ESSAY: SOVEREIGN SYNDICATED BANK CREDITS IN THE 1970S

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I
INTRODUCTION

This essay reviews the development of the documentation of bank-syndicated credit agreements with sovereign states and state entities during the formative years of the 1970s. One of the main objectives of this review is to examine the impact that the documentation had upon the resolution of sovereign insolvencies in the lost decade of the 1980s.

This essay is based on the direct recollection of a number of practitioners in London who had worked on syndicated credit documentation with sovereign states during the 1970s.[1]

Most of the documentation was and still is confidential, and we therefore do not refer to particular transactions. Rather, our objective is to preserve the participants' memories of the events, as primary sources. Historians who may subsequently authenticate this record can of course do so in subsequent years by consulting the archives, to the extent they still exist. Regrettably, many of the original loan documents have probably by now been destroyed. On the other hand, they were quite repetitive and the contributors to this paper believe that the record set out below is a reasonable reflection of what the documents actually said.

We do not review the practice for bond issues. Bond issues in the 1970s were made almost exclusively by advanced sovereign states with an impeccable credit rating, as opposed to countries that subsequently became insolvent. The bond market was not prepared to invest in issues by what are now called "emerging

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1. The English lawyers who contributed to this essay and participated in discussions, having been practicing in the 1970s in this field, are Michael Bray (Clifford Chance, then Coward Chance); Keith Clarke (Clifford Chance); Chris Fitzgerald (Slaughter and May); Jonathan Horsfall Turner (Allen & Overy); Martin Hughes (Clifford Chance); Francis Neate (Slaughter and May); and Hugh Pigott (Clifford Chance). The author is most grateful for their contributions.

countries," then called "lesser-developed countries." The international bond market for emerging countries only really opened in the 1990s.

One of the origins of the Eurodollar market based in London was an American interest equalization tax which effectively imposed a withholding tax on loans out of the United States. Bank loan agreements were favored, particularly after the abundance of petro-dollar deposits in banks after the oil price hike in 1973. The bond market was also discouraged by problems with the extra-territorial impact of U.S. securities laws and perhaps the relative cheapness of bank syndication fees compared to the fees for bond issues.

The sovereign debt crisis of the 1980s was effectively started by the failure of Poland in 1980. At the time, the market considered this to be a one-off event that was attributable to the political situation of Poland. The series of defaults proper commenced with the defaults of Costa Rica and, four weeks later, of Mexico in August 1982. By the end of the decade, practically every single emerging country in the world that had foreign borrowings had gone through a rescheduling with its banks, with the exception of Russia and China.

II
ORIGIN OF THE DOCUMENTATION

The documentation for syndicated credits was largely based on American forms, presumably developed during the 1930s and before.

It is possible that the first English–law-syndicated Eurodollar loan agreement in London was entered into on April 10, 1968. The borrower was Standard Bank and the agent bank was Mitsui Trust. The document was drafted by Hugh Pigott of Coward Chance from scratch and without reference to existing U.S. precedents. We do not know whether or not there was an earlier example, now lost, but at any rate, loan agreements began to proliferate in 1969 and 1970. Standard forms were in being by 1979 and were printed by external printers—which showed early attempts at commoditization.[2]

There were probably two main reasons for these multi-bank loans encapsulated in a single agreement in the United States. One was the tradition of small unit banks in the United States stemming from legislation, based upon the fear of all-powerful banks, which prohibited the establishment of branches of a bank from one state in other states. Hence, a large loan might require many banks to be assembled to provide it under a single agreement. The other possible reason was that the United States had developed the largest economy in the world, so that the crude volumes of finance required for projects and for enterprise may have been larger than elsewhere, thereby necessitating a spread of the risk among several banks.

2. The first agreements were very short—maybe ten to twenty pages. They are now over 100 pages.

III

MANDATE AND THE ARRANGING BANK

The process of syndication was then not greatly different from what it is now, that is, the prospective borrower would appoint a bank, or in the case of a large loan a group of banks, to arrange the syndication. The financial terms of the loan would be set out in a mandate letter or term sheet, which stated the amount, term, repayment schedule, interest margin, fees, any special terms, and a general statement that the loan agreement would contain representations and warranties, covenants, events of default, and other usual clauses.

Unlike some modern practices, particularly in relation to acquisition loans, the mandate letter would almost invariably never be legally binding, and there would be a statement to that effect or a statement that it was "subject to contract." The current common conditions, such as there being no material adverse change in the syndication markets or the sovereign state's financial condition, no concurrent syndication by the sovereign state, and the like, were not typical at the time. In particular, there were no "market flex" clauses that allowed the arrangers to change the price, structure, or term of the facility prior to signing if there were a change in the prevailing conditions in the international financial markets.

