# LOAN AND SECURITY AGREEMENTS

## I. Purposes of Covenants

(a) Need arises when loan is repayable at stated future maturity date rather than on demand

(1) Undertakings concerning operations and financial condition give assurance as to ability to repay (or protection to creditor in the event of default)

(2) If breached. provide a basis for acceleration and thus some degree of liquidity

## II. Categorization (not useful as an analytical tool since covenants overlap in objectives and are otherwise interrelated)

(a) Observance of generally accepted and fairly basic standards of business conduct

(1) Maintain legal existence. franchises. etc.

(2) Pay taxes

(3) Maintain properties

(4) Maintain insurance

(5) Maintain financial records in accordance with GAAP or other agreed principles

(b) Provide credit and business information

(1) Financial statements

(2) Permit inspections of records and properties

(3) Other specially prepared information: e.g. hydrocarbon reserve reports; subscriber base information

(c) Limit substantial changes in or growth of business

(1) Changes in management

(2) Engaging in different lines of business or unrelated ventures

(3) Mergers, acquisition or sales of assets

(4) Significant capital expenditures

Rationale is that creditor is lending to borrower based on assumptions as to future operations

(d) Limit competing claims of other creditors on assets

(1) Restrict indebtedness

(2) Restrict guarantees

(3) Restrict lease obligations

(e) Preserve asset quality, liquidity and availability

(1) Negative pledge, restricting liens

(2) Restrict sale leasebacks

(3) Restrict loans and advances to third parties

(4) Restrict investments

(5) Restrict dividends

(f) Satisfy ongoing financial tests indicating continued credit worthiness

(1) Net worth or tangible net worth

(2) Cash flow/coverage

(3) Working capital

(4) Debt/equity ratio

III. Affirmative/negative categorization

(a) No real reason for historical distinction; "will/will not"

(b) Affirmative covenants customarily appear first, usually standard and not subject to extensive negotiation

(c) Negative covenants customarily follow affirmative covenants

(1) Negative covenants are "tailored", financial and more important from a credit analysis standpoint

(2) Ordinarily breach of negative covenant gives right to immediate acceleration whereas affirmative covenants involve cure period

(d) Affirmative covenant re informing lenders of Event of Default--relationship with acceleration

IV. Issues raised when borrower has subsidiaries or affiliates

(a) Whether to apply covenants to borrower alone or borrower and subsidiaries

(1) Does lender rely on subsidiaries' earning power?

(2) Covenants may be applied on a "consolidated" basis

(3) A holding company (vs. an operating company with subsidiaries) will depend on dividends from subsidiaries (and possibly on interest on advances to subsidiaries) to service and repay debt

(4) Concept of "restricted" or "significant" subsidiaries'

(i) In loan agreements often defined as accounting for 10% of net income, total assets or revenues

(ii) In public debt, often defined as manufacturing or similar facility in U.S. at least 80% owned by borrower

(b) Risks of dealing with borrower having subsidiaries

(1) Lender has claim on parent company and not on subsidiaries, which may have independent indebtedness and obligations

(2) Lender's resort to subsidiaries will be limited to equity interest of parent borrower and (to the extent recognized as such) debt owed by subsidiaries to parent, i.e., usually a secondary position to creditors of subsidiaries and holders of subsidiary preferred stock

(3) Lender might require all funded indebtedness to be incurred at parent level with parent making advances to subsidiaries. Risk of "deep rock" subordination of subsidiaries' debt to parent company.

(4) Lender could obtain upstream guarantees or pledges from subsidiaries

(i) Corporate law considerations, including shareholder approvals

(ii) Risk of fraudulent transfer if subsidiary does not receive equivalent benefit. If proceeds actually advanced to subsidiary, it would get value to extent of advance and a'guarantee limited to that amount (plus perhaps a pledge by parent of the subsidiary's indebtedness on the advance) should not constitute a fraudulent transfer.

