

INTERNATIONAL PROJECT FINANCING

HOW DOES A SYNDICATION AGREEMENT DEAL WITH THE CONFLICTING INTERESTS OF LENDERS?

EIGBE ODIANOSEN

o.s.eigbe@dundee.ac.uk

Abstract: In a world of high costs and high risk investments, the importance of project finance has never been underestimated. This however becomes even more crucial when approached from the point of view of the project lender, who would clearly appreciate the need to share the costs and risks associated with high cost project financing. Syndicated loans have been known to provide the avenue through which large amounts of finance can be raised, while at the same time reducing the risks to each of the project lenders. In line with such an arrangement, a syndicated loan agreement would usually be entered into by a consortium of lenders; each having its needs and objectives peculiar to itself. This paper examines the way in which the individual rights, duties, obligations, powers, liabilities and limitations of lenders may be designed within the loan agreement to avoid or minimise any conflicts of interests or objectives which may arise.

1. INTRODUCTION

Modelled after the United States multi bank floating rate system, syndicated agreements involve the lending of substantial sums, the underwriting and management of which are handled by more than one financial institution¹. Syndicated loans have since the 1980s emerged as an attractive method of financing oil and gas investments, due to the huge capital and risks associated with such projects. Participants in syndicated loans usually include all types of financial institutions, but are mainly constituted by International banks².

The finance arrangement is structured and managed by one of the lending institutions, known as the lead bank. A syndication agreement is drafted to deal with the relationship between the lead bank and the other syndicate members, on one hand, and the relationship between the individual syndicate members among themselves, with regard to the finance of the project concerned. The need for a syndication agreement cannot be over emphasized. In as much as the interests of banks largely coincide in terms of being repaid their debt in the manner and time envisaged, there is to some extent a conflict of interests, policies and principles, which need to be addressed by some form of agreements between these banks, hence the syndication agreement³.

The aim of this paper is to establish the ways in which a syndication agreement deals with the conflicting needs of lenders. Chapter Two would establish the background to syndication agreements and identify the relevant principles which govern these agreements. Having established that a syndication agreement governs the relationship between the lead bank and the syndicate banks on one hand, and the relationship between the syndicate banks on the other, Chapter Three would attempt to analyse how the former relationship is governed by the syndication agreement, while Chapter Four would deal with the latter relationship under the agreement.

¹ Khambata, D., The Practice of Multinational Banking: Macro-Policy Issues and Key International Concepts (1996) p.225.

² Nevitt, P., and Fabozzi, F., Project Financing, (7th Edition, 2000), p. 83.

³ Chance, C., Project Finance, (1994), p.12.

2. **BACKGROUND TO THE SYNDICATE STRUCTURE**

2.1 **FORMATION OF A SYNDICATE**

As noted earlier, financing of oil and gas projects may need to be done *en route* a syndicated loan structure because of the amount of financing required or because the risk factor necessitates dispersion over a number of institutions. Within the syndicated structure are a number of alternatives; however, the project sponsor starts by designing a borrowing strategy and finance structure best suited to its needs and objectives⁴. Once this is decided, the sponsor invites bids from one or more lenders to bid for the position of the lead manager⁵. This may be done by open bidding, select bidding or queue⁶. The sponsor then makes its decision by granting its mandate for the lead management position to a bank or a consortium of banks.

The project sponsor prepares an information memorandum⁷ and presents this, together with the term sheet⁸, to the lead manager who forwards the same to interested banks. Applications are subsequently received from interested banks; and one of three situations may arise at this stage. Firstly, the loan may be fully subscribed, at which stage negotiations commence leading up to the syndication loan agreement being drawn up, and an effective syndication put in place. Secondly, the loan may be over-subscribed, creating the need for participations to be prorated among the interested banks⁹. Alternatively, the loan may be under-subscribed, and the borrower would have to make do with less or the banks in the management group would have to book the balance themselves, thereby exceeding their target takes, if syndication is fully committed¹⁰.

⁴ Supra, note 1, p.231.

⁵ The lead manager would remain the vehicle for structuring, placing and managing the loan and is perhaps the most critical element in the syndication process.

⁶ The queue is not very popular, but involves the sponsor offering the mandate on a rotation basis, if the first lender refuses.

⁷ This contains the financial, economic, historical and political facts pertinent to current and proposed credit worthiness.

⁸ This contains the conditions of the loan, prefaced by a disclaimer of all responsibility for its content on the part of the lead manager.

