Syndicated Lending – Standard Documents and other Developments

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1. The concept of the standard document

Where there are a great number of similar transactions in a market, then it is in the obvious interests of participants to have standardised documentation, to reduce transaction costs, and increase efficiency, by reducing the time necessary to produce the documentation. In turn that helps to promote the use of that market.

(a) Standard documents in other markets

Derivatives and trading

Standard form master agreements are common in derivatives and various commodities trading markets. There is now a regular AS[1] of acronyms. Examples include the ISDA master agreement for derivatives produced by the International Swaps and Derivatives Association, the IFEMA[2] master agreement for foreign exchange transactions, the CPMA (Cross Product Master Agreement) for netting across products, the GMRA[3] for repo transactions, and the OSLA, GMSLA or AMSLA[4] for securities lending.

Capital markets

Standard documents are increasingly common in the capital markets.
For ECP programmes in 2000, in a peculiar situation, a standard form dealer agreement was agreed by participants at a meeting of a committee of the European Commercial Paper Association, but not formally adopted by the meeting. That document, or documents virtually identical to it, are now used throughout the London market. In March 2003 the International Primary Markets Association (IPMA) produced a set of market conventions for the ECP market, covering such items as minimum denominations and minimum and maximum maturities for ECP.

The fact that the dealer agreement had effectively become standard was raised at a recent meeting of the British Bankers Association where the majority of those present favoured approaching the Bond Market Association to assist in implementing a standard form dealer agreement following its success in agreeing a standard global commercial paper dealer agreement.

English law firms, dealers and paying agents worked last year with the Bank of England to agree on standard documentation for the issuance of Eligible Debt Securities in dematerialised form which are to be settled through CREST. These documents are available on the Bank of England website.

As to US commercial paper, the Bond Market Association has a set of standard form dealer agreements available on their website which are used in the market.

DTC (Depository Trust Company of New York) also has a set of standard documents on its website which are used for issuance of USCP.

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[1] Alphabet Soup.

[2] International Foreign Exchange Markets Association.

[3] Global Master Repurchase Agreement developed by ISMA and the Bond Market Association.

[4] Overseas Securities Lenders Agreement, Global Master Securities Lending Agreement and Australia Master Securities Lending Agreement.

As to global CP, a standard dealer agreement was drafted over a number of years and finally agreed in early 2003. Banks in New York and London were involved as were a number of law firms.

For MTNs, IPMA has produced a standard form of subscription agreement, pricing supplement and comfort letter, and standard wording for a number of clauses. Dealer agreements tend to vary between law firms.

In Australia AFMA (the Australian Financial Markets Association) has a committee looking at documentation, but to date has concentrated on standard clauses. A draft template information memorandum has been circulated.

Loan agreements – the model NPA

Model loan agreements are more rare.

One very successful example is the US private placement market, where funds are borrowed from insurance companies, to be held for the long term. That market is now a major source of funds for Australian Borrowers. There has been since 1994 a successful model note purchase agreement, which is the basis now of all transactions. Participants in the market when circulating drafts give a mark-up against the model. That mark-up is an easy point of reference for the non-drafting party and to all other participants in the transaction.

The model was put together by the Private Placement Enhancement Project, which included leading institutional investors, lawyers and investment bankers. Since its adoption, there has been a significant increase in the size and reach of the market. The form is highly prescriptive. There is considerable resistance in individual transactions to changes, though there can be variations, particularly warranties, undertakings and events of default.

(b) The bank lending market

In the bank market generally standardisation has proved more elusive but is developing.

Each bank has its own standard forms for bilateral documentation. Some borrowers also have their own. Law firms have their own. The American Bar Association has had for some years a model credit agreement task force, but has not yet produced an agreement..

In the syndicated loans market, while many law firms have had their own standard forms, the concept of a standard document for many years proved elusive. In syndicated loans, there is the additional incentive for standardised documentation in achieving liquidity, and to make secondary trading easier. In London an association was formed in 1996 by leading participants in the syndication loan market, the Loan Market Association (***LMA***). It worked on producing a standard set of "Primary Documents" for use in the syndicated loan market. The initial drafts were published in 1999. Despite some initial scepticism, these are now widely used as a model, and form a basis of most loan documents in the corporate loan market coming out of London. They are also increasingly used throughout Europe.

I discuss in greater detail the history of the LMA document below. It is the model for the documents now produced for the Australian market by the Asia Pacific Loan Markets Association (***APLMA***).

In America they appear to have gone a different route. The equivalent body to the LMA, the LSTA, (the Loan Syndication and Trading Association), in January 2004 published a set of "model credit agreement provisions" which contains most of the boilerplate, for example, yield protection, set-off, sharing of payments, agency provisions and the like and the definitions used in those provisions. It was put

together by a committee with assistance from Millbank Tweed and input from the ABA task force. They have not gone so far as to try and produce a standard document or the standard mechanics, representations and warranties, events of default and undertakings. The provisions were discussed with the ABA Task Force. The drafting is very "American".

It is early days yet. I am told they are being used, but it is not uncommon for borrowers to want to stick to their existing documentation.

(c) The LMA Documents

The Primary Documents project was begun by the LMA to provide a standard form of syndicated facility agreement in response to demand from the syndicated lending market .

At the outset various formats were considered by the LMA, including an approach to documentation very similar to the ISDA style of master agreement and confirmation of terms. That approach was, thankfully, rejected, so that those involved in producing loan documents are not stuck with a nightmarish life like those who have to toil with the standard ISDA documentation, schedules and confirmations and its transatlantic committee-camel drafting style.

It was felt instead that it would be more appropriate to follow the then current market practice and develop a standard facility agreement which could be amended as necessary to deal with transaction-specific requirements.

They formed a working group consisting of representatives of the LMA, the British Bankers Association, the Association of Corporate Treasurers and major London law firms to consider drafts. The initial draft was produced by Clifford Chance.