(iii) Possible equitable subordination; advisability of notice (in footnotes to financials) to subsidiary creditors

(5) Risk of substantive consolidation of parent and subsidiaries in bankruptcy proceedings; "separateness" issue

(6) Same problems exist if parent and subsidiaries are "co-borrowers"

(c) Definition of subsidiary"

( 1 ) Usually 50% or more of ordinary voting power in election of directors or similar officials

(2) Applicability to partnerships and joint ventures

(3) "Owned" or "majority owned" or "otherwise controlled"

(d) Issues to be considered in restricting subsidiaries' operations or allowing borrower to deal with subsidiaries

(1) If subsidiaries are not wholly owned, equity investments by parent may give rise to immediate dilution

(2) If minority interests exist, problems may arise if parent majority shareholder agrees to restrict subsidiaries' operations

(3) Domestic vs. foreign subsidiaries

(i) Repatriation of dividends (foreign financing)

(ii) Exchange risk

(iii) Political risk

(4) Subsidiaries in specialized or regulated businesses often carved out of covenants: e.g. insurance, finance subs, S&L's

(e) Restricted subsidiary designation/redesignation

(1) Sometimes borrower is given ability to designate and redesignate restricted subsidiaries. If so, special attention must be paid to mechanics, timing and effects of mergers and acquisitions

(2) Optional designation usually subject to limitations:e.g. ability thereafter to incur additional funded debt, minimum net worth, limit on total investment in nonrestricted subsidiaries

(3) Investment in nonrestricted subsidiaries should be deemed to include guarantees, net worth maintenance agreements, etc .

(4) Redesignation as restricted subsidiary sometimes disallowed if liens have been incurred that borrower could not have incurred under negative pledge

V. Bankruptcy

(a) Any acceleration or workout must take into account bankruptcy possibilities. If covenants too restrictive, hesitancy to accelerate will result in numerous defaults (giving rise to disclosure and accounting issues) and waivers

(b) Creditor "control" of borrower may have bankruptcy implications

(1) "Insider" of debtor has one year preference period vs. 90-day preference period

for other creditors. Insider includes any person "in control" of debtor, but "control" is not defined and is factual question. Any person controlling 20% of voting securities of debtor is deemed to be insider, but pledge of 20% of voting securities will not result in insider status unless pledgee exercises voting power

(2) There are cases to the effect that a loan payment to an independent creditor prior to 90 days before bankruptcy but during the one-year insider preference period may be recovered from the creditor i£ an insider has guaranteed the loan. The reasoning is that the payment is preferential since it is made by the debtor "for the benefit of the guarantor" (i.e., reduces its liability on the guarantee) and that Section 550 of the Code permits recovery of an avoidable transfer from both the initial transferee (i.e., the creditor) and any entity for whose benefit the transfer is made (i.e., the guarantor). A well-drafted guarantee will provide for reinstatement of the guarantor's obligations to the creditor in respect of amounts so recovered from the creditor. (c) Equitable subordination--usually control plus some inequitable conduct to the detriment of other creditors; both debt and liens can be equitably subordinated

(d) Recent lawsuits for damages independent of debtor's estate based on reliance of third parties on lenders' agreements or improper exercise of lenders' rights: e.g. construction contract-completion, maintaining insurance, etc.

(e) Most dangerous covenants are those giving lender right to direct use of funds, approve management or obtain voting control. Lender will likely have independent liability for employee withholding taxes 'if working capital loans are made and lender has knowledge that taxes are not being paid

VI. Types of lenders

(a) Banks, insurance companies and other institutional lenders,including pension plans, and public

(b) Each typically has different arrangement:

(1) Banks historically furnish short and medium term financing; other institutions furnish both this and longer term financing; public furnishes very long term financing

(2) Banks have loan agreements and insurance companies have note purchase agreements; difference is primarily historical: Banks have more "loan" flexibility (vs. "investments") and insurance companies authorized under state laws to acquire "notes"

(3) Agreements are similar. Banks tend to have negative pledge (traditional unsecured lenders) whereas insurance companies and public debt more often have pari passu negative pledge provisions. Actual implementation of pari passu security is

problematic

(4) Bank and insurance company agreements have more detailed covenants and subject to more variation; public debt generally has basic affirmative covenants and a negative pledge/sale leaseback restriction

(i) Public debtholders generally have a trading market and liquidity, enabling more risk adverse holders to transfer to less risk adverse investors. Institutional investors are generally locked in and get credit protection with covenants and right to accelerate when credit risk rises to an unacceptable level

