Debt financing

Legal information for community organisations

This fact sheet covers:

- what is debt financing?
- secured vs unsecured debt
- key terms in debt financing
- representations, warranties and undertakings
- events of default, and
- legal duties of committee members and directors.

Understanding debt financing can help your organisation to identify and assess potential investment opportunities and greatly enhance an organisation’s financial position and long term sustainability.

Debt financing concepts and structures that are common place in the for-profit sector are also generally applicable to not-for-profit organisations.

The purpose of this guide is to provide an overview of the key concepts in debt financing and to explain some of the terminology that is used in debt financing arrangements.

1. What is debt financing?

In its simplest form, debt financing is where a person or organisation (the borrower) borrows money from another (the lender). The lender and borrower make an agreement (a lending contract) for the borrower to repay the money at a later date and pay interest on the amount borrowed.

Debt financing arrangements range from straightforward loans through to sophisticated arrangements with complex terms and conditions. Basic debt financing broadly consists of:

1. Loans from banks, financial institutions (eg. credit union) or one of the new lending sources in the market like debt funds and peer-to-peer lenders.
Debt financing (CTH)

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EXAMPLES

Debt funds
An example of a debt fund is Social Ventures Australia’s Social Impact Fund. The fund lends money to both for-profit and not-for-profit social enterprises. It can provide a loan (or equity investment) from $150,000 to $1 million with loan terms from one to five years. For example, it lent $163,000 to Ability Enterprises Ltd (a charity) in October 2012, to enable new employment opportunities for people with disabilities and mental health issues. Further information is available at www.socialventures.com/investment/impact-funds.

PEER to PEER lenders
Peer to peer lending (called P2P lending) is an alternative to lending from a bank or financial institution. There are a number of online platforms that facilitate such lending (ie. www.moneyplace.com.au). In very simple terms, P2P platforms provide a place where borrowers seeking funds can link up with investors (lenders). P2P lenders generally offer lower interest rates than banks or financial institutions. Similar to other online marketplace platforms like Airbnb or Uber (which take a percentage fee for each transaction), P2P lending platforms make money by charging a commission fee for each transaction. This fee is usually factored into the interest rate paid by borrowers.

2. Debt instruments (also known as debt securities), such debentures, bonds or notes issued by investors, including financial institutions and specialist bond traders.

EXAMPLE

An example of a bond that is relevant to the not-for-profit sector is the social impact bond. The first of such bonds in Australia, the “Newpin Social Benefit Bond”, was launched in 2013 by Social Ventures Australia in collaboration with the New South Wales government. Under the bond (of $7 million), private investors provide the funds and in return, receive a share in the savings made by the NSW government through service deliver efficiencies made through restoring children in foster care with their families. The return to investors is linked to the positive social impact gained through restoring children with their families (eg. a ‘restoration rate’ of 60% of children in foster care being restored with their families delivers a 7.5% return for investors).

Debt vs equity financing

In addition to debt financing, one of the most common sources of funding is equity financing. Equity financing involves raising funds from investors through the sale of shares in an organisation. The organisation receives an injection of funds from the investor and, in exchange, the investor receives a portion of the ownership (and profits) of an organisation, making them a shareholder or owner of the organisation.

Equity investing is common in for-profit structures because the organisation can provide a benefit to its shareholders (the investors) through the distribution of profits (dividends), or through an increase in the value of the organisation. It is generally not possible for not-for-profit organisations to use equity financing, as profits generated by a not-for-profit organisation must be used to further the purposes of the organisation and cannot be distributed to members.

Equity financing is, however, a financing option available to social enterprises that have a ‘for-profit’ structure. Social enterprises may choose a ‘for-profit’ or ‘not-for-profit’ legal structure (or a hybrid of both). Many social enterprises use a ‘for-profit’ structure, such as a private company structure, so they
can access equity financing from socially minded investors. For more information about social enterprises and funding opportunities, see the Not-for-profit Law Social Enterprise Guide on the Information Hub at www.nfplaw.org.au/socialenterprise.

Debt financing is different from equity financing, in a number of ways. For example:

- A borrower and lender can contractually agree that the lender will receive a periodic payment of interest being the “return” a lender receives on the debt. This becomes a binding obligation on the borrower, regardless of the borrower’s profitability. In contrast, a borrower’s ability to provide a return to its shareholders (through payment of dividends) is linked to its current and historic profitability and is only possible if the borrower can first meet its debt financing obligations (e.g. loan repayments).