The functions of the arranging bank were to assist the borrower in preparing an information memorandum about the borrower and the loan for dispatch to potential participants, to solicit expressions of interest from the banks, and to negotiate the loan documentation. The club of available banks was quite small, initially dominated by U.S. and Canadian banks, and later joined by consortium and Japanese banks.

IV

SYNDICATION PRINCIPLES

The main syndication principles built into the documentation were set in this period and still continue to be followed.

1. Several commitments: each bank agreed in the loan agreement to make a separate loan to the borrower up to its date of commitment. The commitments were several: then, as now, the banks did not underwrite each other. Contributions to loans were made by the banks in proportion to their commitments, and payments by the borrower were, generally speaking, divided between the banks in the same proportion. However, all the loans were made on precisely the same terms. The agent bank did not undertake to make up the defaults of any defaulting bank, and this still continues to be practice.

From time to time there were defaults by participating banks, for example, the failure of the Franklin National Bank in the United States in 1974, an event that influenced further adjustments to the form of loan agreement, which anticipated the failure of Lehman

Brothers in 2008. Even prior to that, there were a very large number of bank failures over the years.

2. Agent bank: for administrative convenience, one of the banks was appointed agent of the syndicate through which payments and communications were channeled. The agent bank was, and still is, agent of the banks, not of the borrower. This is unlike the fiscal agent for a bond issue where the fiscal agent is the agent of the issuer. One consequence is that if the fiscal agent becomes insolvent after having put in funds by the issuer, the issuer has to pay again. In syndications, on the other hand, payments by the borrower to the agent bank discharge the borrower.

3. Syndicate democracy: the banks typically agreed to delegate limited decisions to majority control.

4. Pro rata sharing: the banks typically agreed to a degree of communality by virtue of a pro rata sharing clause designed to ensure that receipts by syndicate members were shared proportionately without discrimination.

All of these clauses are reviewed in more detail below.

V

INFORMATION MEMORANDUM

The arranging bank that was mandated to arrange the syndication would approach other banks in the market to see whether they would be willing to participate. Common practice was for banks who expressed interest to be sent an information memorandum giving financial and other information about the borrower, which had been prepared in conjunction with the borrower by the arranging bank.

This information memorandum generally contained (1) the term sheet giving details of the loan and (2) details of the sovereign state's economy and government. The memorandum was typically an extremely short document since it was assumed that potential participating banks would have access to their own credit information about the prospective borrower. It was perhaps also considered that there was a large element of political decision in making a loan to a sovereign state, based on the common, but wrongly held view that states never become bankrupt.

Then, as now, it was assumed that this information memorandum did not attract the regulation of prospectuses for public issues of securities. The reasons were variously that the circular was private, that loans were not securities within the securities legislation, or that the persons to whom the circular was sent were sophisticated investors within an applicable exemption. In any event, it was assumed that the documents did not have to meet the factual standards of public prospectuses or attract the sharpened and enhanced remedies available to investors if a public prospectus should turn out to be misleading.

It therefore came as a considerable shock later in the 1970s when consortium bank UBAF Ltd. commenced an action in the English courts against another consortium bank, European-American Banking Corp. (EABC), whereby UBAF alleged that EABC had invited UBAF to participate in an existing shipping loan to the Greek Colocotronis Group on the basis of incorrect statements.[3] At the time, it was said that the Colocotronis Group was in dire financial straits, but this was allegedly not revealed by EABC. The case was subsequently settled, but the lower court suggested in 1984 that the lending bank had fiduciary duties of care to the proposed participant.

At the time, the writer recalls that a banker enquired, "Is this a new law? Is it correct that we are no longer permitted to, well, make the loan sound better than it really is in order to get the deal done?"

The writer responded, "This is not a new law. In fact, it is an old law, a very old law. There is a law against lies which has been around for quite a bit. It was proposed by a burning bush in antique times."

The immediate impact of the UBAF action was twofold. First, the arranging bank's then customarily very short disclaimer in the information memorandum for the contents of that memorandum was substantially and comprehensively extended so as to exclude all liability. Lawyers wrote anxious memoranda on the law relating to contract misrepresentation and exclusion clauses. Secondly, the agency clause in the credit agreement almost tripled in length by the insertion of elaborate exclusions of liability for the benefit of the agent bank and an insistence that the agent bank had only ministerial or administrative duties and no fiduciary discretions.

