



# BANKING CREDIT AGREEMENTS ACCORDING TO THE ENGLISH LAW

## 1st Part

JUDr. Katarína Chovancová, PhD.

### Introduction

In the analysis submitted, we are going to look at the issue of British banking credit agreements. The introduction and the first part have been focused on credit agreements in Slovakia as an introduction of their status quo as well as, on the definition of a bank within the English legal system, and a short synopsis of the basic sources of English banking law. The reader will also be familiarized with the underlying mechanism of bank lending in Britain. The second part has been dedicated to the detailed classification and a brief analysis of English banking credit agreements. There are the drafts of international loan agreements in day-to-day banking practice, which are commonly used to support the medium-sized enterprises through the "pre-financing" of their business activities. International credit agreements are usually designed, e.g. to finance investment imports that are insured by the respective insurer from the exporter's country, and also to finance exports to the country of a contractual foreign partner. Banking credit agreements concluded between the Slovak and the foreign bank, governed by the foreign law, may be designated as international commercial contracts in accordance with the UNIDROIT Principles of International Commercial Contracts.

These Principles<sup>1</sup> in fact assume "the widest interpretation of the term international contracts so as to ultimately exclude only those cases where the contract does not include any international element, in other words, where all the legally significant elements of the given contract are connected with the law of only one state." However, a banking credit agreement governed by the foreign law contains not just one foreign element, but several at once at least, for example, the registered offices of the contracting parties in different countries, the choice of law of different countries, or the interconnection with international commercial interests. Under the Slovak law, loan agreements are governed by Sections 497 to 507 of the Commercial Code (Act no. 513/1991 Coll.), as amended. This legal regulation is uncontested as the basis and main pillar of banking loan agreements governed by the Slovak

law. International banking loan agreements are, however, usually governed by the foreign law and typically by the law applicable to the foreign banking entity – especially where it is in the position of a principal creditor. It may be concluded that foreign creditors invariably prefer to use the foreign law and that the option of establishing the Slovak law as the applicable law is usually discarded in the preliminary negotiations. In international credit agreements between banks in Slovakia and abroad, the applicable law has been chosen most often to be the English law (along with the German law), reflecting the current (though not always very appropriate) tendency to prefer the English law and the historically strong traditions of the German banking capital in Slovakia.

Before outlining the sources of British banking law, firstly, it is necessary to define the term "bank" in the context of the English legal system. According to Ellinger et al.,<sup>2</sup> "the 'banking industry' in the United Kingdom is divided into a number of sectors, each having its own distinctive elements that differentiate it from the others." That may be why the British legislation does not need to have a single definition of a bank. The term "bank" has been elaborated in several laws without any all-encompassing definition. The alpha and omega of an English bank is in practice no more than an approximate definition, one based on a refined experience, i.e. on the common law.<sup>3</sup> Under the common law, a bank is an institution performing banking transactions – though the nature of the transactions is not stipulated as in civil law, i.e. by parliament, but instead by the courts in their capacity as lawmakers within the English common law system.<sup>4</sup> Under the common law, a commercial company may perform banking transactions without a license – subject only to restrictions laid down in the Financial Services and Mar-

<sup>1</sup> UNIDROIT Principles of International Commercial Contracts, page 19.

<sup>2</sup> Ellinger, E.P. et al.: Ellinger's Modern Banking Law, p. 69 (hereinafter cited as "Modern Banking Law").

<sup>3</sup> Common law / The Anglo-Saxon legal system – based on judicial precedents, customs and traditions. See, for example, Chovancová, Katarína: Vylúčenie pôsobnosti Arbitration Act 1996 v bankových úverových zmluvách (Excluding application of the Arbitration Act 1996 in bank credit agreements); published in Legal View, 86, 2003, no. 5, pp. 521-530.

<sup>4</sup> See the detailed interpretation on page 6.

<sup>5</sup> Rutheford, L., Bone, S.: Osborn's Concise Law Dictionary, page 99 (hereinafter cited as the "Law Dictionary").



kets Act 2000.<sup>5</sup> The courts as interpreters of the common law have not only established the definition of a bank but also the three basic principles for the conduct of banking transactions in the United Kingdom: the substance of the term "banking transaction" may be changed "from time to time"; a financial institution performing banking transactions "in one place" need not be deemed to constitute a bank "in another place"; and finally the importance of the reputation of a financial institution – where it is generally considered as a bank, the courts will consider it to be a bank.

The detailed banking acts of Slovakia and Germany undoubtedly provide not only a more precise definition of a bank and banking transactions, but a comprehensive legal regulation for the operation of commercial banks in general. In comparison with the common law, with its different definitions and varying judicial opinions, these acts are undoubtedly drafted more clearly and more precisely.