⁹ Smith, R., and Walter, I., Global Banking (1997) p. 26.

¹⁰ Ibid.

It should be pointed out that neither over-subscribed nor are under-subscribed loans attractive, as they result in unhappy lenders and unhappy sponsors, and may put the competence of the lead manager to question.

2.2. THE SYNDICATE STRUCTURE

2.2.1 THE LEAD BANK OR 'AGENT'

Theoretically, once the loan agreement is signed, the lead bank is replaced by an Agent, who becomes responsible for the administration of the loan. In practice however, both functions are usually performed by the same bank¹¹.

The duties of the Agent are usually set out in the loan agreement, and are administered in return for a compensatory fee. These duties may be grouped into contractual and ancillary duties, for the purpose of convenience. The contractual duties of the Agent usually include: ensuring that the borrower has complied with any condition precedent, acting as a paying bank in respect of transfers of funds between the borrower and the syndicate, monitoring the covenants of the loan agreement and taking appropriate action in the case of default by the borrower¹². The Agent also performs ancillary duties, such as receiving formal notices from the borrower, including borrower's financial statements and reports¹³.

2.2.2 THE CO-LENDERS

The co-lenders would normally constitute a consortium of banks or other financial institutions who have contributed a percentage share towards the syndicated loan. Once these institutions have advanced their quota of the loan, and the syndicated loan agreement is signed; they usually take a more passive role in the project, relying to a large extent on the competence of the Agent to further their interests.

¹¹ Rampaul, I., *How does a syndication agreement deal with the conflicting needs of lenders?* http://www.dundee.ac.uk/cepmlp/car/html/car4_art8.htm (last visited on 20 April 2004).

¹² Hobson, M., <http://www.lexisnexis.com.au/nlr/articles-files/bank/> (last visited on 22 April 2004)

¹³ Ibid.

2.2.3 THE SYNDICATION AGREEMENT

The syndication agreement is a document which establishes the relationship between the project sponsor and the syndicate lenders, on one hand and the between the syndicate lenders *inter se*. It marks the final stage of the pre-contract syndication process, and once it is signed by all the parties involved, it becomes a binding agreement, enforceable by law.

The aim of the agreement is to cater for the special and conflicting needs of all the parties involved. However, the discussion in this paper would be restricted to the ways in which this agreement caters for the needs of the lenders to the syndication agreement.

3. HOW ARE THE CONFLICTING INTERESTS OF THE AGENT AND THE CO-LENDERS DEALT WITH IN THE SYNDICATION AGREEMENT?

The syndication agreement must adequately balance the interests of the Agent and the co-lenders¹⁴. One of the purposes of the syndication agreement is to appoint the Agent, who would be responsible to carry out its duties in the interests of all the lenders involved. This relationship between the Agent and the co-lenders and between the agent and the borrower represents the main source of conflict, which although addressed by common law, needs to be defined with considerable precision and dealt with adequately in the syndication agreement¹⁵.

In determining the relationship between the agent and the co-lenders, the Agreement would usually contain words to the effect that "nothing in this Agreement constitutes the Agent as trustee or fiduciary.....". Whether this provision will be upheld remains to be seen as courts have always looked at the substance of an agreement rather than the form.¹⁶ If the Agent wishes to escape or modify any of the fiduciary duties,

¹⁴ Supra, note 11.

¹⁵ Sullivan, J., *The Roles of Managers and Agents in Syndicated Loans* [1992] *Journal of Banking and Finance Law and Practice* 162, p.167.

¹⁶ Supra, note 11.

which may be implied by law¹⁷, it must therefore ensure the necessary clauses are placed in the Agreement. This Chapter attempts to establish the duties owed by the agent to the co-lenders, as expressed from the substance of a typical syndication agreement. If these duties are clearly expressed in the agreement, it should go a long way to deal with the interests of conflicting lenders.

3.1 FIDUCIARY DUTIES

3.1.1 DUTY TO ACT IN THE BEST INTEREST OF THE SYNDICATE

This duty of the agent bank is two-fold. On one hand, it implies the duty to avoid a conflict between the personal interest of the Agent and the interest of the syndicate. This is especially crucial where the Agent subsequently develops some other form of relationship with the sponsor, such as being its financial advisor or becoming a lender in another context¹⁸. This creates an inherent conflict and the syndicate agreement would not go as far as to restrain the agent from entering into some form of relationship with the sponsor. All that is required of the agent is a full disclosure of all the material facts of those duties to the sponsor which may conflict with its duties to the syndicate¹⁹. This duty is typically addressed in the agreement by a clause worded along the following lines:

*"The Agent shall have the same rights and powers hereunder as any other Bank and may exercise the same as though it were not the Agent"*²⁰

The second aspect of this duty owed to the co-lenders is the duty to disclose secret profits made in the course of his duty as an agent to the syndicate.