While there may have been litigation by disappointed syndicate banks against arranging banks in the 1980s for misselling, particularly in the United States, we suspect that little of this was prosecuted successfully to verdict.

VI

PARTIES TO SOVEREIGN SYNDICATED BANK CREDITS

The parties to the syndicated credit were (1) the borrower; (2) the arranging bank, mainly to benefit from the exclusions from liability; (3) the lending banks; and (4) the agent bank.

Typically, in the case of many emerging countries, the borrower was the central bank under the guarantee of the state itself. One purpose of making the central bank the borrower was that many of the facilities were effectively balance-of-payments facilities and, therefore, should have been under the control of the central bank. More importantly, from the point of view of the banks, the fact that the central bank was the obligor meant that any foreign reserves held by the central bank would be potentially available to the banks in the event of a default.

3. *See* UBAF Ltd. v. European American Banking Corp., [1984] 1 Q.B. 713.

The banks were therefore considerably more hard-headed in their approach than subsequent bond investors: bond issues by emerging countries from the 1990s onward were almost invariably issued by the sovereign state itself without any involvement of the central bank so that in most cases central bank foreign reserves were insulated from attachment by unpaid bondholders. The bargaining power or leverage that these later bondholders could therefore exercise over a sovereign state was very much less.

The technical exposure of central bank foreign reserves proved to be less of a problem for rescheduling negotiations in the 1980s than in later years in relation to disgruntled bond investors. While foreign reserves may well have been substantially run down by insolvent states, the main reason for this outcome was probably that international banks considered themselves to be a club, a club whose rules required an adhesion to various values of restraint, propriety, and discipline. This club-like view was reinforced by the close links between the large international banks and their central banks: the commercial banks were probably much more susceptible to suggestions from the central bank as to how they should conduct themselves. The fact that hedge funds and the like had not been heard of to any significant extent and certainly did not participate in the syndicated loans meant that on the whole, the problem of the "hold-out creditor" was much less than it is now.

VII

GOVERNING LAW AND JURISDICTION

Governing law and jurisdiction were a major preoccupation at the time. Probably by far the largest number of these sovereign international loan agreements were governed by English law, with the submission by the borrower to the jurisdiction of the English courts. One reason that English law was chosen was that the new interbank-deposit funding market was located in London.

From the point of view of the banks, it was considered crucial to have an external governing law. The prime reason for this was that the governing law insulated the contract from exchange controls, moratoriums, and other interferences with the borrower's obligations by legislation in the borrower's jurisdiction. This was well-settled by English case law. Another reason is that the banks sought a governing law that they considered conferred stability and predictability. For example, the banks wished to be sure that if, say, an event of default clause stated that if an event of default occurred, the banks could immediately accelerate the loans, then this action would be upheld by the courts. English lawyers were able to confirm that this was the case, but in a celebrated tour of continental Europe carried out in the 1970s by a major American bank and their lawyers, it was reported that other jurisdictions in continental Europe would not be able to say the same.

Other factors that influenced the choice of law were non-legal preferences, such as tradition, familiarity, and convenience; the avoidance by the lender of

the detailed investigation into an unfamiliar system of law; and an ability to use lawyers who had a special experience in the type of financial contract concerned; as well as language. One suspects that Anglo-American affinities played a part.

Various unfounded prejudices might also have been influential. Some English lawyers thought that under English law, an agreement could freely say what it liked, but civil code systems were despotic. There may have been some truth in this as regards to such matters as good faith contracts, fine-trigger accelerations, and literal interpretation. They also thought that under English law, you had to write it all down, otherwise it did not exist. This notion seemed to have been derived from the prevailing view among, for example, French lawyers that the code filled in everything that was missing, a point that caused some surprise by those lawyers who drafted increased costs and market disruption clauses. If any French lawyer did say that at the time, the statement was not substantiated by the reality, although there might have been a greater tendency for civil law courts to rectify agreements and fill them in if the parties must clearly have intended what was missing. In any event, nowadays all those old theological battles are past, although individual legal systems do put a different emphasis upon literal interpretation, good faith performance, predictability, and rectification of contracts.

Once the governing law had been chosen, jurisdiction followed suit since the benefits of an external governing law might well be lost if the courts that enforced it were different, even though technically most courts could then, as now, apply foreign law.

Initially the borrower submitted only to the non-exclusive jurisdiction of the English courts, but later in the decade there was typically also submission to the Federal courts sitting in New York. This reflected the importance of American banks in the syndicated loans.

Another factor was whether or not the courts would apply the chosen system of law: England had case law going back to 1865 which affirmed the situation. The predictability of the choice of governing law probably stemmed in England from the dominance of British shipping in the 19th century, where typically charter-parties would be governed by English law, even though the charter-party had no relation at all to England and could be between parties in some distant part of the British Empire.