(ii) Public not directly represented in negotiations

VII. Particular Covenants

(a) Lender could provide for right to accelerate whenever there is a material adverse change or other circumstances under which lender deems itself insecure

(1) UCC Section 1-208--good faith belief that prospect of payment or performance is impaired before acceleration permissible. Not applicable to demand obligation (or to

loans outside UCC)

(2) Common law cases applying "good faith" and "material breach" standards to decision to

accelerate (cf. "equitable principles" exceptions in opinions). Similar considerations in refusals to extend or roll-over credit under circumstances where credit commitment or course of dealing would entitle borrower to rely on continued credit availability.

(3) Specific nonambiguous covenants serve to define materiality and enhance certainty that acceleration will be enforced

(b) GAAP

(1) GAAP changes from time to time and can throw off tests and ratios, causing defaults or vitiating covenants

(2) Keeping dual books, however, is burdensome

(c) Affirmative covenants

(1) Maintain corporate existence, properties and franchises

(i) sometimes encounter limited existence, particularly with foreign entities or joint ventures

(2) Maintain insurance

(i) Question of permitting self insurance

(ii) How much is enough?

(3) Pay taxes and other obligations when due

(i) Tax claims have priority under bankruptcy code and certain state laws

(ii) State doing business and sales tax problem--hidden liabilities

(iii) Usually carve out taxes being contested diligently in good faith by appropriate proceedings provided adequate reserves are established.

(4) Continue to operate business in substantially the same manner

(5) Financial statements and other information

(i) Consolidated or consolidating financials, gear to covenants and whether subsidiaries are restricted

(ii) Usually obtain no-default certificates quarterly from officers and annually from accountants. Accountants have legal obligation to inform lenders if certificate is discovered to be incorrect

(iii) Notice of incipient and matured Events of Default, material litigation and judgments, "reportable events" under ERISA, prospective or actual material adverse change in financial condition or business

(iv) Borrowers may want financials and other information kept confidential. Lenders may need to show to regulators and confidentiality could impact participations

(6) Compliance with ERISA

(i) Liability for unfunded vested benefits can result in a lien on all assets for. an amount up to 1/3 net worth of borrower and/or subsidiaries

(d) Negative Covenants

(1) Restrictions on indebtedness

(i) Definition of "indebtedness"

(A) For "borrowed money"

(B) All liabilities on balance sheet

(C) All liabilities on balance sheet plus other items (borrowers can be creative with off balance sheet financing)

(D) Don't define--significant uncertainty results

(ii) Items often encountered include

(A) Obligations for borrowed money, or evidenced by notes, bonds, debentures or similar instruments, or on which interest charges are customarily paid

(B) Obligations under conditional sale or title retention agreements

(C) Deferred purchase price of property or services (other than accounts payable to trade creditors incurred in the ordinary course of business)

(D) Capitalized lease obligations

(E) Guarantees and contractual contingent liabilities, including keepwell agreements, take or pay agreements, etc.

(F) Liabilities for deposits and advances (insurance and construction industries)

(G) Liabilities secured by liens on assets even if nonrecourse to borrower

(H) Tax accruals

(I) Production payments

(J) Reimbursement obligations on letters of credit, bankers acceptances, etc. (double counting)

(iii) Defeasance--is defeased debt still "indebtedness"; does defeasance violate negative pledge or constitute payment; if "indebtedness" not specifically defined, courts might look to accounting treatment; defeasance of public debt creates Investment Company Act problem

(iv) Swap obligations. Are they "indebtedness" or just footnote disclosure; what if a naked swap?