- When an organisation is liquidated, debt financing obligations (repayment of the loan and interest amounts agreed under debt financing arrangements) take priority over any payments due to shareholders, including the return of their initial investment amount and dividends.

- Debt financing attracts a different treatment under the tax laws and accounting rules applicable in most countries, including Australia (e.g. interest payments paid to a lender are generally tax deductible for the borrower, whereas no such deductions are available for the payment of dividends to shareholders).

- For debt financing, the overall return that the lender is entitled to receive from the borrower is capped at the sum of money originally borrowed (called the ‘principal’ amount), plus interest and any agreed fees or costs. In contrast, the overall return that a provider of equity is entitled to is uncapped - as a shareholder or owner of the organisation, they have the right to a share of the assets of the organisation (proportionate to their ownership), once creditors have been paid.
Some key advantages and disadvantages of these financing arrangements for organisations seeking funding include:

<table>
<thead>
<tr>
<th>Debt financing</th>
<th>Equity financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advantages</td>
<td>Disadvantages</td>
</tr>
<tr>
<td>- No loss of control/dilution of ownership</td>
<td>- May be difficult for not-for-profits to forecast future income (eg. Due to reliance on competitive funding sources such as grants) and therefore be certain of the ability to make repayments</td>
</tr>
<tr>
<td>- Some flexibility in use of funds</td>
<td>- A good financial track record is typically required</td>
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<td>- Interest payments linked to risk of loan (can also be a disadvantage for riskier projects)</td>
<td>- Repayments schedules are inflexible as they are tied to the lending contract</td>
</tr>
<tr>
<td>- Tax treatment of interest payments made by borrower</td>
<td>- Balance sheets would be dramatically affected by taking on the debt</td>
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<td></td>
<td>- Cultural change required for not-for-profits (debt is not always an indicator of poor performance)</td>
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<td></td>
<td>- Security often required – creates risk of loss of that asset</td>
</tr>
</tbody>
</table>

Equity financing

- Flexibility – not conditional on delivering particular projects
- Patient – returns can be delivered over a long period
- Sharing of risk (but also reward)
- Managing investor expectations
- Restricted by legal structure – only available to for-profit structures
- Equity provider may want a ‘seat at the table’

**CONVERTIBLE DEBT**

Sitting in between debt and equity are a range of instruments known as convertibles, also referred to as convertible debt, convertible notes or convertible loans. A convertible is simply a loan or a debt instrument that can subsequently be converted into equity.

Before conversion, the instrument enjoys all of the features of debt (as described in this guide) and can be secured or unsecured (see below for an explanation of these terms). After conversion, the instrument enjoys all of the features of equity and all of the rights that accompany ownership.

Convertible can be structured in a variety of ways, with conversion occurring at the direction of the borrower, the lender, or automatically at a specified time or on the occurrence of specified conditions. Convertibles are subject to nuanced tax, accounting and legal treatment which is largely dependent on each instrument’s individual features.

**Loans vs debt securities**

Both loans and debt securities are a type of borrowing that achieve the same practical objective for the borrower - raising funds in the form of a debt, which must be repaid at a later date.

A “debt security” is simply structured as an IOU (or ‘I owe you’) - a promise to repay a debt. The borrower (known as the “issuer”) issues the IOU to the lender (known as the “holder” of the security). The holder pays the issuer a fixed amount upfront (known as the “subscription amount”) and the security carries with it the promise to return to the holder the fixed amount at a later date (known as a “redemption”), usually with interest.
Although a debt security achieves the same as a loan for a borrower (that is, access to and repayment of funds), a borrower may have very good reason for structuring a debt financing as a debt security. They are common to large companies (public and for-profit). A company might choose a debt security (ie. a bond) because the interest rate the issuer (borrower) would pay the holder (lender) is often lower than the interest rate payable on loans from banks, and the conditions attached to the bond may be less restrictive than those of a bank loan. Governments also issue bonds, for example to raise funds to build roads or other infrastructure.

Some bonds are able to be sold on (or ‘traded’) to other investors. This is because the holder (of the security) is permitted to sell the security freely. Where a bond is sold on to another investor, the investor holding the security on the date specified for payment of interest or repayment of the fixed amount is the one entitled to receive these payments. This is one of the key differences between debt securities and loans - debt securities are generally considered to be more “tradeable”. For example, some bonds can be bought and sold on the Australian Stock Exchange (for more information about bonds, see ASIC’s MoneySmart at [www.moneysmart.gov.au](http://www.moneysmart.gov.au) and [www.asx.com.au](http://www.asx.com.au)). Loans are usually non-tradeable and the bank (or other financial institution) is obliged to see out the term of the loan. See the section 5 below on transfer of a loan by a lender.