3.1.2 DUTY OF SKILL, CARE AND DUE DILIGENCE

The Agent is required by law to fulfil his duties to the syndicate with skill, care and diligence to the standards of a reasonable man and would be liable to his principal in

¹⁷ For example, section 2(1) of the Misrepresentation Act of 1967 and The Unfair Contract Terms Act.

¹⁸ Langer. V., Syndicated Loan Agreements: Role of the Agent Bank <http://www.ganz-recht.de/stlehere/Ausland/finl2.htm> (last visited on 25 April 2004)

¹⁹ New Zealand Netherlands Society Oranje v. Kuys

²⁰ Gooch, A. C. & Klein, L.B., Annotated Sample Revolving Credit Agreement, 3rd ed, International Law Institute, (1998).

negligence for failure to perform to these objective standards²¹. This usually represents a source of conflict between the parties as the Agent is not willing to assume such a high duty of care, as its fees are not sufficient to pay for bearing such risk²². What the syndicate agreement does is to cater for this conflict by providing for an express clause worded to the effect that:

*“The Agent shall have no responsibility for any action taken or omitted to be taken in connection with this agreement...save for actions arising out of gross negligence or wilful misconduct”.*²³

3.1.3 DUTY TO DISCLOSE INFORMATION

The Agent owes to the co-lenders a duty to disclose any information regarding the financial status of the sponsor, which are likely to result in a default of payment by the latter²⁴. This is to enable the co-lenders take informed action, such as suspending any further borrowings and accelerating the repayment of the loan. The Agent represents the link between the sponsor and the co-lenders and should pass any such information to the latter without delay.

However, another situation arises where the Agent obtains such information in confidence, as a result of financial services performed for the sponsor. In this situation, the interest of the Agent would conflict with that of the co-lenders and has to be addressed in the syndication agreement. Such a provision would be drafted to exempt the Agent from disclosing any information to the co-lenders, which may in its opinion, place it in the position of breaching the law or any duty of confidence owed to the sponsor²⁵.

3.2 DISCRETION OF THE AGENT

It is usually provided for in syndicated loan agreements that the Agent shall follow the instructions of the majority banks in the fulfilment of its rights, obligations and

²¹ *Beal v. South Devon Railway Co.*, (1864) 3 HOC C377 at p 341

²² *Supra*, note 11.

²³ *Supra*, note 20.

²⁴ *Supra*, note 11.

²⁵ *Ibid.*

duties²⁶ and the Agent is only required to make minor decisions such as the choice of an auditor and the value of collateral. The discretionary powers of the Agent and any limits thereof must be adequately defined in the agreement.

It becomes obvious in the light of the foregoing that the discretionary powers of the Agent are usually limited. This approach is suitable to both the Agent and co-lenders, as it enables the former to escape liability; and for the latter, it enables them retain some degree of control. It may however have its downsides for both parties in a situation where the Agent needs to take urgent action to protect the interest of the syndicate, such as in the case of a default²⁷. The result is that the Agent may be unable to act until it has received a majority decision from the co-lenders, which would usually be located in different countries²⁸. It has however been suggested that a clause should be inserted into the syndication loan agreement authorising the Agent to accelerate the loan where it would be in the general interest of the syndicate to do so²⁹.

3.3 DEFAULT CLAUSES

Default by a lender to make good the value of its commitment when due may ordinarily make the bank liable to the sponsor, who may bring an action in damages against the Agent for the shortfall³⁰. Hence, it becomes necessary for the Agent to be protected against this by the syndication loan agreement. This may be done by providing expressly that the Agent is the agent of the banks and not the sponsor and accordingly, owes no such duty to the latter³¹. Also, where the Agent instructs full transfer of funds to the sponsor on behalf of a lender, and such lender subsequently defaults in making a repayment of the same to the Agent, the syndication agreement should provide for the 'Claw back' provision to take effect³².

²⁶ Wood, P. International Loans, Bonds and Securities Regulation, (1995)

²⁷ Supra, note 11.

²⁸ Ibid.

²⁹ Rampaul, I., *How does a syndication agreement deal with the conflicting needs of lenders?* http://www.dundee.ac.uk/cepmlp/car/html/car4_art8.htm (last visited on 26 April 2004).