(v) Not all types of "indebtedness" will be treated equally in bankruptcy

(A) Real property leases

(B) Other leases or agreements, to the extent a trustee can reject

(C) Guarantees will involve subrogation rights

(vi) Agreements usually prohibit borrower from "incurring, creating or permitting to exist" any indebtedness, except a laundry list:

(A) Notes subject to agreement

(B) Existing indebtedness (but perhaps not extensions thereof)

(C) "Current indebtedness" (due in less than one year and not renewable at option of

borrower. But lender may demand periodic "clean up" or impose a current ratio test)

(D) Accounts payable in the ordinary course of business and not overdue

(E) Perhaps. additional funded indebtedness (i.e . due after one year or renewable at the option of the borrower) if not in excess of a stated dollar amount or if a ratio of funded indebtedness to tangible net worth or to net income or cash flow for prior periods is satisfied

(F) Subordinated debt (requires definition; there are different levels of subordination)

(G) Borrowings from subsidiaries (often required to be subordinated)

(2) Negative pledge

(i) May be only covenant in a public debt indenture

(ii) Definition of "lien" can include any "mortgage. lien. pledge or other encumbrance of any nature and any assignment of rights to future income and any agreement to grant a security interest or to file a financing statement". Broad definition will pick up easements. options. contractual set-off rights. etc.

(iii) Public debt instruments often limit negative pledge to manufacturing properties or fixed assets of restricted subsidiaries and stock of restricted subsidiaries

(iv) Relationship with sale leaseback

(v) Stock of subsidiary/assets of subsidiary relationship; danger of subsidiary asset pledge

(vi) Customary exceptions include:

(A) Statutory liens, workmans compensation liens, etc.

(B) Deposits required by law (other than in connection with a contract to borrow money)

(C) Tax liens, if liability contested in good faith and appropriate reserves set aside

(D) Liens existing at the time of the agreement, and perhaps refinancing of indebtedness secured thereby so long as amount of secured indebtedness is not increased and liens are not extended to other properties

(E) Purchase money mortgages and mortgages to secure indebtedness incurred to finance acquisition of properties, but often limited to a percentage of the lower of cost or fair market value of property acquired. Also, lien should be created substantially simultaneously with acquisition or a major loophole in negative pledge would exist

(F) Liens already existing on property acquired after date of agreement, so long as not created in contemplation of acquisition

(G) A "basket" which may be calculated in terms of indebtedness secured or assets affected in relation to tangible net worth or stockholders' equity. In public debt it is 5% and sometimes 10% of stockholders equity

(H) Other minor encumbrances that don't materially interfere with use or operation of property and which do not secure monetary liabilities

(vii) Public Debt Anomalies

(A) Even if there is a negative pledge there is ordinarily no restriction on subsidiary borrowings

(B) There is often no restriction on major sale of assets or changing the nature of borrower's business

(C) Parent borrower might attempt to transfer assets to subsidiary to avoid negative pledge and incur additional indebtedness at subsidiary level; case law indicates this may not work

(viii) Margin regulations--negative pledge (and sale of asset restriction) will constitute indirect security for purposes of Regulations U if 25% or more of assets subject to covenant consist of margin stock

(3) Sale leasebacks

(i) Usually prohibited or included in a basket with permitted mortgages

(ii) Sale leaseback is no different than secured loan

(iii) Public debt instruments often permit sale leasebacks if proceeds utilized to reduce funded indebtedness; however, the borrower could thereafter reborrow amounts repaid with same effect as though new secured indebtedness had been created without concomitant retirement of funded debt

(4) Restrictions on operating leases

(5) Restrictions on capital expenditures

(6) Guarantees

(i) Preferable to define explicitly, since substantial ambiguity exists as to what a "guarantee" is

(ii) Entering into a partnership is equivalent to guaranteeing third party obligations, but is usually restricted in connection with permitted investments

(iii) Guarantees usually deemed not to include endorsements for collection in the ordinary course of business.

(iv) Agreements sometimes prohibit the borrower from subordinating indebtedness due to it; such subordination is the equivalent of a limited recourse guarantee of the senior indebtedness

(7) Investments

(i) Object is to provide asset liquidity and safety as well as prohibit expansion into different fields

(ii) Permissible investments typically limited to high quality short-term investments such as U.S. government securities, prime commercial paper and major bank certificates of deposit

(iii) Investment prohibition may extend to any equity investment (including in partnerships), the making of loans or advances, and the purchase of any debt obligations

(iv) Increasing investments in subsidiaries and forming new subsidiaries may be subject to restrictions

(8) Sale of assets

(i) Restriction should extend to stock of subsidiaries and assets of subsidiaries, as well as other assets, if reliance is placed on subsidiaries