The pool of investors (eg. private individuals or superannuation fund managers) who are willing to invest in and trade debt securities is generally different to those who are in the business of making loans (eg. banks and credit unions). There are very different standards in the debt securities and loan markets with respect to the legal structures used and the rights provided to lenders and borrowers. There are also very important legal and regulatory considerations in structuring debt financing as a debt security. If you are considering this type of arrangement, we recommend you seek legal advice.

**NOTE**

Debt securities are subject to a number of complex and technical provisions in the Corporations Act 2001 (Cth) (similar to those that apply to the issuing of shares). This is because debt security falls within the definition of a “debenture” and “security” under the Corporations Act (while loans do not).

For example, a public company seeking to issue debt securities may be required to produce a disclosure document (i.e. a prospectus) providing detailed information about the company and the security being issued, and subsequently make continuing public disclosures. We recommend you seek legal assistance if you are considering this arrangement.
2. Secured vs unsecured debt financing

Debt financing can be secured or unsecured. Providing security in support of a secured debt essentially means that the debt is “backed” by specified assets as collateral. On the other hand where a debt is unsecured, the lender relies solely on the borrower’s ability to repay the debt.

Secured debt

Where the debt is secured, if the borrower is unable to repay the debt when it is due, or the borrower otherwise breaches the terms of the lending contract, the lender will be entitled to take possession or control of the assets offered as collateral and utilise those assets in order to obtain repayment of the debt. Typically, a lender will look to recover the debt through by selling the collateral. A lender is able to take security over most assets of the borrower (there are some exceptions).

Even where a lender has security, in no circumstance can it recover more than the amount of the debt (plus interest and other agreed costs) – any money that a lender recovers (for example, from the sale of collateral) in excess of its debt must be returned to the borrower.

Generally, secured debts are considered to be less risky for the lender and as a result, lower interest rates may apply to secured debts. A lender may require security for a debt where the borrower does not have a good financial track record or where the borrower is a start-up.

Unsecured debt

Where the debt is unsecured, the lender does not have access to specific collateral assets in order to obtain repayment of its debt. In the event that the borrower fails to make repayment, the lender’s only option will be to bring legal action against the borrower for breach of contract and to place the borrower into liquidation. In a liquidation of the borrower, the lender will be entitled to a proportional share of the proceeds of the sale of all of the assets of the borrower (other than those assets that have been provided as security for other debts), along with all of the borrower’s other unsecured creditors. The unsecured creditors not only “rank” behind those creditors who have the benefit of security, but also certain other “preferred creditors” like employees.

EXAMPLE

A neighbourhood house owns a piece of land worth $300,000 and two cars worth $25,000 each. The organisation borrows $200,000 from Lender A, $200,000 Lender B and $200,000 from Lender C. The neighbourhood house enters liquidation. At that time, the land is still worth $300,000 but each car is only worth $15,000 (a total of $330,000).

If no lender is provided security, each will receive $110,000 in the borrower’s liquidation - their proportionate share of the borrower’s total unsecured assets of $330,000.

If Lender A is provided security over the borrower’s land, then Lender A can directly seek repayment of its debt through a sale of the land. It will receive $200,000 (plus unpaid interest). Lender B and Lender C are
then left to take their proportionate share of the borrower’s remaining unsecured assets of $30,000. They will receive $15,000 each, plus a share of the amount left over from the sale of the property after paying the secured lender.

Security over property

The Personal Property Security Register (PPS Register) is a national online register of security interests in personal property, essentially assets other than land (e.g., equipment, cars or merchandise).

The register is established by the Personal Property Securities Act 2009 (Cth) (PPSA), which enacts a regime to validly register and protect security interests, sets out the order of priority where security is taken over the same property and describes how security can be enforced.

Security over land

Securities over interests in land are taken by way of a mortgage. The laws of each State and Territory regulate securities over interests in land. Registration of the security (mortgage) is critical. In most states, registration requires a validly executed mortgage, payment of stamp duty and a description of the land being mortgaged and the debt being secured. The land titles office (or equivalent in each State and Territory) typically has prescribed registration forms for registration of mortgages.

Guarantees

In a debt financing arrangement, a ‘guarantee’ is essentially a promise by another party (person or corporate body – the ‘guarantor’) to fulfil the obligations of the borrower to repay the debt, in circumstances where the borrower cannot meet them itself.