The document was, therefore, from its very early stages considered by both borrowers' and lenders' representatives and it was hoped that it would be recognised as a balanced and reasonable starting point. The intention was to provide a position that reflects the then current London market practice for an unsecured syndicated corporate loan facility, to a UK incorporated company with an investment grade credit rating.

As a result, in October 1999, the LMA produced a set of standard Primary Documents for various types of facilities which contained the imprimatur of those three organisations, together with a users' guide. The documents have become colloquially known as the "LMA".

The resulting document is a workable, generally readable document which is considered to be "plain English", though by Australian standards it is perhaps unnecessarily wordy and long.

It has since achieved almost universal market penetration, and except where history dictates a different document, it is now used for most unsecured corporate loan facilities. Allen & Overy still have their own form but it is consistent with the LMA forms, using boilerplate that is identical in wording or in principle. Some agents have variations on the agency clause, some banks have specific "know your customer" language.

It has however not represented the end of life as we know it, for those lawyers involved in producing documentation. While most boilerplate is in a settled form, there is still room for some negotiation of those points, and parties can concentrate on the more important issues like representations, warranties, financial ratios, undertakings and events of default.

Term sheets don't have to elaborate on boiler plate, usually they can simply say that the format will be LMA or an existing agreement. Initial draft documents are accompanied by a mark-up against the LMA.

The Primary Documents do set out a relatively full set of representations, warranties, undertakings and events of default, but in some cases set out alternatives and in others, for the most contentious clauses, left them entirely blank, like the definition of material adverse effect, and the material adverse change clause.

The User's Guide for the LMA itself provides:

> *"it is expected that many of the mechanics and boilerplate provisions of the Primary Documents will not require further consideration or negotiation. However, a large number of provisions will need to be amended on a case by case basis. In those cases, the Primary Documents provide a sensible starting point only and do not attempt to deal with the complexities of each transaction. In particular, the provisions setting out the representations, undertakings and events of default are not intended to be exhaustive or absolute. It is expected that further representations, undertakings or events of default may need to be added and the Clauses that are included may need to be amended. The recommended forms of Primary Documents do not preclude this."*

The introduction of the standard form has been a major achievement in that market, and overcame initial scepticism. In one sense it is easier to achieve in London than in Australia, given the greater depth of the market and perhaps the greater readiness to treat market practice as something akin to wholly writ, that emerges from beneath a burning bush, rather than as something to be challenged and tested.

In Australia acceptance of a standard may take a little longer for the reasons discussed later in this paper.

Since producing the Primary Documents, the LMA has also produced a standard set of secondary trading documents, a standard term sheet and a set of standard facility agreement for leveraged transactions.

A new edition of the Primary Documents has recently been released.

(d) The Asia Pacific Loan Markets Association

This Association was formed in the late 90's by banks participating in the Asian market, mainly in Hong Kong, as the local equivalent to the LMA.

In June 1999 an Australian branch was established, and quickly became the most active branch

The APLMA wanted to establish standard documents in its markets, equivalent to the LMA, and in early 2000 entered into an agreement with the LMA to develop the LMA for use in the Asia Pacific region. A documentation committee was formed in Hong Kong to develop an Asian version. The Australian branch established its own subcommittee to produce documents for the Australian market and retained Allens Arthur Robinson for the production of the drafts. The subcommittee consists of representatives of the four major Australian trading banks, Deutsche Bank and Toronto Dominion, Allens Arthur Robinson, Clayton Utz and later Freehills. Allens were appointed as lawyers to prepare the documentation.

At a very early stage, the decision was made to follow as closely as possible the LMA form, rather than to branch out on its own. Tempting though it might be to start out afresh, to put our personal stamp on it, and to attempt to prove in another field of activity, the superiority of Australians, there are three powerful reasons to stick with the LMA:

(i) the loan syndication market is an international one, so that the use of an internationally recognised form could only assist in the marketability of Australian loans overseas;

(ii) it was easier to establish that clauses were standard,if they had been adopted by the same institutions elsewhere and were internationally recognised as such; and

(iii) it would save reinventing the wheel, and the cost that that would represent.

Therefore, (although that principle is eroding slightly in the later edition which is being produced as we speak), as far as possible the loan documentation which has been produced by the APLMA Australian branch does track word for word the LMA document. We have bitten hard and resisted the temptation to improve the drafting style or change the drafting, except where necessary.

Some areas of departure from the LMA are outlined below (see section 2). The main areas of difference arise from the following:

(i) the different funding arrangements, based on Australian dollars, so that there are references to BBSY as well as to LIBOR and a reliquefication bill clause; references to mandatory costs have been removed;

(ii) the different legal regime, though in most material respects the laws of England and Australia are identical;

(iii) the different tax regime, the gross-up clause is somewhat different, and the clauses which in England apply to VAT have been generalised so as to include all indirect tax like GST; and

(iv) some changes to reflect different market conditions, in some respects Australian documentation is a little more "borrower friendly" than that used in London, reflecting different market dynamics, though in relation to some boiler plate the reverse is the case.

The Australian committee did produce a set of six standard loan documentation which was published on the APLMA website in February 2002 and is still available. We are in the process of producing a new edition. It was hoped that in the same way as occurred in London, there would be some sign off from a treasurers' body, but while there was some discussion with the Finance and Treasury Association, in the end that body did not produce any funding for looking at the documents. While they said the documents are generally reasonable that was as far as it got.

The initial set of documentation was designed for an Australian domestic corporate unsecured financing for an Australian incorporated borrower and Australian guarantors, from Australian banks or Australian branches of overseas banks, where the borrower is investment grade.

The first documents were published on the APLMA website in February 2002.

It took a little longer to produce a set of documents able to be syndicated overseas, designed to comply with the requirements for exemption from interest withholding tax under section 128F of the *Income Tax Assessment Act 1936*. The first draft of those documents appeared on the website in October 2003.