(ii) Restriction ordinarily applies to sales of a "substantial" portion of assets in one transaction or any related series of transactions and may permit annual sales not exceeding a set percentage of net worth

(iii) Sales of inventory in the ordinary course of business not subject to restriction

(iv) Sales of receivables--are they ordinary course of business; usually perceived as indicating serious cash flow problems

(v) Asset sales may give rise to mandatory prepayments out of net proceeds (tax questions)

(9) Mergers and consolidations

(i) Concern as to changing nature of business

(ii) Mergers between subsidiaries and of subsidiaries into parent borrower usually permitted, mergers of subsidiaries with third parties may be permitted if surviving company is a subsidiary (or wholly owned subsidiary); mergers involving a non-

subsidiary could result in a "sale of assets" and/or creation of significant minority interest

(iii) Borrower mergers with third parties often permitted if borrower is survivor or obligations are expressly assumed by survivor and there is no resulting default

(10) Financial covenants

(i) Particular care must be taken to ensure that covenant works as a computational matter and is clearly spelled out. A major error often encountered is the failure to designate the balance sheet date as of which an item such as net worth is to be computed. For example, "the Borrower may sell assets in any fiscal year not in excess of 5% of the Borrower's Net Worth". Does the 5% test relate to net worth at the end of the preceding year, preceding quarter or current year? How can the lender know when the borrower is in default? Similarly, an income statement concept, such as cash flow tests and coverage ratios, must relate to a specified period. For example, it is insufficient to provide that "the Borrower will not at any time permit Cash Flow to be less than 110% of the Borrower's interest expense" .

(ii) Typical financial covenants include:

(A) Net worth or tangible net worth test; usually a dollar amount that may be required to increase over time (either in stated dollar increments or as a mandatory retention of a percentage of earnings) on the theory that long-term uncertainties require added protection. "Tangible" net worth factors out intangible assets (patents, goodwill, etc.) and, sometimes, write-ups in the book value of assets; if approached definitionally from the liability side of the balance sheet, it should also exclude treasury stock. Cost/market value accounting (B) Working capital test--usually a minimum dollar amount of current assets in excess of current liabilities. Borrowers can manipulate current assets and current liabilities under GAAP. Available borrowings under a revolving credit arrangement (even though not drawn) may be counted as "current assets" for purposes of the test; the related indebtedness would ordinarily constitute a long term liability. Deferred assets (other than prepaid items) and receivables due from affiliates are sometimes excluded from current assets; commercial paper borrowings (particularly if backed by RCAs) are sometimes excluded from current liabilities

(C) Current ratio test--current assets must bear a minimum percentage relationship to current liabilities,

e.g., 1.1 to 1. Working capital test itself would not be triggered by a large increase in both current assets and current liabilities without a proportionate increase in the spread between them

(D) Funded debt--ordinarily a ratio to tangible net worth or stockholders equity. Subordinated debt may be included in stockholders equity or tangible net worth for purposes of the test. Absolute dollar restrictions on funded debt are sometimes included. In industries with typically low or negative net worth, such as the cable TV industry, funded debt is sometimes limited on the basis of cash flow for preceding annual periods. In LBOs, which involve extremely high leverage, interest rate spreads will sometimes be automatically adjusted downward if borrower substantially reduces leverage

(E) Coverage ratios--requirement that cash flow or adjusted net income for a period bear a stated percentage (greater than 100%) relationship to interest expense during such period. For purposes of the test, noncash expenses (such as depreciation and amortization), the provision for income taxes and interest expense are added back into net income or reflected in cash flow, so that the test reflects the actual ability of the borrower to service interest expense during the period. Scheduled principal amortization may be added to interest expense-- this makes sense if, for example, additional funded indebtedness is prohibited and refunding cannot be effected

(11) Dividends and restricted payments

(i) Covenant usually restricts the payment of dividends and other distributions on capital stock and the retirement, redemption or repurchase of capital stock or options or warrants to acquire capital stock

(ii) Often, cash dividends are permitted to the extent that cumulative dividends do not exceed a stated percentage of aggregate cumulative net income

(iii) Typical exceptions include:

(A) Dividends payable in shares of common stock

(B) Cash dividends from subsidiaries to parent borrower

(C) Regular payments of dividends on, and scheduled mandatory redemptions of, outstanding preferred stock

(12) Transactions with affiliates

(i) Agreement may prohibit or restrict all transactions with affiliates of borrower or may permit transactions only in the ordinary course of business on arm's-length terms and for fair value

(ii) May also require approval of disinterested directors for material transactions and subordination of indebtedness to affiliates

(iii) Definition of affiliate can be quite broad, including, ~, holders of 5% of any class

of voting securities, relatives of officers, directors or stockholders, etc.