Similarly, there had to be certainty that the courts would accept the submission to jurisdiction. Fortunately for London, there was a European convention of 1968 on judgments in civil and commercial matters, which had a special, though grudging, article sanctifying the choice of law in international contracts.

It was typical in the jurisdiction clause for the borrower to appoint an agent in England for service and process. Very often, this was the sovereign state's ambassador to the United Kingdom at the Court of St. James. We have never heard of an ambassador actually being served.

In the early days of the Eurodollar market, a number of emerging countries, especially those in Latin America, expressed strong opposition to foreign governing law and submission to foreign courts. In some cases, notably Brazil, Venezuela, and Colombia, negotiators argued that there were provisions in their constitutions that prohibited a submission to foreign courts, provisions that were based on the Calvo doctrine, developed by an Argentinean statesman after the gun-boat diplomacy of European powers in the 19th century. This was intended in part to enforce payment of debts by Latin American states to the nationals of the European countries concerned. Almost invariably, banks refused to lend under local law.

The banks were not usually prepared to accept arbitration as an alternative to foreign courts. Arbitration was seen as indicating a lack of commitment in principle. Various technical reasons were advanced, for example, that expert adjudication was not required, that arbitration was a condition precedent to enforcement, that the procedure was looser and less predictable, that there might be jurisdictional disputes, that arbitration would give rise to expense and delay, and so on. Ultimately there was a strong prejudice against this method of resolving disputes on the fundamental ground that, if there were a default, there really would be nothing to arbitrate, and that anything that was an obstacle to the right to direct enforcement would be seen as weakening the bargaining position of the banks.

Some banks did give into the arbitration saga, and lengthy arbitration clauses in favor of London were introduced for Brazil and Venezuela. Possibly one of the earliest arbitration clauses was around 1972 in favor of Minas Gerais. Arbitration clauses fell into desuetude when a U.S. lawyer pointed out to Venezuela that the presence of a constitutional objection to arbitration would result in Venezuela being excluded from U.S. credit markets.

Suggestions that a loan agreement should be made subject to a public international law instead of a municipal system of law were uniformly rejected. The banks considered public international law to be too vague and unpredictable compared to a hard-edged system of law such as English law.

The idea of a floating law was toyed with in Mexican negotiations but not adopted, so far as we could see.

VIII

WAIVERS OF SOVEREIGN IMMUNITY

The agreements invariably contained an express waiver of sovereign immunity by the borrower. Thus, the borrower would waive immunity from jurisdiction, immunity from pre-judgment proceedings, and immunity from enforcement.

At first, these waivers of immunity were more hope than anything else, but in 1976, waivers of immunity were validated in the United States by the Sovereign Foreign Immunities Act of 1976 and in the United Kingdom by the State Immunity Act 1978.

In the 1980s, there were indeed some actions by banks against sovereign states, but on the whole these were isolated. Instead, the impact of the waivers of sovereign immunity was mainly to strengthen the bargaining position of banks in the event of a sovereign state default since strictly, the foreign reserves of central banks were exposed to creditor attachments.

IX

INTERNATIONAL ORGANIZATIONS AS BORROWERS

From time to time, international organizations were the borrowers under these syndicated credits. International organizations are entities created by treaty between sovereign states.

In 1977, a proposed loan to the Comecon bank, the International Bank for Economic Corp., was brought into doubt on the ground that there were said to be legal problems in the recognition of an international organization on the theory that international organizations were like sovereign states. Under then-prevailing theory in the United Kingdom and the United States, the courts would not recognize a sovereign state unless the court was advised by the authorities that they did indeed recognize the state concerned. The law firm acting for the lenders on this particular occasion referenced a famous Oxford public international law professor who opined that the English courts would not recognize the international organization unless the Foreign Office had confirmed to the court that the United Kingdom recognized the organization. Banks had been used to lending to sovereign states on the basis that, by reason of sovereign immunity, they might not be able to enforce their loans, but lending to a ghost was an entirely different matter.

Subsequently, an equally eminent Cambridge international law professor delivered a contrary opinion. To resolve these doubts, there was an exchange of correspondence between the Bank of England and the Foreign and Commonwealth Office in May 1978, in which the Minister for Foreign and Commonwealth Affairs stated that an organization set up by foreign states by treaty, which had legal personality in states outside the United Kingdom, would enjoy legal personality and capacity in this country without any formal statement by or on behalf of Her Majesty's Government, in the same way, and to the same extent as any other banking, commercial, or other trading organization established in a country other than the United Kingdom and enjoying legal personality in that country. There were also other reassuring statements.