In addition, the APLMA Australian Branch has produced a form of confidentiality agreements just over a page long. There are two separate versions, one for use with sending out information memoranda in the initial package of information to banks, the other on selldown.

The Hong Kong Branch of the APLMA has produced for the Asian market a set of standard documents which follow the LMA but adopt some of the changes made in the Australian documentation.

(e) Using the APLMA Primary Documents

There are 12 different standard documents: 6 purely domestic financings, and 6 designed to be 128F effective. The 6 represent separate revolving, term and revolving and term facility documents, for Australian dollars only and for multi-currency.

All APLMA standard documents are available on the APLMA website but only to members and associate members. The membership includes most banks participating in the Australian markets together with a number of law firms and some rating agencies.

The best introduction to the documents and to the terminology is the User Guide which is also on the website.

They are designed for an unsecured corporate loan to an Australian company. If the borrower is a trustee or the loan is secured, additional clauses are necessary. Additional clauses may be necessary for particular borrowers.

(f) The Australian experience

The confidentiality agreement has achieved widespread acceptance.

The take-up of the form of facility agreement has been slower, though it has appeared in a number of transactions[5], and pieces of it are used in documentation in other transactions. There are a few reasons for this:

(i) there are fewer corporate transactions, many syndicated deals in Australia are project finance, or highly leveraged transactions;

(ii) larger deals tend to be designed to comply with section 128F for overseas syndication, and the 128F document took longer to produce, only being published late last year;

(iii) many deals are refinancings, a borrower often produces or insists on a document for refinancing which is based on a previously agreed set of documents; and

(iv) the familiarity of lawyers with their own documents.

Nevertheless, it is gaining wider acceptance, and a number of term sheets have been produced specifying use of APLMA documents, which saves having to reproduce the detail.

I am using it currently in a "club deal" involving banks. It is proving invaluable on getting to the issues and minimising comments. We are able with the draft to send a mark-up to the standard.

Some banks have experienced that there is a "ratchet effect" as the standard form is used as a base from which the borrower seeks further concessions or suggestions by sub-investment grade borrowers that they should have the same clauses.

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[5] To date there have been 12 known to the subcommittee. In addition some dual-listed companies and international groups with Australian borrowers have used the LMA.

(g) The new edition

A new generation of APLMA documents are just about to be produced. They will make clear to greater extent that the representations, warranties, events of default and undertakings, while reasonable for an investment grade borrower, are a starting point. The first new edition document should be out within about a month. There has been significantly more buy-in in the preparation of this draft from more parties, both banks and law firms, than the previous version. A general appeal for comments from law firms participating in the market was made last year. Most recently Mallesons have kindly met with the subcommittee to discuss comments but other law firms outside the committee have remained silent.

(h) The future

Lawyers in their heart of hearts might prefer to continue to use their own documents, for a number of reasons, including, familiarity and that they may regard their own documentation as being easier to read and more compact when compared to the APLMA. The absence of standard documents has advantages for the firms with larger precedent systems and more hands-on experience.

However in the end the pressure will grow to use a standard document, particularly as familiarity grows with the standard. It will take time.

In the end it would be odd if Australia was able to hold out against a global trend. The bank market, as well as considerations of efficiency, will increasingly demand it.

2. Some points of difference with the LMA document

As I mentioned, while the wording of the APLMA Australian version is mostly identical to that of the LMA, there are some differences . These include the following:

(a) Tax gross-up and taxation

There are a few changes in the Taxation clause. Most relate to the different taxation treatment in Australia and the UK. The Australian clause is somewhat more general in its application, the English is very specific to UK taxation. There are however two other differences:

(i) In Australia the mechanism of the gross up clause has been changed so as to require payment of an additional amount, rather than simply increasing the amounts that is subject to interest withholding tax. The idea is to try and reduce the amount payable under th clause, and to take advantage of the thinking in *Federal Commissioner of Taxation v Century Yuasa Batteries Pty Limited* (1998 ATC 4380). The effect of it is that if a payment of $100 is subject to 10% withholding tax, then only an additional $10 needs to be paid to cover the interest withholding tax. If the amount of interest had been increased, then the extra amount payable would have needed to have been $11.11 (making a total of $111.11) so that after deduction of 10% of the increased amount, the Lender receives the $100.

(ii) The indemnity against taxation excludes the carve outs from the gross up clause.

The VAT clause has been internationalised to cover all indirect tax, and altered.

(b) Accounting policy changes

The big news in terms of ratios is of course the introduction of International Accounting Standards, which will significantly alter accounting treatment, in particular in relation to the treatment of hedges and asset revaluations.
There has, to my knowledge, been one Australian entity which has recently signed loan documentation which anticipates the effect of IAS. However, with some the details are yet to be finalised, and borrowers still analysing the impact of the changes, so loan documentation is being prepared and ratios negotiated taking account of existing accounting standards. For that reason, the loan documentation needs to take account of the possibility of changes. The APLMA has adopted a clause which provides that when accounting policy does change so as to materially alter the effect of the financial ratios, the parties will negotiate in good faith, to amend those ratios. As no doubt accountancy bodies will continue to dabble with their standards, such clauses are sensible for the long term.

Until the parties agree, the company will as well as producing accounts under the new accounting standard, continue to produce statements under the old accounting standards so that the compliance of the financial ratios can still be judged. Obviously producing two sets of accounts effectively is significant administrative burden on borrowers, so that there will be some incentive to come to some agreement.

(c) Cross default clause

In English (and American) documentation a cross default in the strict sense of the term is more common. A cross default is an event of default which is triggered if there has been an event of default in another loan document allowing another lender to accelerate. This applies whether or not the other lender actually does accelerate. In Australia a "cross acceleration" clause is more the norm: there is only an event of default if the borrower defaults in payment of an amount over a threshold, or another lender actually accelerates following event of default. In the APLMA form the relevant language for a true cross default is included but in square brackets.