Where an organisation has a debt financing arrangement and no guarantee is provided, only the organisation is liable for the debt. For example, if individual directors have not provided a guarantee, they will not be liable to repay the debt on behalf of the organisation in the event that the organisation cannot meet its repayments (other than if the directors act improperly in incurring the debt, refer to NFP Law Duties Guide available at: www.nfplaw.org.au/governance).

Consider a simple situation in which a borrower needs to borrow $25,000 to renovate a building that will be used to make furniture. The borrower is a social enterprise that has been set up by a large not-for-profit organisation (Large NFP). The enterprise will make and sell furniture and all the funds will go back to the not-for-profit.

If the bank wants to lend money on the basis that the Large NFP will pay the debt if the borrower fails to do so, it will need to get a guarantee and potentially security from the Large NFP. Without the guarantee and (or) security, a lender may either not be willing to provide the financing or they may propose terms and conditions (e.g. high interest rate) that are not appealing to the borrower.
3. Key terms in debt financing

Below is a high level summary of some of the key terms in debt financing arrangements (some terminology may vary between lenders).

Loan amount

The loan amount borrowed (excluding any interest and fees payable) is commonly referred to as the principal. Interest payable on a loan is calculated on the principal. Some debt financing arrangements have a fixed principal amount (e.g., generally debt securities have a fixed issuance amount), while others are more flexible and allow the borrower to increase the principal over time (subject to the lender’s approval).

A lender will generally specify an availability period for the loan once it has been approved, and the borrower must borrow the funds before this period expires or the loan will need to be re-approved.

EXAMPLE

An organisation may wish to (a) borrow funds to pay suppliers periodically (b) repay those funds when it gets revenue from sales and (c) re-borrow amounts when it next needs to make payment to suppliers. Such a scenario would suite a revolving loan. Under a revolving loan, the borrower is approved for a facility limit and is entitled to borrow up to that limit at any time. The borrower can also re-borrow amounts that it has previously repaid. This may be suitable to finance day to day operations, where an organisation has a recurring need for smaller amounts of funds to meet ongoing expenses. It is not dissimilar from an overdraft facility.

The same organisation may also require financing to purchase a new building. That would be more suitable to a term loan. Under a term loan, the borrower is entitled to borrow up to a fixed limit but once it makes a repayment, it may not re-borrow the amount repaid.
Term & repayments

The term of a debt financing arrangement is the length of time over which the borrower must repay the amount borrowed. Terms for debt financing arrangements can vary from short-term arrangements over a few months, to long-term arrangements over 30 years. Generally, the longer the term of a debt financing arrangement, the lower the repayments.

The frequency and amount of repayments can vary between different types of debt financing arrangements. Repayments may be in advance (due at the start of the loan and then subsequently the beginning of each repayment period, for example the first day of each month), or in arrears (due at the end of the first repayment period, for example, the last day of each month).

Repayments may be comprised of principal and interest, or just interest. For example:

- under an amortising (or principal and interest) loan, the borrower must make periodic repayments of the loan principal and interest during the term, and
- under a non-amortising (or interest only) loan, the whole principal amount is repaid in one lump sum payment at the end of the term, with the borrower only making repayments on interest during the loan term.

The lending contract will often include a repayment schedule, which sets out the repayment amounts and due dates (and sometimes also the interest and principal component of each repayment).

Generally, the interest rate on a non-amortising (or interest only) loan is higher than an amortising loan and a borrower may want to have the option to repay some or all of the principal prior to the end of the loan’s term (to reduce the amount of interest payable). This type of early (unscheduled) repayment is referred to as an optional or a voluntary repayment. In more complex arrangements, a lender may also require a mandatory repayment of some or all of the loan principal prior to the end of the term where certain key events occur (eg, the disposal of material assets, or a change in the ownership of the borrowing entity).

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**EXAMPLE**

An organisation (borrower) borrows funds in the form of an interest only loan in order to purchase an office building. The interest payments on the loan are paid for with the income it receives from renting out office space in the purchased building.

The borrower wants the flexibility to repay the full loan early in the event that, for example, they want to re-finance the property through another lender in a few years time due to changes in interest rates. To allow for this, the borrower has negotiated for voluntary repayments to be included in the conditions of the lending agreement.

The lender has stipulated that a mandatory repayment of the full loan amount is due if the borrower sells the office building.

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**Interest rate**

An interest rate can be fixed or variable (also known as floating).