VIII. Events of Default

(a) Typical Events of Default include:

(1) Representation or warranty false or misleading in any material respect when made

(2) Failure to pay principal or interest on Notes or other fees or amounts due under agreement (short grace period typically provided for interest and fees but not principal)

(3) Default in the performance of any negative covenant or of the affirmative covenant to advise lender of occurrence of Event of Default

(4) default in the performance of any other covenant under agreement which continues unremedied for a grace period (10 or 15 days in bank agreements, 30 days in public debt) after initial occurrence thereof or after notice thereof is given to borrower by lender

(5) "Cross Default" to other indebtedness of borrower. Should include failure to pay when due (after any applicable grace period) any principal of or interest on other indebtedness (with such other indebtedness--but not the missed payment--typically required to be in an aggregate principal amount in excess of stated dollar amount or, less frequently, stated percentage of tangible net worth). Remaining provisions of "Cross Default" typically structured to trigger Event of Default at one of three points

(i) Actual acceleration of maturity of the other indebtedness-'--this is "cross acceleration" and has the effect of excluding lenders from participating in negotiations between the borrower and lenders having the right to accelerate. Lenders resist cross acceleration since it reduces their leverage over borrower and since borrower will attempt to obtain waiver from other lenders entitled to accelerate which such lenders may condition on granting of security, increasing interest rates, partial prepayments or other actions of borrower favoring such lenders but not lenders without presently exercisable acceleration rights

(ii) "Matured" ability to accelerate—Event of Default occurs when other lenders have the immediate ability to accelerate, regardless of whether they do (i.e., after expiration of grace periods and required notices)

(iii) Pure "cross default"--Event of Default occurs whenever any covenant is breached under agreement relating to other indebtedness which would entitle other lenders. with or without lapse of time or giving of notice, to accelerate their debt. Effect is the same as if other lenders' covenants were incorporated in agreement. Definition of

"indebtedness" may require limitation of pure cross default to certain types of indebtedness, such as indebtedness for borrowed money, or may require a grace period or carve outs with respect to "indebtedness" such as production payments, nonrecourse indebtedness or capital lease obligations where payment obligations are limited to certain assets or may be subject to good faith dispute. Sometimes cross defaults will be deemed cured if the other lenders have waived the default under their agreement prior to the time of acceleration under the agreement with the cross default--this raises the same problems discussed in clause (i) above

(6) Voluntary Bankruptcy proceedings instituted by borrower, borrower fails to controvert or consents to institution of proceedings by others, borrower applies for or consents to appointment of a receiver or trustee, borrower makes a general assignment for the benefit of creditors or borrower becomes unable, or admits in writing its inability, to pay debts as they become due

(7) Involuntary bankruptcy or similar proceedings are instituted against borrower and not dismissed for a stated period (usually 30 or 60 days)

(8) Final judgment for the payment of money in excess of minimum stated amount not fully covered by insurance remains undischarged for a stated period (usually 30 days) during which execution has not been stayed (Based on Texaco/Pennzoil experience, the "final" judgment requirement is often deleted and the legal commencement by the judgment creditor of execution on the judgment made an Event of Default)

(9) ERISA--reportable events occur which permit termination of employee benefit plans or appointment of receivers for such plans if borrower's liability in respect of unfunded vested benefits exceeds a stated minimum amount

(b) If an Event of Default occurs, lenders can, by giving borrower notice, typically (i) terminate further lending commitments and- (ii) accelerate principal and interest on Notes. In the case of bankruptcy Events of Default, such termination and acceleration is usually deemed to occur automatically without any action by the lenders, since the Bankruptcy Code automatic stay prohibits postpetition actions to collect debt or enforce security. However, if bankruptcy does occur, under the Bankruptcy Code future lending commitments are in deemed accelerated at the date the petition is filed, although postpetition interest is generally not collectable

IX. LOAN SALE PROVISIONS

(a) Nowadays, so-called "asset sales provisions" frequently occur in commercial bank loan documentation.

