safe and secure lending arrangement. It is also necessary to avoid legal complications that generally arise in the absence of a watertight yet flexible agreement.