A fixed interest rate is set for the term of the debt financing arrangement and cannot be changed throughout the course of the term.
Conversely, a **variable** interest rate is set by reference to a published lending rate determined by the lender and can vary throughout the term.

Debt financing arrangements can also have a combination of both fixed and variable interest rates. For example, lenders offer home loans with a low fixed rate for the first few years of the loan, and then a variable interest rate applies for the rest of the loan’s term.

Interest payments are typically paid on a monthly, quarterly or semi-annual basis, and this period is known as the **interest period**.

Where a borrower fails to make a scheduled repayment by the due date, the rate of interest payable on the overdue amount may be increased by the lender. This is referred to as a **default** interest rate.

**NOTE**

Variable or floating interest rates are set by reference to a generally accepted “market rate” like the “BBSW” (Bank Bill Swap Rate) in Australia. This generally reflects the rate at which a lender itself raises funds, often called the base rate. The lender will then add their margin to the base rate to calculate the floating rate to be applied to the debt. Those seeking to borrow funds should consult an expert to determine whether a loan with fixed or variable interest rate (or combination of the two) would best suit their situation.

The law generally does not seek to place a limit on the amount of interest that can be charged. There are three exceptions to this:

i. **individuals** are protected from being charged excessive rates of interest under consumer protection legislation

ii. where the **borrower goes into liquidation** and the interest or charges on the loan are **extortionate**, the loan is voidable against a liquidator and liquidator can claw back interest paid to the lender, and

iii. where a lender charges **default interest**, it must be able to demonstrate that the increase in interest charged is a **genuine pre-estimate of the loss** suffered by the lender as a result of the default, rather than an unfair penalty (which is not permitted by law).

**Fees**

Lenders may require a borrower to pay an initial fee in order to obtain financing from them such as a **loan approval fee**. If you are providing collateral for secured debt finance, a lender may charge a **valuation fee** to cover their costs in relation to obtaining a valuation of the collateral. These fees are generally charged as **upfront fees** to be paid on commencement of the debt financing arrangement. Where a lender has provided pre-approval for a borrower to borrow an amount of money over time, or re-borrow amounts that have been previously repaid to the lender, the lender may charge a fee to the borrower for keeping funds on “stand by”, known as a **commitment fee**.
Other transaction fees may apply throughout the term of the loan, for example, a request for a loan statement, copy of a repayment schedule or an early termination figure (the total sum due to repay the loan in full before the end of the term) would usually attract a fee.

Some lenders may charge an early repayment fee or early termination fee where a borrower repays a debt ahead of the scheduled term agreed.

### 4. Representations, warranties and undertakings

Once a lender’s money is “out the door”, they are left to rely on any security and guarantees taken, and the contractual terms of the lending contract to protect their position as a creditor of the borrower. Specifically, the lender will rely on terms called representations, warranties and undertakings.

These representations, warranties and undertakings form part of the standard terms and conditions of most lending contracts. Where negotiations take place between the lender and borrower, it is often the representations, warranties and undertakings that are the focus point of the negotiations.

An undertaking is a promise by a borrower to a lender to do, or to not to do, something. A promise to do something is called a positive undertaking and a promise not to do something is called a negative undertaking.

A representation or warranty is a statement of fact or an affirmation of a fact at a given point in time. A lender will require the borrower to make a number of representations and warranties when a lending contract is made and for ask for certain representations and warranties to be reaffirmed throughout the term of the financing (eg. confirmation of the borrower’s satisfactory financial position through the provision of up-to-date financial statements throughout the term of the loan).

A failure by a borrower to comply with a representation, warranty or undertaking of a lending contract, would typically entitle a lender to declare an event of default. The consequences of an event of default are discussed in section 5 below.

Under contract law, a breach of a representation that induced the counterparty to enter into the contract can entitle the non-breaching party to have the contract declared void (undoing the contract). On the other hand, a breach of a warranty keeps the contract in place and only entitles the non-breaching party to financial compensation from the other party for the losses they suffer because of the breach (also known as damages).

Lenders will therefore often seek matters to be represented and warranted so they may seek compensation and have the contract declared void where a breach occurs.

Your organisation should think carefully before making any representations, warranties or undertakings to a lender. In particular, you need to consider:

- how your organisation will ensure that these contractual obligations are being met
- any costs associated with ongoing compliance of your contractual obligations, and
- whether your organisation is planning on making any changes to its structure or operations in the future that may affect your contractual obligations.
Negotiating a debt financing arrangement

Lenders often use a template document called a term sheet (see Tool 1 for an example) to outline the main terms of the debt financing arrangement as agreed between the parties. Once the terms in the term sheet have been agreed upon, the parties will then proceed with negotiating the remaining terms and conditions in the debt financing documentation.