(1) In simplest form, provisions permit lenders to sell or assign loans or participations in loans to third parties without consent of borrower. If certain conditions are met, the participation will receive GAAP and RAP accounting treatment as a "sale", enabling selling bank to remove asset from its balance sheet and cease to maintain capital in respect thereof.

(2) GAAP permits sale treatment if sale to maturity and no repurchase option on part of seller. RAP requires, in addition, that sale be totally without recourse to seller.

(3) "Strip sales" developed in connection with RCAs, e.g., defining each interest period as a separate borrowing which is due and payable on last day of interest period. Banks then sold participation in the resulting short-term loan to maturity. FRB now takes position that "strip sales" do not qualify for sale treatment because, as a practical matter, selling banks are committed to refinancing strip loans at maturity with new loans under RCA. Accordingly, to get RC loans off balance sheets, banks must assign RCA lending commitment to participant as well and, in effect, substitute the participant for the bank as a lender under RCA. Borrowers may have problems with this. Term loans sold to maturity do not involve same problem.

(b) Participation agreement may provide for various benefits, for example, yield protection, indemnities for breakage, reserve cost reimbursement, etc., to be passed on to participants.

(c) Comptroller has stated that purchase of loans and participations in loans may constitute an unsafe or unsound banking practice in the absence of satisfactory documentation, credit analysis and other risk controls. Accordingly, seller of participation would generally commit to provide credit information to purchaser on a continuing basis and loan agreement would permit seller to pass such information to participants. Borrower may require participants to commit to maintain confidentiality of information.

x. LENDER LIABILITY

(a) Number of cases impose liability on lenders, often as a result of exercising "control" over borrower

(1) taking actions indicating "ownership" such as exercising voting power, selecting or dismissing management

(2) taking actions usually reserved to management, such as financial decisions, taking control of or operating borrower's properties

(3) monitoring and advising insufficient

(4) if lender exercises "control" will be held to higher standard and may be viewed as a fiduciary

(b) Bases of liability:

(1) Common law fraud--misrepresentations to cause borrower to take action.

(2) Duress--lenders may be liable for economic duress if they threaten to take action (even. if they have legal right to take it) unless borrower agrees to their terms.

(3) Tortious interference--lenders interference with borrower's existing or prospective contractual relations. Requires (w) existing (or reasonably certain prospective) enforceable contract, (x) of which lender has knowledge, (y) with which lender intentionally interferes (z) causing borrower damage.

(4) Controlled borrower as "alter ego" of lender.

(5) Negligence

(6) Promissory estoppel

(7) RICO ("pattern of racketeering activity")

(c) Environmental liabilities

(1) A number of states have stringent environmental laws relating to hazardous waste clean-up. Four states (Mass., N.J., N.H. And Tenn.) grant the state a super-priority lien to secure clean-up costs senior to previously perfected security interests in real and personal property

(i) In Mass., lien only applies to polluting asset

(ii) In Tenn., lien is to extent of increased value in property as a result of clean-up

(iii) In N.J. and N.H., lien is on all assets and will prevail over lender security interests which were obtained, e.g., at a time prior to borrower's acquisition of a polluting asset

(2) Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA")

(i) Clean-up costs may be recovered from:

(w) owner of operator of facility;

(x) any person who was an owner or operator of facility at time hazardous substances were disposed of there;

(y) any person who arranged for disposal of its hazardous waste at a facility owned by

another;

(z) any person who transported hazardous substance to a facility selected by it

(ii) "owner or operator" does not include lender which without participating in management of facility holds indicia of ownership primarily to protect security interest. One court has limited this defense to deed of trust situation; may not be defense after foreclosure or if bank purchases at foreclosure sale. Other decisions to contrary.

(iii) Secured lenders may have liability under CERCLA if they "control" borrower or participate in day to-day operations or management.

(iv) Obvious potential liability in connection with repossession of personal property containing hazardous material.