### 1. Credit under the English law and the basic sources of the English banking law

English legal experts Rutheford and Bone define credit as: "The time stipulated by a creditor for the payment of a loan, or the entire amount which, with the creditor's permission, may be borrowed or owed." In other words, it concerns in effect both the deferral of the loan repayment up to a time designated by the creditor and the borrowing of the money, i.e. the whole amount stipulated by the creditor. In the United Kingdom, bank loans are provided to legal persons – to commercial companies and entrepreneurs (business loans) and to consumers (consumer loans) – for different purposes. In fact, under the British credit agreements, the basic mechanism for providing loans and banks' procedures for lending to legal and natural persons are basically the same. Likewise, the standard structure of the credit agreement has been generally regulated under English contract law. Each banking credit agreement is therefore drawn up in accordance with a stable contractual structure, though how credit agreements are divided in terms of regulation and overall treatment is important – in compliance with the Consumer Credit Act 1979, they must be divided into commercial and consumer loans.

Having mentioned the Consumer Credit Act as one of the sources of the legal regulation of lending in the United Kingdom, it is logical to continue with a synopsis of the other sources of British banking law. The first successful English bank was – though it sounds paradoxical – the Bank of England. It was founded in 1694, and two years later, as Ellinger et al.<sup>6</sup> observe: "the amended Bank of England Act 1696 provided the bank with a vir-

tual monopoly in the performance of extensive and complete banking transactions."

It was not, however, until the nineteenth century that the Bank of England assumed the functions of an issuing bank and central bank. During the First World War it began to perform monitoring and administration of foreign exchange transactions.<sup>7</sup> In 1946, the bank was nationalized by the leftist Labour Government, but though the bank was transformed by the new law into its current form of a state institution (the bank's shares were transferred from private ownership to the Treasury), it has remained fully independent of the Government.<sup>8</sup>

We have briefly mentioned the Bank of England in connection with the introduction of the two basic statutes of British banking law, which, among other things, have modified the bank's duties – the Banking Act 1979 (BA 1979), replaced by the Banking Act 1987 (BA 1987). BA 1979 was the first statute to regulate comprehensively the granting of banking licences.<sup>9</sup> Its main purpose was to forbid the acceptance of deposits from the public, in the United Kingdom, by any entities other than authorized institutions or institutions not subject to statutory restriction. For the institutions to which it applied, however, the law did not lay down uniform criteria for granting deposit-taking authorizations. On the contrary, it divided institutions authorized to accept deposits into 4 groups.<sup>10</sup> The shortcomings of BA 1979 appeared in the second half of the 1980s, when they resulted in the crash of several well-known banks.

The new BA 1987 removed the shortcomings of its predecessor and established three new principles of British banking which continue to apply today. The most important change confirmed by the new law was the creation of the Board of Banking Supervision and the elaboration of the Bank of England's role in the field of banking supervision.<sup>11</sup> In addition, the statute terminated the two-level system under which deposit-taking institutions were

<sup>7</sup> The Bank of England ceased to perform these functions in 1980.

<sup>8</sup> The Bank of England is at present governed by the Bank of England Act 1998.

<sup>9</sup> There were two pressing reasons for the adoption of this law. The first was undoubtedly the then crisis in the banking sector – because of the system of "unrestricted bank trading" and, at the same time, the inadequate provision for depositors under the Protection of Depositors Act 1963, there was a large-scale and very simple run on deposits by the public. Apart from that, the Council of the European Communities had issued the First Banking Co-ordination Directive (No. 77/780 of 12 December 1977), which required the authorization of "credit institutions", i.e. banks.

<sup>10</sup> The four groups comprised: the Bank of England, banks, 'licensed deposit-takers', and other institutions identified in the law, such as building societies and the central banks of members of the European Communities.

<sup>11</sup> The introductory provisions of the Banking Act 1987 impose on the Bank of England the obligation to exercise general supervision over "all institutions" which have been granted a licence. The regulation strengthened the powers of the bank's banking supervision division.

<sup>6</sup> Modern Banking Law, ref.2, p.29.



divided into banks and "licensed deposit-takers", and at the same time it established a single deposit-taking licence for all institutions – thus it created a single scheme for the licensing of all institutions.