Most lenders will typically have a set of “standard terms and conditions” for debt financing arrangements. Generally, the borrower will have very limited scope to negotiate the terms offered by a lender. However, there may be scope for the borrower and lender to negotiate some of the terms included in the debt financing documentation.

The preferred position for a borrower is to keep the number and scope of representations, warranties and undertakings in the lending contract to a minimum. However, there are usually standard contractual protections that a lender will expect in any lending arrangement and may not be willing to negotiate on.

Generally, a lender will decide which protections it requires based on:

- how familiar the lender is with the borrower and its activities
- the level of risk involved in lending to the borrower and the lender’s risk appetite
- the borrower’s financial situation, and
- any security or guarantees taken.

The nature of the contractual protections required by lenders generally fall into the following categories:

- **Requirement to provide information**: The borrower will agree to provide the lender with regular information about the way that the borrower is performing. This enables the lender to monitor the borrower’s performance and have an early warning if problems are likely to arise for the borrower in the future. Typically, the borrower will also need to declare that the information provided to the lender is accurate and not misleading.

- **Requirement to maintain the borrower’s “state of affairs”**: The lender will want to ensure that the borrower does not materially alter its financial structure or operations during the term of the debt financing arrangement.

- **Financial performance indicators**: The lender will typically want to have the ability to require the borrowed funds to be repaid well in advance if a borrower is likely to experience financial trouble. The lender achieves this by requiring the borrower to show that the business is meeting certain financial targets, usually expressed in the form of financial ratios. Terms and conditions in lending
contracts which relate to the borrower’s financial performance are often called **financial covenants**.

The table below provides a simple breakdown of some of the main representations, warranties and undertakings contained in debt financing contracts.

<table>
<thead>
<tr>
<th>Providing information</th>
<th>Maintaining “state of affairs”</th>
<th>Financial performance indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive Undertakings</td>
<td>Positive Undertakings</td>
<td>Undertakings</td>
</tr>
<tr>
<td>Audited financial statements</td>
<td>Comply with all laws</td>
<td>Debt to earnings ratio</td>
</tr>
<tr>
<td>Half-yearly financial statements</td>
<td>Maintain existence of company</td>
<td>Debt to cash flow ratio</td>
</tr>
<tr>
<td>Budget and management accounts</td>
<td>Maintain insurance</td>
<td>Debt to value of assets ratio</td>
</tr>
<tr>
<td>Reports provided to shareholders</td>
<td>Pay all taxes</td>
<td>Interest to income ratio</td>
</tr>
<tr>
<td>Notice of material litigation</td>
<td>Negative undertakings</td>
<td></td>
</tr>
<tr>
<td>Notice of event of default</td>
<td>Not dispose of material assets</td>
<td></td>
</tr>
<tr>
<td>Annual meeting with management</td>
<td>Not provide security to third parties</td>
<td></td>
</tr>
<tr>
<td>Periodic financial ratio calculations</td>
<td>Not pay dividends</td>
<td></td>
</tr>
<tr>
<td>Representations &amp; Warranties</td>
<td>Not make material acquisitions</td>
<td></td>
</tr>
<tr>
<td>Information is accurate and not materially misleading</td>
<td>No change of business</td>
<td></td>
</tr>
<tr>
<td>Representations &amp; Warranties</td>
<td>No liabilities not disclosed to lender</td>
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<tr>
<td></td>
<td>Borrower is solvent</td>
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<td></td>
<td>No material litigation ongoing</td>
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<td></td>
<td>No event of default outstanding</td>
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<tr>
<td></td>
<td>Loan documents are validly executed and are binding</td>
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</tbody>
</table>

5. Events of default

An ‘event of default’ under a debt financing arrangement typically occurs when a borrower either breaches the terms of a lending contract or becomes insolvent (cannot repay its debts when they fall due).

On an **event of default** occurring, a lender may:

(a) demand that all amounts outstanding under the financing arrangement be repaid immediately or at any time determined by the lender

(b) immediately cease lending any further funds to the borrower, and

(c) enforce security or guarantees provided for under the lending contract.

The obligation on the borrower to repay debt financing early as a result of an event of default can have far reaching legal consequences. Critically, a demand from a lender to repay a debt will have the effect of making the borrower insolvent where a borrower does not have the financial means to repay the debt (for more information about insolvency see section 6 below).
The table below shows a standard set of events of default that a borrower may find in a loan agreement.