(d) Change of control clause

Until recently, a point of difference was this clause. The Australian clause simply provides that it is effectively a review of it, that is that the majority lenders can demand repayment if they don't approve of the change of control of the borrower. Until recently the English document required every lender to approve of the change of control, giving each a veto, but this has now changed and is closer to the Australian version.

(e) Material Adverse Effect

The Australian document ventures some suggested language for the definition of material adverse effect, where the drafters of the LMA feared to tread. The Australian committee has hazarded two alternate suggestions.

(f) Guarantee

To take account of the decision in *Citicorp Australia Ltd v Hendry & Ors*[6] the indemnity and the undertaking to pay make it quite clear that they apply to what would have been guaranteed obligations if the underlying obligations had been valid and enforceable. The LMA form, and indeed a number of standard form guarantees, fall into the trap of providing that the clause only applies to "guaranteed obligations". As Clarke J and the New South Wales Court of Appeal pointed out in that case, if the underlying obligation is invalid, there are no "guaranteed obligations" for the clause to pick up.

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[6] (1985) 4 NSWLR

In the new edition, the drafting of the operative clause of the guarantee has been changed to reinforce the "triple cocktail" aspect of the clause as outlined in the recent article by Alan Berg[7]. That is, the clause emphasises that the three key separate obligations, a guarantee, an indemnity against loss to cover particularly the risk that the underlying obligation is invalid, and an undertaking to pay the underlying amount, again irrespective of whether or not it is valid, are all separate and independent.

(g) The pro rata sharing clause

The pro rata sharing clause is one of the main planks of one of the cardinal principles of syndicated lending, that is that all lenders are treated equally so that they all have the same effective interest in decisions.

In general such clauses require a bank which has received a greater proportion of the amount due to it than the others (either because it has received payment directly or it has been able to exercise the right of set-off on combination of accounts against a deposit) to share with the other lenders so that they will rank equally.

The importance of such clauses was shown in sharp relief by the Iran Hostage Crisis in 1980 when there were a large number of syndicated loans involving both American and non-American participants and Iranian borrowers. A presidential order froze all Iranian deposits with US banks.

As a result, no Iranian borrower was able to make payments in US dollars. All Iranian loans went into default. On the other hand, a number of US banks were sitting on large deposits, and were able to "apply" money in those deposits by way of set-off to recover amounts owed to them. This raised the question as to what extent the US banks could be compelled to share their recoveries with the other banks, and if they did, to what extent they could "double dip", that is, apply more of the deposit in payment of the amounts that, as a result of sharing with the other lenders, were still owed to it, and then to be forced to share it with the other lenders. In other words, again using the terminology of the time, to what extent was the pro rata sharing clause a "black hole" into which the deposits could disappear. A similar situation arose in the Falklands War when Britain froze Argentinian deposits.

An exact repeat of those situations is highly unlikely in the Australian domestic context. It may also thought to be unlikely that an insolvent borrower would still have a large deposit with a bank that could be the subject of such a regime. However, it is by no means unlikely that a bank could have a position in relation to derivatives trading where it was substantially "out of the money" so far as the borrower is concerned, and that it would owe the borrower a substantial amount of money on close-out. In that case, the bank would be able to set-off the amount owed by it on close-out against the amounts owed to it under the loan agreement. If a lender does set-off its obligations in that way, then under the principles of syndicated lending, it should be required to share the results with the other lenders.

A difficulty arises if the borrower is subsequently wound up. The set-off by the original bank would not be a voidable preference, as the amounts would in any event have been set-off in the liquidation under section 553C of the Corporations Act 2001. However, if that lender does share its recovery with other lenders, then the other lenders would have received funds of the borrower in payment to them in relation to unsecured debts of the borrower. If the borrower was insolvent at the time they will have received a preference, and in the absence of being able to establish any defence, may be required to disgorge those funds in the winding up of the borrower under s588FF of the Corporations Act 2001.

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[7] "Rethinking Indemnities" Butterworth Journal of International Banking and Financial Law, October and November 2002.

That would have the result that the total amount available to the banks as a whole would have been reduced. Because of its obligation to share, the original lender would not be able to keep the deposits which otherwise it would have been quite entitled to keep in liquidation, and the proceeds of that deposit would be required to be shared with other creditors.

The English clause does not appear to address that problem, so that the Australian clause entitled "Redistribution of Payments" is drafted somewhat differently. The English clause simply provides that the recovering lender must share the recovery with the other lenders. The Australian clause provides that if a bank exercises a right of set-off it must distribute the amount recovered, but it does so by purchasing from the other lenders the identical amount of their participations in the loan. The amounts received by the other lenders is therefore not in satisfaction of the amounts owed to them by the borrower, which could constitute a preference, but consideration for the sale of obligations of the borrower. That should not be a preference. In this respect, it is more akin to the approach taken in typical American documentation.

For various reasons, if the borrower does go into a winding up, it may not be possible to "double dip".

(h) Definition of Financial Indebtedness

This has been expanded and will be expanded further in the new edition.

(i) Indemnities

There are additional indemnities in relation to actual or alleged inaccuracies in the information memorandum (which in LMA practice is left to the mandate letter), and against the costs of enquiries and litigation relating to the subject matter of the agreement

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The increased cost clause has been slightly expanded to make clear that it covers capital adequacy. The mitigation language will give some alternatives in the new edition.

(j) Warranties

The warranty as to no deduction of tax has been removed. Additional warranties have been inserted: that it is not a trustee, the due authorisation of the authorised signatories, and tax consolidation.

(k) Undertakings

The undertaking as to authorisations has been extended to material authorisations required in connection with the Obligor's business. There are some minor changes in the negative pledge and disposals clause. There are additional insurance clauses and space for the insertion of an environmental undertaking.

(l) Events of Default

An additional event of default regarding visciation of finance documents has been inserted. The drafting of the insolvency proceedings event of default has been altered somewhat to allow for the easy insertion of days of grace.