Another major revision of the entire British banking system, including the regulation of financial services, began in 1997 as one of the main priorities of the new Labour Government. It sought to establish a "super" supervisory institution in the British banking sector, and the resulting supervisory colossus was the Financial Services Authority (FSA), all of whose powers and obligations were laid down by the Financial Services and Markets Act 2000 (FSMA 2000). As regards financial market regulation, the FSMA 2000 "transferred" the task of supervising the financial services sector from the Bank of England to the FSA. As Ellinger et al. note:<sup>12</sup> the FSA stands "as one of the world's strongest financial regulators in regard to its remit, powers and independence in decision-making".

FSMA 2000 represents an important new stage in the development of British banking and finance. Indeed, its remit encompasses the entire financial sector – banking, insurance and investment transactions. It regulates financial aspects of trading as well as the specific conduct of trading in the financial sector. Moreover it emphasizes (as does BA 1979 and 1987) the need for banking activities in the sense of "deposit-taking" to be subject to a banking licence.<sup>13</sup> A criticism often levelled at FSMA 2000 is that it regulates only deposit-taking "through trading" without either defining the trading or explaining its meaning. The Treasury has produced auxiliary definitions and explanations through statutory instrument,<sup>14</sup> though these are said to be incomplete and do no more than copy the texts of the older banking statutes.

With regard to these basic sources of English banking law, an account should also be taken of the significant standing of the United Kingdom in the European Community (EC), a natural consequence of which was the considerable influence exerted on UK banking law by all EC activities and efforts to create a single financial market, including banking services. According to the EC, a bank is a credit institution whose principal activities are the acceptance and provision of credit – a bank is required to act in accordance with the relevant legislative measures of the EC (especially EC directives). It should be noted that most of the EC directives implemented in the United Kingdom have been consolidated by the Banking Consolidation Directive 2000.<sup>15</sup>

<sup>12</sup> Modern Banking Law ref. 6, p. 35.

<sup>13</sup> FSMA 2000 generally forbids deposit-taking "by anyone" with the exception of "authorized persons" and "exempt persons".

<sup>14</sup> The Financial Services and Markets Act 2000 Order 2001, S.I. 2001, No. 1177.

<sup>15</sup> Directive 2000/12/EC, [2000] OJ L 126/1 the Banking Consolidation Directive (the "BCD").

UK banking practice has long included use of the Banking Code,<sup>16</sup> (the latest version was adopted in 2005) and the Business Banking Code. Neither of them are legally binding regulations, but the voluntary codes which banks have accepted and comply with, also in regard to the conduct of banking transactions. Moreover, the conformity of banks' procedures with the principles set out in the Banking Code is monitored by the Banking Code Standards Board (BCSB), which regularly evaluates and revises the Banking Code to take account of the latest changes and requirements in banking practice. The Banking Code lays down standard procedures to be followed by banks in relation to clients who are natural persons. By contrast, the Business Banking Code regulates banks' client relations with selected legal persons.<sup>17</sup> But while both codes are generally accepted by banks in practice, they cannot be described as having a legal status in the sense of generally binding legal regulations. As previously mentioned, the compliance of banks' procedures with the banking standards is based above all on the principle of voluntarism – in practice, though, the standards contained in both codes are commonly accepted, for example, in banking agreements.

## 2. Mechanism of bank lending

When deciding on whether to give a loan to a potential borrower, a British bank shall, in its capacity as the future creditor, give particular consideration to the level of credit risk in regard to the recoverability of the lent funds and to the overall financial position and standing of the prospective borrower. In addition, the bank has to consider the profitability of the loan and the overall legality of the planned financial transaction. As regards the provision of business loans, banks take the note of the current cash-flow of the borrower and whether he has sufficient funds to repay the loan. As is widely known, a bank will in its own interests expend considerable effort to determine the borrower's financial resources. A bank will also consider how the loan will be repaid – whether, for example, in regular instalments (amortized repayment), or in gradually rising instalments (balloon repayments), or in a one-time payment made upon utilization of the loan (single bullet or bullet repayment). In certain cases, such as the provision of a loan for the purpose of founding a company, the bank may charge interest on the loan only for a certain period, accepting the fact that the borrower will simply not be able to repay the loan in the initial stages

<sup>16</sup> The Banking Code was adopted by the British Bankers' Association (BBA), the Building Societies Association (BSA) and the Association for Payment Clearing Services (APACS).

<sup>17</sup> These include entrepreneurs-natural persons, limited liability companies, associations, and so on.



with the entire borrowed sum having been invested into the founding of the company.

