SYNDICATED LENDING
THE SYNDICATE PARTICIPANTS PERSPECTIVE

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INTRODUCTION

There are as many possible reasons that a particular bank might enter a syndicate as there are banks and syndicates. The practice itself, which is by no means new, blossomed in Australia during the 70s and 80s in response to a number of factors:

- size - the sheer size of loans outstripped individual bank's risk capacities;
- fee income - the drive for non-interest income; and
- territorial expansion - banks wanting to spread their exposure by entering new markets often did so in the first instance by means of entering syndications. The idea was to build a conservative portfolio which could act as a platform to expand into direct relationships if that next step was appropriate.

What is clear, is that banks **did not** become syndicate members in order to put vast portions of their capital in the hands of syndicate leaders for the purpose of having it managed by them in a totally discretionary fashion either during the term of the facility, at the end (ie, if a rollover was necessary) or on default.

Perhaps in retrospect, I might be forgiven for thinking that certain syndicate leaders were or still are suffering under a contrary impression.

In the following brief paper I hope I can give you some feeling for the syndicate participant's perspective on a number of practical issues. I use the term "syndicate leader" to encompass the concepts of promoter/arranger as well as agent/manager and the term "syndicate participant" as the minority bank participant. I have ignored the situation where the transaction has been arranged by a third party, non bank participant.

PRE-DOCUMENTATION "DUE DILIGENCE"

Why should the syndicate participant be naive enough to expect a degree of "due diligence" from the syndicate leader, sometimes even in the face of unconscionable exclusion clauses?

Firstly, the whole global banking system works on trust. Every day we take each others unsecured credit pledges for vast amounts. This system has stood the test and is based on the expectation that another bank will "do the right thing" and honour its obligations. Naive maybe, but given the minute by minute volume of interbank

transactions that occur, it is clearly not possible to formally and fully document each transaction.

Secondly, the syndicate leader having structured the transaction is the only party with access to all the information. They briefed the tax advisors, the lawyers, they did the cash flows, the sensitivity analysis, it is their client, their relationship, only they know where the weaknesses lie, ie, where the advice may have been different if the assumptions were changed even if only slightly.

The participant is not afforded this opportunity to the same extent - the fees do not cover his expenses. His only assumption is that the syndicate leader has done its job. A risk assessment is made, but if the assumptions are fundamentally flawed the participant often goes the way of the "proverbial lamb".

After all, the syndicate leader is paid to the a professional job. Arrangers fees, syndication fees etc while shared to some extent, predominantly go to the syndicate leader.

SHORT TERM PARTICIPANT VERSUS LONG TERM LEADER

Syndicate participants have recently been soundly berated by certain syndicate leaders for taking a short term view and in particular for not "rolling over" for a further term.

Didn't you realise this was really a 15 year deal, you merely entered the first of five "3 year" tranches?

The syndicate leader often has or is in the process of establishing a long term relationship with the borrower and conspires with the borrower to get the cheapest available funds.

We all know that a commitment for 15 years is more expensive than a commitment for three years, so the syndicate leader "structures" a feasible transaction with a 3 year time horizon whereas they knew (or ought to have known) that the borrower had no chance nor any desire to end the facility at the end of 3 years.

On the other hand the syndicate participant bases his credit judgment, maybe even his country risk judgment on 3 years and should be perfectly entitled to do so because that is the transaction offered and the only one he is being paid for.

If the borrower needs a 15 year facility then it is the obligation of the syndicate leader to point that out in the first place, even at the risk of losing that client. The alternative is that they risk their reputation as professional syndicate leader in respect of many clients.

CONFLICT OF INTEREST

Is it the syndicate participant's fault that the syndicate leader has a conflict of interest between his duty to the participants as syndicate leader and his duty to the borrower as its financial advisor, or its rights as a shareholder etc?