In the new edition, days of grace on misrepresentation will be allowed and the assets versus liabilities insolvency test removed.

(m) **Agency**

The agency clauses have been altered to take account of the GST issue referred to below, and the agreement does not provide that the agent signs "as agent for the lenders".

(n) **Electronic notices**

In the new edition, the subcommittee are grappling with the language necessary to allow the giving of electronic notices and information.

(o) **Certificates and Determinations**

The LMA provides these are conclusive: the Australian edition provides that they are sufficient evidence unless the contrary is proved.

3. Withholding Tax and the s128F documents

(a) **The Tax**

Under the Income Tax Assessment Act 1936, Interest Withholding Tax at the rate of 10% is imposed upon payments of interest or in the nature of interest by:

- Australian residents (unless they are operating through an overseas permanent establishment) or Australian permanent establishments of non-residents;

to

- Non-residents (unless acting through an Australian permanent establishment) or Australian residents acting through an overseas permanent establishment.

Traditionally this has prevented the overseas syndication of loans to Australian borrowers and limited the pool of banks available in the market to those with presences in Australia.

In the last few years, changes to the legislation have allowed transactions equivalent to syndicated loans to be created under which interest payable is exempt from interest withholding tax.

In May 2003 a protocol to the Australia US Tax Treaty was signed which generally exempts interest paid to US banks and similar financial institutions from withholding tax. A similar protocol has been signed between Australia and UK extending a similar exemption to UK financial institutions. It took effect on 1 July 2004.

S128F Exemption

Section 128F of the Act (and now also s128FA) provides an exemption for interest payable under ***debentures*** which satisfy a ***public offer test*** set out in the section. The exemption is lost where interest is paid to an ***Associate*** of a borrower, if at the time of payment the company knows, or had reasonable grounds to suspect, that the person was such an Associate, and the Associate is off shore and not a clearing house, paying agent, custodian, funds manager or responsible entity of a registered scheme.

Associate is defined in s318 of the Act.

Recently the definition has been restricted so that broadly, entities are associated with each other, if one controls the other, or they are under common control. Control is broadly the 50% test. However, a complication is that a trustee of a trust is an "Associate" of each beneficiary of the trust.

The withholding tax exemption is available for

- Australian company borrowers and government entities;
- Australian permanent establishments of non-residents;
- trustees of certain types of trust where the only beneficiaries are companies which are not themselves trustees;
- (under recent legislation which introduced s128FA) certain trusts, like listed property trusts. Until this year listed property trusts could not avail themselves of the exemption.

"Debentures" include bonds and notes and other securities, and instruments that create or acknowledge indebtedness. They can include bills of exchange and promissory notes.

The Public Offer Test

The public offer test is set out in s128F(3) with a qualification in s128F(5).

There are two main relevant ways of satisfying the test:

(i) the ***ten offeree*** method (in s128F(3)(a) or (e)), under which the debentures must be offered to at least ten financial institutions, none of whom were known or suspected by the borrower to be an associate of the others. For this method, it is sufficient that genuine offers be made, it does not matter that less than 10 parties take up the offer.

(ii) the ***electronic offer*** method (in s128F(3)(d) or (e)). This requires the offer of "debentures" to be made as a result of negotiations being initiated publicly in electronic form, or in another form, that was used by financial markets for dealing in debentures. Usually this would be satisfied if was made through Bloomberg or Reuters. In this test, it does not matter how many offerees receive the offer or take up the debentures or whether or not they are associates of each other.

In both cases, the offer will not qualify as satisfying the public offer test if at the time of issue the borrower knew or had reasonable grounds to suspect the debenture would be acquired directly or indirectly by an associate of the borrower who is off shore and not a clearing house, paying agent, custodian, funds manager or responsible entity of a registered scheme. In other words some care needs to be taken that initial offerees are not off shore non-custodial associates. It is important to note that it is the borrower's knowledge that is relevant, not the arrangers.

The offer of debentures is to be made:

(i) by the borrower (usually by an arranger on behalf of the borrower); or

(ii) by an underwriter within 30 days of issue (see s128F(3)(e)). This would commonly apply in a syndication where there was a narrow group of joint lead arrangers and underwriters who provided the initial funds, but intended to syndicate (for example, a privatisation or leveraged acquisition). In that case they would need to make the offers within 30 days of issue, in any of the permitted ways, including the ten offeree or the electronic offer method.

The scope of the legislation is continually expanding. The criteria for satisfaction are expanding or softening and in addition, there are a set of rulings from the Commissioner of Taxation which make the hurdles lower.

Once significant expansion in legislation currently before the parliament is that it will no longer only apply to "debentures" but all "debt interests" as defined in division 974 of the Income Tax Assessment Act 1997. That will effectively extend it to all obligations treated as debt for the purposes of the debt equity rules. In other words, it

will no longer be necessary for the transaction to be dressed so as to constitute "debentures".

(b) History – extension to the loan market

Originally the test in section 128F was fairly narrow, and it applied to debentures where arrangements were made to achieve "wide distribution" and those arrangements satisfied the Tax Office. The difficulty of the provision was that it was uncertain, and in particular, that one couldn't be sure that the test was satisfied until such time as the Tax Office had accepted it, and it would only do so after the issue of the relevant loan instruments.

While there were transactions such as revolving underwriting facilities (RUFs) or note issuance facilities (NIFs) where effectively banks underwrote debt instruments issued by borrowers, the general feeling was that the section would apply only to genuine capital markets instruments and there was resistance from the Tax Office in relation to disguised syndicated loans.

That "wide distribution" test disappeared with amendments made in 1997 which changed the attack of the provision. Instead of a vague "wide distribution" test with Tax Office discretion, it introduced the objective "public offer" test with testable criteria. In 1999 there was further liberalisation to allow the legislation to apply even where the debentures were first offered inside Australia, and irrespective of where interest was paid, and the Associates test has been liberalised. The section continues to be softened in a series of amendments, and in rulings issued by the Tax Office.