Although the provisions of different credit agreements are not uniform, the basic provisions are very similar. Commercial credit agreements typically contain conditions precedent which the borrower is required to fulfil before first drawing the loan. The conditions precedent include the standard obligation of the borrower to submit various documents to the creditor, such as the respective founder's agreement, the consent of the debtor's supervisory board to the requested loan, a legal opinion of an independent foreign legal advisor (in the case of international banking credit agreements) or a representation by the borrower affirming the authenticity of all the warranties submitted to the creditor under the credit agreement, etc. The representations and warranties that the borrower has to submit to the creditor under the credit agreement may be divided into the two categories. The first category includes the warranties concerning the legal status of the borrower, and the second category covers the warranties relating to the borrower's overall financial position. The borrower's representations and warranties in the credit agreement may be said to fulfil an investigative function, since they provide the creditor with much important information about the borrower and about the purpose for which the loan is to be provided.

The borrower's covenants constitute another key provision in British credit agreements; along with the provision on the borrower's arrears, they represent the most revised of the contractual provisions. The borrower's basic contractual covenants pertain to providing information to the creditor,<sup>18</sup> to maintaining an adequate level of financial stability,<sup>19</sup> to restricting the borrower's rights of use in its property,<sup>20</sup> to restricting the borrower's right to offer collateral to another creditor,<sup>21</sup> and to ensuring "minimum" equality between the borrower's contractual covenants and his other unsecured obligations.<sup>22</sup> The contractual regulation of the loan security, interest rates or specific repayment conditions depends on several factors, such as the legal status of the borrower (entrepreneur, public corporation or private company, natural person), the purpose of the loan, etc. The interest rates are set by the creditor in accordance with their assessment of the credit risk, with the maturity period, and with the method of loan security, among other things.

The purpose for which the loan is provided is more or less precisely defined in the agreement, and any violation by the

borrower of their obligation to use the lent funds exclusively for the prescribed purpose<sup>23</sup> constitutes a serious breach of contract. On the whole, all credit agreements incorporate the borrower's right of early repayment or pre-payment, as well as the creditor's following rights in the event of the borrower's default:

a) to require immediate repayment of the principal and the interest, and the repayment of any other amounts which the borrower is required to pay under agreement and which fall immediately due upon the creditor's declaration; and/or

b) to annul its obligation to provide any undrawn part of the loan, by means of a declaration that any undrawn part of the loan is terminated with immediate effect. As regards particular instances of default,<sup>24</sup> the borrower is "least secure" when subject to a contractual cross-default. Where the credit agreement includes a cross-default clause, then the borrower shall be deemed to have defaulted on the agreement in the event that he defaults on another agreement concluded with the same (or a different) creditor. Given that a cross-default clause may bring an undesired "boomerang" effect upon a borrower, or in extreme cases its liquidation, prospective borrowers always do their utmost to avoid having a strict cross-default clause included in the credit agreement.

Default or cross-default is connected with one of the principles of English law – "contra proferentem". Many principles particular to the English common law (such as contra proferentem) may be used in favour of the borrower in the event of a dispute over a credit agreement. British legal experts Rutheford and Bone<sup>25</sup> define contra proferentem as "the principle according to which the least favourable interpretation of the law may be used against the party bringing the lawsuit." Although similar principles are generally used by parties before the English courts, judges do not apply them when deciding disputes over credit agreements.<sup>26</sup> Otherwise it could have happened that the court imposes a penalty on a creditor who has responded to the borrower's default by applying its right to require the immediate repayment of the loan.<sup>27</sup> The overall decision-making process and the final court's verdict is, however, always influenced to an exceptional extent by the personal and, in English law, binding legal opinion of the judge.

*To be continued in Issue no. 9/2006*

<sup>18</sup> For example, the provision of various financial statements, accounts, annual reports, and so on.

<sup>19</sup> For example, the requirement to preserve and maintain at least a minimum net worth.

<sup>20</sup> For example, precluding the borrower from entering into any unsecured financial transactions.

<sup>21</sup> Negative pledge.

<sup>22</sup> A pari-passu clause.

<sup>23</sup> Exclusivity of the prescribed or stated loan's purpose.

<sup>24</sup> For a typical example of default, see Chovancová, K., Králik, J.: Porušenie záväzkov v bankových úverových zmluvách (Breach of obligations in bank credit agreements); published in *Obchodné právo*, 3, 2002, no. 8, pages 39-46.

<sup>25</sup> *Law Dictionary*, p. 88.

<sup>26</sup> See, for example, the case of *Bank of Scotland v Ladhaj* /2000/ 2 ALL ER /Comm./ 583, 589.

<sup>27</sup> By contrast, English courts would not hesitate to impose a penalty on a creditor where the contract requires the debtor, upon default, to pay all the interest on both the drawn and undrawn parts of the loan.