Much of the acrimony directed toward participants could have been avoided if the syndicate leader had acted professionally in the first place by not also being a shareholder or financial adviser, a secured or unsecured creditor or being a participant or syndicate leader in another syndicate with say the holding company of the borrower or with its asset rich subsidiary.

These situations are of course complicated where the borrower is a large Group, sometimes borrowing through a variety of mechanisms and subsidiaries and offering varying degrees of security.

In one infamous situation recently participants who had a relatively safe position with a loan to an operating subsidiary company were "asked", not too politely, by their syndicate leader to effectively rank themselves with the unsecured lenders to the whole Group and furthermore they were "asked" not to complain when the Directors of the subsidiary declared dividends to the upstream Group Holding Company. The syndicate leader was of course at the same time an unsecured lender to the Group Holding Company (which desperately needed those dividends).

If a syndicate leader wants protection in the syndicate agreement against possible suit by participants then it must not knowingly put itself in a position of conflict.

Apart from the concurrent multiplicity of roles that a syndicate leader might have, it will usually have the strongest relationship with the borrower. As mentioned earlier this can lead to certain understandings between the borrower and the syndicate leader such as the cost/term trade off which may not be fully communicated and thus directly raises a conflict between syndicate participant and the syndicate leader.

SYNDICATE DEMOCRACY OR SYNDICATE AUTOCRACY?

It seems to be the aim of every syndicate leader to be in a position to make all the decisions without consultation, but also to take absolutely no responsibility for doing so.

This notion seems to spring from the argument that to do otherwise would cause the arrangement to be "unworkable". In many matters within a syndication a participant can have some sympathy with this notion - ie minor waivers, timing matters perhaps, rate setting, certain administrative matters - however, any experienced syndicate participant must seriously question whether such concept stretches to the extent requested by syndicate leaders, such as - events of default.

I suggest to you that if the matter was originally considered important enough to amount to a default then each and every participant should have a right of independent action in that regard. The matter is complicated when security is involved, however, in the basic situation if an event of default occurs and one particular participant wants to call a default and thus be entitled to repayment, then the borrower can either remedy the default, pay out that participant or come to an arrangement with those who are happy to stay in the transaction. If none of these alternatives can occur then clearly the borrower is in trouble.

Invariably each bank will be motivated by what is best for itself - by not calling the default the syndicate leader will be as much motivated by self interest as the participant who seizes the opportunity to prematurely receive repayment.

The problem arises of course when there is not enough to pay out all the participants which is probably why the default has occurred and indeed is probably why even the syndicate leader should realise that a default exists and face up to the problem with the client instead of trying to force the participants into staying in the deal.

If a participant calls for repayment when it is not entitled to do so then presumably the usual remedies will be available to the borrower and other participants.

The concept of "majority participant" has been widely used to attempt to add an element of democracy. I question whether or not it really achieves this result, more likely it is a useful tool in helping to protect the syndicate leader from suit by a participant and/or results from the desire of the syndicate leader to protect its client from the irresponsible and arbitrary decisions of those "other participants" rather than from any democratic principle.

Allow me to give you two examples of its inappropriate use.

Example 1

Many events of default are drafted so as to include within them this Majority Participation concept.

<u>eg</u>: **"It is an Event of Default if ...**

a) ...

b) ...

c) the borrower sells certain assets except where the Majority Participants have agreed in advance etc etc."

Followed by a clause usually styled - **"Effect of Event of Default"** and expressing words to the effect of:

> **"Upon ... the occurrence of an Event of Default the Agent may, if so directed by the Majority Participants ... declare ... the moneys due and payable etc."**

My first objection to this dual test is the obvious, ie if the Majority Participants have considered the sale of the assets, in the above example, and refused permission to sell and the borrower had proceeded to sell the assets, then why should **any individual participant** not have the right to call on Event of Default - why a second test?

My second problem with this same dual test is the following.