It was in the background of the 1997 amendments and their greater certainty and objectivity, that the market started to explore the possibility of using the exemption in relation to syndicated loans. The first transactions used were for Colonial Finance Limited and Sydney Airports Corporation in 1999.

The approach in those transactions has been followed in the APLMA 128F document. Some have expressed a residual concern that the Tax Office may continue its attitude to syndicated loans from the old drafting. The APLMA documents go some of the way to meet that concern but not the whole hog.

There is nothing in the legislation or the rulings which would back up that attitude. Indeed, there have now been three transactions which are clearly syndicated bank loans and in which the Tax Office has given rulings in relation to section 128F. The latest of these was issued earlier this year. Nevertheless for various reasons, it has not been the practice of participants to seek rulings. This issue will further recede when the section is extended to all "debt interests".

(c) The APLMA 128F document

The APLMA has developed a standard document designed to allow borrowers to take advantage of the s128F exemption. It is developed from the APLMA loan agreement. The document follows a fairly standard approach though there are different views.

This has been released onto the website. The documents resemble in many respects the normal syndicated loan, and most of the words are identical to that contained in the normal APLMA loan document.

The transaction is structured so that the loans take the form of subscription for "debentures" in the form of loan note for the purposes of the section. Those loan notes represent the obligation to pay the total principal amount lent under the documents.

To achieve this, the contents of the normal APLMA loan document are split into two documents:

(i) a Subscription Agreement; and

(ii) a Loan Note Deed Poll.

The Subscription Agreement contains the obligations to lend and most of the terms, such as conditions precedent, representations and warranties, undertakings and events of default. It also contains the mechanics for making the loan.

The Loan Note Deed Poll constitutes the debentures. It contains the obligations to pay interest and other amounts and to repay the loans. it is signed in escrow and becomes effective on first drawdown. A deed poll is the normal w
ay registered securities are created in the capital markets.
It is intended that the syndication process would satisfy the public offer test.
Commonly this is done by the ten offeree method, that is, participations are offered to at least ten unassociated banks. It could also be done by the electronic offer method.

It should be emphasised that while this and similar methods have been common in the last few years, and the approach has been seen by the tax office in at least two of the transactions and a similar approach in a third, the Tax Office has not formally blessed the APLMA documents, nor have there been any discussions with the Tax Office.

Loan Notes

The Loan Notes represent the amount lent. There are no separate pieces of paper. They are "paperless", created by inscription in a register kept by the agent. Again this is a common approach in the capital markets. That register resembles the normal register kept by agents in the normal syndicated loan.

The Loan Notes do not have individual face amounts. This is to assist in syndication and sell down. Rather, each lender has Loan Notes which together add up to the total amount which it has agreed to lend and has lent.

The principal amount of a lender's Loan Notes at any stage is the amount lent by the lender, the maximum principal is equal to its Commitment.

For revolving facilities, there is always a possibility that all Loans would be repaid leaving Commitments outstanding, so that the borrower could draw again. There would be a danger that the Loan Notes would be discharged as there was nothing left owing. For this reason, the documents provide that in those circumstances A$1 will still be owing. This may be thought unnecessary given s563AAA of the Corporations Act 2001 which allows "debentures" to continue even where nothing is currently owing, but because of the carve-out in paragraph (a) of the definition of "debenture" in the Corporations Act 2001, many corporate loan notes (except those issued by some holding companies or treasury subsidiaries) are not "debentures" for that Act.

There is an alternative approach particularly with revolving facilities. That is to effectively have a new issue of loan notes on each drawdown. My own preference is to retain the original loan notes, so that it is easier to say that they are the notes issued pursuant to the original offer, and that is the approach adopted in 128F.

It should also be mentioned that some prefer a more conservative approach in relation to the drafting. There are also some in the market place who prefer to adopt a more conservative approach still and alter the subscription agreement so that it talks in turns of subscriptions being made rather than loans. This seems to me to be unnecessary particularly when one considers that classic debenture issue is one of effectively a loan (see also *Handevel Pty Limited v Controller of Stamps (Vic) (1985)* 157 CLR 177. This caution may in any event, go out the window when the section is expanded to

apply to all "debt interests". Also at least 2 of the 3 transactions which obtained a ruling, made no effort to disguise the fact they were basically one of loan.

Indeed, when the "debt interest" amendments come in, it may be possible to simplify the drafting further, though it will still be necessary to something to make clear than on sell-down, debt interests are transferred and not novated.

Risk Sharing – Clause 29

Fundamentally the gross up clause in the documents remains the same as in a normal loan agreement, so the borrower broadly bears the risk of there being withholding tax. If there is withholding tax, then it is required to gross up. There is an exception to this discussed below where the lender is its Associate.

However there is some risk sharing set out in clause 29 as to whether or not the loan notes do comply. Risk sharing reflects the control of the parties. The various requirements of s128F are under the control variously of the arrangers and the borrower. While the arrangers are in charge of the offer, the borrower is the only party who knows what it knows. If a party does not comply with clause 29, there is still a gross up but damages may be payable. Some borrowers argue that there should be no gross up if the public offer test is breached because of a breach by an arranger. This would limit liquidity as it would be subsequent lenders who would suffer for the sins of the arranger.

It is important in relation to s128F to make sure the procedures generally comply with the legislation, that includes all syndication documents, offer letters and the like. The parties need to decide what process they will use. Clause 29 should then be altered to reflect that reality.

Normally it is the arrangers who make the offers, so that clause 29 contains confirmation by them that they have made the offers, and they made it to parties whom they believed were financial institutions. However, the second part of the ten offeree method requires the offerees not to be parties whom the <u>borrower</u> knew or suspected were associates of each other. At that stage it is the borrower's knowledge that is relevant.