<table>
<thead>
<tr>
<th>Standard events of default</th>
<th>Brief Description</th>
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<tbody>
<tr>
<td>Failure to make a payment</td>
<td>The borrower does not pay interest or repay principal when due. The lender will typically provide the borrower a “grace period” of a few days (eg. 2 or 3 business days) to make the scheduled repayment. An event of default will occur if payment is not made after the grace period.</td>
</tr>
<tr>
<td>Breach of undertaking / breach of representation and warranty</td>
<td>The borrower breaches an undertaking or representation and warranty. The lender may again provide the borrower with a “grace period” to fix the breach (eg. up to 30 business days in some cases). For more important undertakings, there may be no grace period.</td>
</tr>
<tr>
<td>Insolvency of the borrower, guarantor or security provider</td>
<td>The borrower, guarantor or security provider becomes insolvent, or enters into voluntary or involuntary liquidation, administration, receivership or any compromise or arrangement with its creditors.</td>
</tr>
<tr>
<td>Cross-default</td>
<td>The borrower, guarantor or security provider defaults on any of their other debt obligations.</td>
</tr>
<tr>
<td>Lending contract, security or guarantee becomes invalid or unenforceable</td>
<td>The lender loses the protection of the security, guarantee or contracts because they become invalid or unenforceable.</td>
</tr>
</tbody>
</table>

**Conditions precedent**

A lender will typically require a borrower to provide certain information before the lender agrees to make funds available, known as ‘conditions precedent’. In a simple personal loan arrangement, these may be thing such as proof of income, address and identity and valuation of property or security.

A failure by a borrower to satisfy a condition precedent is not a breach of contract, it just might mean that the lender is not willing to enter into a lending contract with the borrower. Common conditions precedent in debt financing arrangements include:

- duly executed loan and security legal documents
- certified copies of the borrower’s rules or constitution
- board and/or shareholder minutes authorising financing
- certified copies of latest financial statements
- most recent budget and/or business plan
- original title documents in respect of real estate
- no event of default in previous debt financing arrangements
- no breach of representation, warranty or undertaking in previous arrangements
- payment of all fees, costs and expenses
- legal opinions on certain matters of interest, and
  compliance with financial, corporate, legal, property tax due diligence requests.
Transferability of a debt by a lender

Generally, debt securities are freely transferable between lenders. For other debt financing arrangements (ie. loans), lenders will seek to have the ability to transfer a debt without requiring the borrower’s consent included as a term in the lending contract. This allows for the debt to be transferred (or sold) to another lender in the event that original lender no longer wishes to have exposure to the borrower (eg, because the borrower’s performance is declining).

It is common for lending contracts to be set up to accommodate multiple lenders (to retain flexibility for the lender). In this case, a borrower may see terms such as **Facility Agent** and **Security Trustee** used in lending contracts to describe another party to the financing arrangement. The Facility Agent and Security Trustee sit between the borrower and the lender(s) and are representatives of lenders. A **Facility Agent** is typically responsible for the day to day administration of the debt, including collecting interest and processing payments on behalf of the lender(s). A **Security Trustee** is responsible for holding and enforcing security interests on behalf of the lender(s).

From a borrower’s perspective, it is preferable to know the identity of the lender. The requirement to obtain the borrower’s consent before transferring the debt to another lender could be a negotiated term of the contract. Often a compromise may be that the lender is restricted from transferring to certain identified parties without the borrower’s consent unless an event of default has occurred, in which case the borrower loses its consent right.

6. Legal duties of committee members

Committee members (those that sit on the governing body of the organisation) have a legal duty to act in good faith, in the organisation’s best interests, and for a proper purpose.

Before entering into a debt financing arrangement, committee members need to be satisfied that it is in the best interests of the organisation to incur the debt. In particular, committee members should be satisfied that the organisation:

- is solvent when it enters into a debt financing, and
- will not become insolvent as a result of entering into the debt financing.
For more information about the legal duties of committee members, including the duty to prevent insolvent trading, see the Governance page on the Not-for-profit Law Information Hub at www.nfplaw.org.au/governance.
Tool 1: Example of a debt financing term sheet

The following template is an example of a debt financing term sheet (see Negotiating a debt financing arrangement in this fact sheet for an explanation of a term sheet). The meanings of the terms listed in this template may vary from lender and lender so you should check with your lender if you are unsure of the meaning of a term in a lending contract, or seek legal advice.