Assume "Majority Participant" is defined as 75% of lenders by number. The Borrower has to get 75% of the lenders to agree to an asset sale - on the surface more difficult than getting 50% to agree. But if the Borrower ignores that requirement and sells the assets anyway, he has only to convince 25% (26%) of the Lenders that they should **not** call up the loan. In other words the test for the asset sale clause might as well be that only 25% (26%) of lenders need to approve an asset sale.

Example 2

A 75% definition of Majority Participant is not necessarily more favourable to the individual participant than 50% - it depends on the clause. (For the purposes of these examples I am not addressing whether the percentage is set by value of number).

For example, where the Borrower is permitted to do something with the consent of the Majority Participants - take the Asset Sale situation in Example 1. It is a more difficult task for the Borrower to get a 75% majority, than 50%, thus it works in favour of the individual participant. When the same test is applied to the rights of the individual participant, say for example where the borrower has an obligation to do or perform

something "at the insistence of the Majority Participants" then it works in favour of the Borrower and thus against the individual participant.

Thus when the document tries to make do with only one definition of Majority Participant, the result is often a logical inconsistency, that is, of course, if the rationale is to create some democracy for the minority.

Drafting problem you say? You would be surprised how many times this very combination of clauses appears in existing documentation.

In all syndicated facilities there are matters which might properly be left to Majority Participants to decide - sometimes 75% and sometimes 50% (by number or value), but there are also matters which more appropriately should receive the approval of **All Participants** otherwise it is simply **Syndicate Autocracy**.

ASSIGNMENT RIGHTS

It has become a necessity of modern financing practice to have the unilateral right to sell what you buy. Securitisation of assets, asset packaging, monitorisation of assets, call it what you like. It amounts to banks taking on assets and selling them, the same flexibility that borrowers need to fund themselves is also needed by banks.

The Syndicate leader often mumbles to himself:

> **"I gave you a part of the syndication because I knew you would vote with me, I didn't know you were going to sell your participation to that disagreeable (Australia) bank. They actually require their borrowers to repay on time."**

Why was the syndicate established?

- to spread risk,
- to introduce the borrower's name to a wider group of banks,
- to make the deal more profitable for the syndicate leader.

What are the alternatives?

- bilateral loans,
- a public note/bond issue.

Was the credit (borrower) good enough to be syndicated?

When the answer to the last question turns out to be - **NO** - that is when the syndicate leader finds he has a problem and begins to wish there were only the original 6 banks in the deal instead of the final 12. The answer to the first two questions indicates "convenience" for the borrower or syndicate leader rather than commitment or stability of relationship on behalf of the syndicate participant. Not enough thought is given to the fundamental reason for adopting one financing structure over another.

Often problems arise because of the inadequacy of the agency/management agreement. It has the usual "boiler plate" provisions, but the important terms have been overlooked because the syndicate leader was too busy telling the syndicate participants

that their suggestions for changing the documents were "**Irrelevant**" and the circumstances contemplated by the participant "**would never happen**" or "**our lawyers can't see a problem**", "**just sign**", "**our client is in a hurry**".

The documents should clearly reflect the ways in and out of the syndicate; these will obviously differ, but as long as:

1. appropriate notice is given;
2. the opportunity exists for existing participants to take over the loan in priority to third parties; and
3. volume rules are adhered to;

then fundamentally the very nature of syndications surely dictates that participants can sell out in most instances. The documents should facilitate this rather than hinder it.

On the other hand the syndicate leader, while ever it maintains that complete role (ie, where they structured and now manage the deal) should also maintain a minimum participation and should commit to do so.

THE RESULT/WHERE TO FROM HERE

Syndications have become fewer; however, it is hard to say whether the reason is more attributable to the difficulties arising between syndicate leaders and syndicate participants or more in relation to the general credit slowdown.

Certainly both syndicate leaders and syndicate participants have their preferred lists of "bed fellows", but I suspect when things improve we will forget and accept business from whatever quarter.