Comfort as to whether or not the borrower knew that the offerees were associates should come from the borrower. The normal process is that the arrangers prepare a list of potential offerees, and the borrower vets them. The borrower is then required to confirm that, so far as it was aware, none were associates of any other.

Paragraphs 1(b) and (c) are optional, and has some comfort moving from the banks to the borrowers. A number of banks object to giving such comfort. In a sense the borrower does not need it, as it is only its knowledge that is relevant.

As set out in clause 29.3, the lenders who receive offers give some confirmation as to who they are. The clauses are broadly similar to those that apply in the capital markets. Similar to capital markets documents there are two further clauses. One requires the arrangers and each lender to give information that may assist the borrower in demonstrating that the public offer test was satisfied,. The other, because we are dealing with obligations that on their face are securities, placing upon the lenders the obligation to ensure that they comply with securities laws in relation to any sell down.

The clause goes on to provide that lenders agree to comply with relevant laws (that is, effectively securities laws) in relation to any sell down. Some lenders object to taking on this obligation.

It has been inserted because the loan notes are more likely to be securities under relevant legislation.

In Australia, the position is not altered by the fact that the loan obligation has been represented by loan notes. The definition of "debenture" in section 9 of the Corporations Act 2001 is a functional one. Whether or not a loan note will be a "debenture" and therefore a "security" will depend on the nature of the lender and the borrower, rather than on the nature of the instrument documenting it.

Generally this has not been a problem as the sell down complies with professional investor exceptions ..

Other differences with standard document

(a) The gross up clause is slightly different. As mentioned above, the gross up clause does not apply to interest paid to an offshore Associate of the borrower that is not a clearing house, paying agent, custodian, funds manager or responsible entity. It is generally thought that the lenders should bear the risks of themselves being Associates, as they have control over which parties ultimately become lenders. This also reinforces for the purposes of s128F the unlikelihood of Loan Notes becoming held by associates of the borrower.

(b) Restrictions on transfer – this is matched by restrictions on transfer to Associates in clause 23.2(f).

(c) The form of transfer certificate is different. The normal method of introducing a new lender on sell-down is a novation. A transfer certificate which novates the outgoing lender's rights and obligations is signed by the incoming and outgoing lenders and the Agent on behalf of all other parties. In the s128F document, on selldown, instead of novation of the entire set of rights and obligations, the existing notes are transferred in order to preserve their tax status, the remaining rights and obligations are novated.

4. GST

We are all now painfully aware of GST, which is imposed on supplies (very widely defined) in Australia at the rate of 10%.

The mechanics are that it is the supplier that pays the GST in relation to its supply, at the rate of 10%, and includes this in its price. The supplier provides a tax invoice to the buyer. The buyer in turn can receive an input tax credit for the amount of GST included in that invoice, if it was a taxable supply, depending on the business of the buyer.

Financial supplies are "input taxed". This means that no GST is charged on the supply, but the supplier is not able to get an input tax credit in relation to GST paid as part of the cost of its own inputs, or is only able to get a reduced input tax credit.

Lending and underwriting are "financial supplies" and are therefore input taxed. Establishment fees (for lending), underwriting fees and interest are not subject to GST.

Agency services and arranging are fully taxable, like shoes and ships and sealing wax.

Some borrowers may not care if the supply by the banks to them was "input taxed" or "taxable". If it is input taxed, they will not have to pay extra to cover GST. If it is taxable, depending on their business, they may be able to get an input tax credit for the amount paid. Nevertheless financiers need to be concerned that they are correctly accounting for GST and giving the correct invoice. It is also relevant to GST on recovery of expenses.

Arranging and underwriting

Front end fees in syndication give rise to some complexity.

Where the deal is what is perhaps dangerously described as a "best endeavours" arrangement, that is the arrangers do not underwrite the deal but seek interest from the market, the position is fairly clear. Any fee paid to arrangers is fully taxable. Curiously front-end fees paid away by arrangers to incoming participants are, under Tax Office rulings, also taxable.

For underwritten deals front end fees paid to the underwriters and arrangers cover both functions. One, underwriting, is input taxed (exempt GST) the other, arranging is not. Arranging is fully taxable. The arranger is required to provide a tax invoice.

Under rulings issued to the Australian Bankers Association by the Tax Office, the front end fee needs to be split between the two roles, irrespective of what it is called.

In relation to the fee paid for an underwriter, there will be no GST. Nor will there be any GST on the amounts paid to it to cover its own disbursements, such as its lawyers' fees. Those lawyers' fees may have a GST component, but the borrower is not able to get an input tax credit for that amount of GST. The supply of legal services was not made to it. If a lawyer's bill was $10 plus $1 GST, the borrower will need to pay $11 to the underwriter by way of reimbursement but not receive an input tax credit.

On the other hand, in relation to arranging services, which are taxable, if a borrower is required to reimburse an arranger for lawyers' fees, GST will be paid on the arrangers' fee together with the amount payable to cover their lawyers' fee, less the input tax credit obtained by the arranger. In other words, if the lawyers' fee charged to the arranger would be $10 apart from GST, it will be $11 inclusive of the $1 of GST. The arranger is able to get an input tax credit for that dollar, and should invoice the borrower $10 for the lawyers' fees as well as its own fee. To both these amounts should be added GST, being $1 in the case of the amount to cover lawyers' fees. The borrower, depending on its business may then be able then to get an input tax credit for that $1.

Agency Fees

The ATO's initial attitude

Agency fees have caused particular difficulties in relation to the GST regime. It is one of those occasions where the advent of GST has required a detailed analysis of the nature of relationships only glibly described in the past. The Tax Office in its discussions with the ABA looked at the traditional syndicated loan agreement and saw that the agent is described as signing as "agent for the lenders".

It said therefore repeatedly in its correspondence with the ABA that the agent is providing all of its services, and receiving its agency fee, on behalf of the lenders. In its view, it is the lenders who should be providing a tax invoice for the relevant portion of the agent's fees, even though they never receive the fees and they normally would not be disclosed to them.

