Provisions in loan and security agreement

Finance

Q. What do you believe are the three most important provisions in a lone and security agreement Be specific. Explain why you believe these are the most important provisions.

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Introduction

Every single loan is given specific restrictive conditions that are unique for each loan situation. These specifications or conditions are formulated by the lender to safeguard the loan. A single restrictive provision alone is not capable of providing the necessary protection for every loan. Collectively, however, these provisions act to ensure the firm's overall liquidity and ability to repay a loan.

Provisions in Loan and Security Agreement

The three most important provisions in a loan and security agreement are:

Working Capital Requirement: The most extensive and generally used requisite in every loan contract is the working capital. The provision is vital as its principle is to maintain the company's present standing and ensure its capacity to repay the loan (Van Horne, Wachowicz & Bhaduri, 2005).

Cash Dividend and Repurchase of Common Stock: The cash dividend and repurchase of common stock restriction is another major provision in this category. The provision is significant as its objective is to limit cash going outside the business, thus preserving the liquidity of the company.

Routine Provisions: This type of restrictions consists of the regular and mostly rigid terms seen in almost every loan contract.

Usually, the borrower is required by the loan contract to maintain satisfactory insurance and to provide financial statements to the bank [ref.]. Also, the borrower is usually required not to put up a major percentage of its

assets for sale. The borrower is also required to pay all due taxes and other liabilities, excluding those the borrower disputes in good faith. Additionally, the borrower is not allowed to mortgage or pledge any of its assets. This restriction is known as a negative pledge clause and is usually included in most loan agreements (Van Horne, Wachowicz & Bhaduri, 2005).

Usually, the borrower is prohibited from selling or even marking down its receivables. Also, the company is required not to enter into any rental contract of property, except up to a certain amount of yearly rental fee. The principle behind this condition is to prevent the borrower from facing a considerable rent burden that might jeopardize the borrower's capacity to pay the loan (Van Horne, Wachowicz & Bhaduri, 2005).

A restrictive provision in loan agreements also ensures that the company purchases, instead of leases a property and thus avoid the restrictions on debt and capital costs. Generally, contingent liabilities have certain limits. Additionally, there is normally a provision against acquisition of other businesses. This provision normally takes the form of a prohibition on acquisitions, unless specifically approved by the lender. This type of restrictive conditions in almost all loan agreements appears to be a form of standard. They provide an extensive and firm loan agreement and ensure the absence of ambiguities.