<table>
<thead>
<tr>
<th>DEBT FINANCING TERM SHEET</th>
<th>GUIDE SECTION REFERENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrower:</td>
<td>[__].</td>
</tr>
<tr>
<td>Lender:</td>
<td>[__]</td>
</tr>
<tr>
<td>Guarantor:</td>
<td>[__]</td>
</tr>
<tr>
<td>Obligors:</td>
<td>[__] A party required to fulfil an obligation under the lending contract.</td>
</tr>
<tr>
<td>Facility Agent/Security Trustee:</td>
<td>[__].</td>
</tr>
<tr>
<td>Facility Type:</td>
<td>[Secured/Unsecured]</td>
</tr>
<tr>
<td>Facility Limit:</td>
<td>A$[__].</td>
</tr>
<tr>
<td>Security:</td>
<td>[1st] ranking security over all right, title and interest in the present and after acquired assets, property and undertakings of the Borrower [and each Guarantor] OR [1st] ranking security over the following assets of the Borrower [and Guarantor]: [list assets]. OR None</td>
</tr>
<tr>
<td>Facility Purpose:</td>
<td>[The purpose of why funds being borrowed]</td>
</tr>
<tr>
<td>Term:</td>
<td>[__] years.</td>
</tr>
<tr>
<td>Repayment:</td>
<td>[Insert details of any periodic amortisation]. Repayment in full on the expiry of the Term.</td>
</tr>
<tr>
<td>Upfront Fee:</td>
<td>[__].</td>
</tr>
<tr>
<td>Interest Rate:</td>
<td>Margin of [<strong>]% p.a. + Base Rate OR Fixed at [</strong>]% p.a.</td>
</tr>
<tr>
<td>Base Rate:</td>
<td>[__]</td>
</tr>
<tr>
<td>Default Rate:</td>
<td>[__]% p.a. in addition to the Interest Rate applicable after an Event of Default.</td>
</tr>
<tr>
<td>Interest Period:</td>
<td>[Monthly/Quarterly/Semi-Annual], or such other period as agreed.</td>
</tr>
<tr>
<td>Availability Period:</td>
<td>[__] from the Closing Date, subject to the Conditions Precedent.</td>
</tr>
<tr>
<td>Optional/Voluntary Prepayments</td>
<td>Permitted on the Borrower providing [__] Business Days’ notice.</td>
</tr>
<tr>
<td>Mandatory Prepayments:</td>
<td>Customary mandatory prepayment events including (without limitation) illegality, increased costs, disposals, insurance proceeds and change of control.</td>
</tr>
<tr>
<td>Undertakings, Representations</td>
<td>The Obligors will make information, general and negative undertakings and representations and warranties including the</td>
</tr>
<tr>
<td>and Warranties:</td>
<td>following [__].</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>Financial Covenants:</td>
<td>[__].</td>
</tr>
<tr>
<td>Events of Default:</td>
<td>Events of default will include the following [__].</td>
</tr>
<tr>
<td>Conditions Precedent:</td>
<td></td>
</tr>
<tr>
<td>Transferability of Loan</td>
<td>The Lender may transfer all or any part of the loan without the consent of the Borrower. OR Unless an Event of Default is outstanding the Lender may not transfer all or any part of the loan without the consent the Borrower.</td>
</tr>
<tr>
<td>Governing Law and Jurisdiction</td>
<td>The law of [State], Australia, will be used to interpret the lending agreement, and disputes will be heard in the relevant court of that state. See left</td>
</tr>
</tbody>
</table>
Resources

Related Not-for-profit Law Resources

The Not-for-profit Law Information Hub (www.nfplaw.org.au) has further resources on the following topics:

- Personal Property Securities Act, at www.nfplaw.org.au/PPSR
- Contracts, at www.nfplaw.org.au/contractsoverview
- Social enterprises, at www.nfplaw.org.au/socialenterprise

General Resources on debt finance and secured lending

- Practical Law, Lending and taking security in Australia, an overview, at www.uk.practicallaw.com/1-501-2672
- Personal Property Securities Act key terminology, at www.ppsr.gov.au/ppsr-key-terminology
- Impact investing, at www.socialventures.com/investment/impact-funds

Related ASIC Resources

- Director’s duties, at www.asic.gov.au/regulatory-resources/insolvency/insolvency-for-directors/directors-what-are-my-duties-as-a-director/

Related Legislation

- Corporations Act 2001 (Cth)
- Personal Property Securities Act 2009 (Cth)

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