This caused some consternation. It would mean that each bank would need to account for the GST in their own returns , and the agent would be required to disclose its fee to its competitors.

It was based on a premise which does not reflect commercial reality.

It is more accurate in fact to say commercially that:

(a) many of the services provided by the agent are not provided "as agent" on behalf of the lenders, but are provided in its own right. These include the normal book-keeping, administrative, calculation and other services; and

(b) the borrower pays a fee to the agent to procure the agent to act as agent for the banks ,Alternately it can be said that the borrower benefits from those services being provided and it is paying the agent to provide those services.

The APLMA documentary approach

It is to match that approach, and in the face of the Tax Office's initial attitude, that the APLMA documents have been drafted. The documents make clear that the agent is not signing as agent for the banks, but in its own right, even though some services are provided as agent for the lenders (see for example, clause 26.1(c)).

There are, however, some additional services which are provided as agent for the lenders, for instance writing correspondence, arranging meetings and the like, where it is paid on an hourly basis. In relation to these services, we felt that the better approach was to say that the fee is paid by the borrower to the agent to procure its services.

If this twofold approach is adopted it is important for it to be reflected in the agency fee letter, and of course, fit the facts.

The "ruling"

On behalf of the APLMA we put in a submission to the Tax Office. That submission appears on the APLMA website. In a nutshell it said that the services provided as principal were provided for the benefit of all parties and paid for by the borrower. As to the agency services (following the principle in Customs and Excise Commissioners v Redrow Group plc [1999] 2 All ER1) the borrower is paying the agent for the right to have the agent supply its services to the lenders.

After further discussion, the Australian Tax Office agreed that the fee for both services was taxable.

It accepted the argument in relation to the administration services. They benefited all parties, and there was a supply to all parties, only one of which was making a payment. As to the agency services, it said it did not agree with the Redrow argument but in the end came to the same conclusion on the basis (a) that the borrower is directly paying for the agency services, (b) there is a clear direct link between the performance of the services and the amount paid by the borrower, (c) the borrower requires the agency services to be provided for the efficient running of the syndicate, and (d) the borrower can sue the agent if the services are not provided.

On that basis it issued a general advice dated 19 January 2004. The advice appears on the APLMA website.

Reliance on the advice

If you read the advice you will immediately notice that though we wrote to the ATO on behalf of the APLMA, it is written to us on the basis that "our client is the borrower".

When we queried this approach with the Tax Office, they indicated that they believed that all members of the APLMA would be able to rely on it. This was on the following basis:

ATO Practice Law Statement PS LA 2001/4 deals with the provision of written advice by the ATO. At paragraphs 42 - 43 it states as follows:

All forms of written advice involving the interpretation of the GST Law, other than GST private rulings, are GST public rulings; section 37 of the TAA. ... GST public rulings can be relied on to the extent provided in section 37 of the TAA. Essentially, to the extent that the general view of the law applies to the entity's circumstances, the Commissioner will be bound by that advice.

On this basis the ATO letter is a public ruling and should be able to be relied upon by any borrower that comes within the factual matrix set out in the letter. Paragraph 94 of PS LA 2001/4 makes the following comment on this issue.

Clearly, the extent to which an entity can reasonably rely on a GST public ruling depends on the extent that the GST public ruling is relevant to their circumstances. If an entity is unsure

about the way in which a GST public ruling applies to their circumstances, it should request a GST private ruling.

These comments in PS LA 2001/4 are consistent with the paragraph entitled 'Effect' in the Explanatory Notes at the end of the ATO letter itself. That paragraph states as follows.

This general advice sets out the ATO view about the operation of the GST Law that may apply to an entity's circumstances. To the extent that this general view applies to an entity's circumstances, the Commissioner will be bound by that advice. If an entity wishes for specific advice dealing with its individual circumstances it should apply for a private ruling using the 'Application for GST Private Ruling' form available at www.taxreform.ato.gov.au or by calling the Tax Practitioner Information Line on 13 72 86.

We sent to the ATO a copy of our letter to the APLMA confirming this.

It is important to note that the advice was in connection with the particular facts put to the ATO, and the documentation, including the fee letter, being in the form supplied.

Revisionism

It will be seen that from the position finally adopted by the Tax Office, it might have been possible to leave the position as agent in all respects providing agency services but not provide that it was signing the document as agent for lenders. On this basis there would be no need to have the particular paragraph separating out the agency functions in the agency clause that has been inserted in the APLMA. That would however, depart from the terms of the ATO advice.

Agency credit risk

Concerns have been raised about the fact that the agent is not receiving payments from the borrower "as agent". This renders it necessary to confirm that payments to the agent by the borrower discharge its obligation. It also theoretically imposes a greater credit risk on the lenders should the agent close its doors between receiving a payment from the borrower, and paying it on to the banks. If it had received the payments as agent, it would have been much easier to establish some form of trust and to trace and claim the funds. In most practical circumstances however, this would be illusory. Where the agent is a clearing bank in the relevant currency, the funds effectively "disappear" when paid to it. All that any creditor has is an unsecured claim against it, except in the unlikely circumstances that it would in some way be able to trace the funds. There might be greater hope where the agent is not a clearing bank in relation to that currency, and there is an agency account with a correspondent bank which is in funds.

Whichever approach is used, it is important to ensure that the agency fee letter matches this position and the documents (including the agency fee letter) reflect this.

Expenses

The agent still need to take care as to expenses, like lawyers' fees. It needs to determine whether they were provided to it alone in its own right in relation to its administration services, or to it alone in order to provide its agency services, or whether it appoints the lawyers as agent for the lenders so that it is the lenders who are ultimately appointing the lawyers. In the first case an input tax credit for the GST component of the cost of the lawyers fees may be available. In the latter case it may not.

Diccon Loxton