³⁰ Prehn v. Royal Bank of Liverpool

³¹ Gabriel, P., Legal Aspects of Syndicated Loans, (1986)

³² Donaldson H, Lending in International Commercial Banking, Butterworths (1979), p 77. The effect of this provision is that the borrower would have to repay the Agent the defaulted sum plus any interests.

3.4 EXCULPATION CLAUSES

Exculpation clauses are provisions within the syndication agreement which are inserted to exclude or limit certain fiduciary duties which may otherwise arise. They are usually drafted to exempt the Agent, its officers, employees from any liability for default or omission, other than due to gross negligence or wilful misconduct³³. To this end, an exculpatory clause may be worded thus:

*“Neither the Agents nor the managers would be responsible to any bank for the execution, genuineness, validity, enforceability, collectibility or sufficiency of the loan agreement”.*³⁴

Another exculpation clause which is believed to be of utmost importance to the Agent is the provision to the effect that the other banks have done their own individual credit analysis and document review of any information contained in the Information Memorandum, and are not relying on the Agent’s advice in joining the syndicate³⁵. To this end, the information memorandum is usually prefaced by a disclaimer by the manager of all responsibility for its content³⁶.

4. HOW ARE THE CONFLICTING INTERESTS OF CO-LENDERS DEALT WITH IN THE SYNDICATION AGREEMENT?

This Chapter addresses the second aspect of the conflicting interests of lenders, which is the relationship of the co-lenders among themselves and how this may be dealt with under the syndication agreement.

4.1 DEFAULT CLAUSES

Default may arise from non-payment of the loan, non-compliance with covenants, such as a negative pledge or representations and warranties or may take the form of a cross default which arises from non-payment by the sponsor of any other loan when due³⁷. The issue of default is one of the most important and controversial clauses in the syndication agreement and must be adequately dealt with. The Agreement must

³³ Supra, note 29.

³⁴ Wood, P., Law and Practice of International Finance, (1980) Sweet & Maxwell, London, p.236

³⁵ For further details, see Hisert, G., Exculpatory Clauses in Syndicated Credit Agreements, in <http://www.brobeck.com/articles/exculpatory.html> (last visited on 26 April 2004)

³⁶ Supra, note 8.

³⁷ Supra, note 18.

include specific clauses to ensure that banks are not prejudiced in relation to other creditors, and these include negative pledges, *pari passu* covenants and cross default clauses³⁸ or cross acceleration clauses.

The event of default by the sponsor should give rise to certain remedies by the banks, and these must also be provided for under the syndication agreement. The available remedies may include a right to accelerate the loan, cancellation of all obligations to lend further loans or suspension of further loans through the application of the condition precedent clause³⁹.

4.1.1 THE RIGHT TO ENFORCE REMEDIES

Once the syndicate loan agreement has provided for default clauses and remedies, it must take a step further to organise how these clauses may be enforced upon default. The fundamental principle here is that minority interests should not be subdued by the majority. It has been suggested that in the interests of the syndicate, the right to accelerate cannot be unilaterally exercised by one bank⁴⁰; however, the Agreement would usually contain an extensive provisions to give individual banks the right to protect and enforce its rights under the Agreement.

4.1.2 THE SHARING CLAUSE

A sharing clause is one of the tools used to ensure syndicate equality, hence balancing the interests of individual lenders. The sharing clause is designed to share individual receipts by one bank, through set off, proceeds of litigation and direct payment by the borrower, in accordance with their prorated participation. The sharing clause may be designed to allow for double dipping⁴¹ or may exclude sharing if the receipt of payment is from a third party e.g. a private guarantee given to one bank only⁴².

The importance of the sharing clause can especially be appreciated in the event of default. It has been observed that in this situation, banks adopt a Machiavellian

³⁸ Supra, note 11.

³⁹ Supra, note 18.

⁴⁰ Ibid.

⁴¹ This occurs where the bank sets off a certain amount against the deposit of the borrower, and must in addition pay the same to the Agent for distribution under the prorate sharing clause.

⁴² Supra, note 18.

attitude to the detriment of other banks and the effect of sharing clauses is to protect the minority banks from the more powerful ones⁴³.