Syndications will not disappear, but I hope we begin to see developments along the following lines:

- The syndicated facility reserved for the "top credits" rather than for the second or third tier credits. By definition almost all these would be unsecured and "tradeable" issues.
- A move towards "club deals" perhaps with some formal trust structure (if security is involved) to enable security sharing, maybe with the issue of a form of debentures to allow for changes in participants from time to time.
- A quantum leap is required in the structure and drafting of Agency arrangements. Too little emphasis has been placed on this part of the deal. I will come back to this point.
- It is difficult to see an ongoing role for non-bank financial intermediaries past the structuring stage of the deal. Banks simply feel more comfortable with other banks as agent/manager and as mentioned earlier more and more participants are requiring the syndicate leader to maintain a commitment in the facility.
- Syndicate leaders must decide whether they want to make the decisions unilaterally and therefore also have the liability. Alternatively they may have to come to grips with treating the participants as being on the same side and accept a high degree of syndicate democracy. This is part of the realistic review

of the fundamental nature of the transaction - is it a syndication in its purest form, or should it really be a bilateral transaction, or in between - a club deal?

All parties and especially those documenting the deal must have a clear view of the appropriate form from the start.

- Syndicate leaders are beginning to wake up to the fact that once they take on an ongoing management or agency role they then represent the participant, no longer do they represent the borrower, ie their client. Unfortunately some have had to be jolted into this realisation by legal action or the threat thereof.

Enough recriminations - what next - how do we go about it in future?

My colleagues have given some useful suggestions. I would like to reinforce one or two "obvious" matters requiring improvement. Banks (mere participants and syndicate leaders), lawyers and borrowers must clearly distinguish between the appropriateness of a syndicated facility on the one hand and a bilateral arrangement on the other. The club deal is in between.

Banks must be more disciplined and professional about their guidelines for entering one type of transaction over another, eg if it is a pure syndication then selling down should be almost without restriction with perhaps the syndicate leader having power of attorney to execute novations, the right to decide all manner of discretionary matters, and hand in hand with that, participants would have their normal recourse in cases of negligence by the syndicate leader - more along the lines of a capital market transaction.

On the other hand as we would move into the area of club loans and towards the bilateral facilities then more power and responsibility is handed over to the individual participants and therefore less liability accepted by the syndicate leader.

This first point seems at first a bit like "motherhood" however, too little thought (particularly by third party packagers) goes into appropriateness, from the participating bank's point of view, of the "syndication" structure.

By simply recognising that there is a difference and having three clearly separated sets of documentation available in a pure form, the legal profession can assist. You can help concentrate the minds of all parties as to the appropriateness in the circumstances of the choices available. So often the first draft of documentation received is already a hopeless mixture of all these concepts.

Secondly, there has to be more professionalism introduced into the actual performance of the syndicate leader in its various roles. This starts with the documentation and that is the concern of the lawyers. The same rules **cannot** apply in the before (structuring and due diligence), during (when the loan is running smoothly) and after (at rollover or on default) situations. Existing "agency" agreements typically cover the before situation simply by going to the absurd extreme of trying to convince the innocent reader that the syndicate leader was not even the "reasonable man".

At the other end, that is, when you really need a professional agent, when the borrower defaults, the agent is again not to be seen.

There do exist banks who take a professional approach to agency work - who view and for their own account in a deal disclose potential conflicts up front, who charge for their services and who refuse participation if that is what is required by the participating banks.

Typically, of course, their fees are a little higher and they switch from being paid by the borrower (although indemnified by the participants) during the term of the facility to being paid by the participating banks after a default usually with an adjustment to the fee. Again typically these banks are not structurers of the transaction and have no vested interest in ingratiating themselves with the borrower. Where they take discretion they have a reasonable indemnity, but since they have no vested interest other than representing the best interests of the participant, they are able to take a detached stance.

If I can leave you with any hope for the future, other than to predict a bonanza for lawyers to come soon from agency litigation, it is to ensure that your bank clients pay appropriate attention to agency arrangements and to seek out the professional bank agents.

Participants Exclusion Clause:

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