4.2 SYNDICATE DEMOCRACY

Syndicated loan agreements usually contain provisions for decision making by the syndicate banks. In this regard, the voting clauses should be drafted so as to ensure that the syndicate obtains majority consensus before acting, while at the same time, ensuring that the minority do not frustrate the decisions of the majority⁴⁴. Votes are usually measured according to bank participation and a majority vote would usually be obtained through a 50% simple majority or a 66% absolute majority, and whichever the case, this must be expressly provided in the syndication agreement.

One of the most important aspects of syndicate democracy, which must be addressed in the Agreement, is the issue of amendment. The Agreement should expressly distinguish between issues which must be permitted by majority, on one hand; and those which do not need to be permitted by majority on the other. The amendments which are generally permitted by a majority may include: waivers of breaches of covenants or relaxation covenants e.g. negative pledge; acceleration of loans in the event of a default; the determination of whether an incorrect representation or an adverse change in financial condition is material for the purposes of the event of default. Other issues which may not require amendment by the majority may include: the waiver of conditions precedent, extension of maturities, the reduction of amount of payment and the reduction of interest rate. In the same vein, other amendments may require unanimous approval, such as a decision on change of currency.

This power to exercise the syndicate voting rights must be exercised in the interest of the syndicate, but not to the detriment of the voter⁴⁵. If adequately addressed in the Agreement, the syndicate democracy clause should be very instrumental in balancing the decision making interests of the co-lenders to the syndication agreement.

⁴³ Supra, note 11.

⁴⁴ Ibid.

⁴⁵ *C.E.G. Logue v. Shoalhaven* [1997] 1 NSWLR 537 (cited in Rampaul, I., *How does a syndication agreement deal with the conflicting needs of lenders?*)

4.3 LOAN TRANSFERS

A loan transfer takes the form of the sale of an interest in the syndicate, by a member of the syndicate to another financial institution. The syndication loan agreement must be designed to cater adequately for loan transfers. Prerequisites to loan transfers, such as pre-emptive rights, minimum standards and timing, must be expressly provided in the Agreement. In designing a clause to provide for loan transfers, the interests of the syndicate as to standards⁴⁶ must be balanced with the anticipated interests of the bank wishing to make a sale in future; hence the conditions precedent must be neither too lax nor stringent in order to balance the interests of all the lenders.

4.3.1 ASSIGNMENT

Under an Assignment, the selling bank transfers a loan to the buying bank by assigning its rights against the borrower to the latter. The effect of an assignment is that the buying bank becomes the assignee and is empowered to recover the amount of loan and interest from the borrower, in the time and manner agreed under the initial finance arrangement with the assignor. An assignment may be legal⁴⁷ or equitable⁴⁸, and only transfers rights and benefits but not obligation⁴⁹.

4.3.2 NOVATION

This involves the substitution of all the creditors by an Agreement with the consent of all parties, as a result of which the contract between the borrower and the lending bank is rescinded and replaced by a new contract between the borrower and the purchasing bank, based however on the same terms⁵⁰. A sale by novation would normally require the consent of the borrower and all the co-lenders to the syndicate agreement.

⁴⁶ These standards would normally be minimum standards as to reputation of the purchasing bank, financial condition and the need to avoid fragmentation of the syndicate.

⁴⁷ A legal assignment must be in writing and must be absolute.

⁴⁸ An equitable assignment is effective without notice and it is possible to transfer only a part of the debt.

⁴⁹ Supra, note 11.

⁵⁰ Holger, V., Loan Transfers/ Sale of Loan Assets, <http://www.ganz-recht.de/stlehre/Ausland/fin14.htm> last visited on 29 April 2004.

4.3.3 SUB-PARTICIPATION

A sub-participation does not involve a transfer of rights and obligations of the original loan agreement. It is rather a separate agreement with the buying bank, under which the latter transfers an amount to the selling bank, equivalent to the selling bank's participation in the primary loan. The legal structure of this arrangement is that of a back-to-back loan, which provides the seller with a non-recourse funding arrangement, and transfers all risks of default and non-payment to the buying bank⁵¹.

5. CONCLUSION

It is imperative for a well-designed syndication agreement be extensively worded to cater adequately for the needs of all the lenders to the syndication agreement. The Agent must be well protected within the Agreement and should not be over-burdened with liabilities. The importance of exculpatory clauses in this regard, cannot be over-emphasized. Similarly, the relationship between the co-lenders within the Agreement should be governed by equity, adequately balancing the interests of majority lenders with the minority.

Situations of default, syndicate democracy and loan transfers constitute the trial period for the determination of the sufficiency of the syndication agreement. A well-drafted Agreement would ensure minimum friction, even in these situations.

⁵¹ Ibid.

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