X

DRAWDOWN OF LOANS AND CONDITIONS PRECEDENT

Typically, drawdowns of loans were permitted during a commitment period of, say, six months. Drawdowns would usually be made in a single amount or in rounded amounts. There were detailed mechanics for the giving of notice of

drawdown to the agent bank who would then advise the banks. Typically, five business days' notice of drawdown was required. In practice, many of the loans were drawn down in a single amount. Revolving loans were unusual.

Loan agreements provided, as they do now, that the banks were not obliged to lend unless certain conditions were satisfied—the conditions precedent. These were not conditions to the coming into force of the agreement since the agreement came into force on signature. They were conditions to lending. First there were conditions precedent to all loans designed to ensure that all legal matters were in order. The clause provided an outline that the banks were not obliged to make any loans unless the agent had received in form and substance satisfactory to it the constitutional documents of the borrower, the necessary governmental authorizations, any official consents, a process agency appointment under the forum selection clause, certificates as to compliance, and formal legal opinions.

At first, English lawyers were very reluctant to adopt the U.S. habit of formal transaction legal opinions because they could not see the point at which the lawyers were already professionally engaged: the legal opinions seemed to be mainly a vehicle for excluding responsibility. Still, the market wanted these ceremonial documents. Legal opinions became longer and longer, filled out with more and more qualifications, many of them trivial, with the result that a recipient must have thought that everything was wrong with the document and nothing right.

Then there were conditions precedent to each loan separately. The clause provided in outline that no bank was obliged to make a loan unless the representations and warranties were true on an updated basis and that no event of default or potential event of default had occurred.

It was not usually a condition precedent that there had been no material adverse change in the financial condition of the borrower. However, a material adverse change event of default was common with the result that the condition that there be no default had the effect of introducing this provision as a condition precedent to lending.

In practice, the ability of banks to suspend new loans when the borrower's financial condition is deteriorating by virtue of a material adverse change clause can be important. Material adverse change clauses have often been used in the corporate sector to suspend new loans which could involve throwing good money after bad. It is a matter of conjecture how often these clauses were implemented during the less-developed-country (LDC) crisis in the 1980s, but it is thought that the need to implement them must have been rare.

XI

APPLICATION OF PROCEEDS

In most cases, the clause providing for the application of the proceeds was in generic and vague terms, for example, the proceeds would be used for balance of payments purposes or some such statement. U.S. banks insisted on this

clause, perhaps to show compliance with Trading with the Enemy legislation and embargos. The clause invariably stated that the banks were not to be concerned with establishing the proper use of proceeds, so it was really a formality—a point dramatically brought out by the famous 1070s Italian loan to save Venice, which inexplicably was not used wholly for that noble objective.

XII

REPAYMENT

The typical repayment terms were a grace period of six months or a year followed by semi-annual equal repayments. Occasionally repayment was in a single amount—a "bullet" loan.

XIII

PREPAYMENTS

Almost invariably, the borrower was permitted to prepay, but only at the end of interest periods (to avoid breakage costs on funding deposits), and to cancel the commitments at any time. Prepayments were in minimum and rounded amounts and were applied to repayment installments in inverse order of maturity so as to shorten the life of the loan. Prepayments were made pro rata to the banks. The only circumstances in which the borrower would be permitted to pay a bank individually without prepaying the others would occur in the event of a prepayment on a tax gross-up, in the event of an imposition of increased regulatory costs, or in the event of illegality.

XIV

INTEREST

Interest was invariably fixed as a percentage margin, for example, one percent, over the London interbank offered rate, which was usually determined as the average rate between three of the banks as reference banks. The fixing was at 11 a.m. London time in the interbank market, two business days before the interest period concerned.

The borrower could generally choose interest periods of one, three, or six months, and sometimes nine or twelve months.

Interest was calculated on a 360-day year basis for U.S. dollars (the usual currency) and was payable at the end of the interest periods and at least six monthly periods.

Default interest was generally charged at one percent plus the normal margin, plus the higher of the existing rate and the new London interbank offered rate. Default interest was capitalized. This led to a huge burden of interest on defaulted sovereign loans.

The interest rate was not provided by a rate provider via a screen service, as is now customary. There were no margin ratchets uplifting the interest rate

according to a drop in the ratings of the borrower. Fixed-rate interest loans appear to have been rare.

XV

MARKET DISRUPTION CLAUSE

The London Interbank Eurodollar market was only a few years old, and therefore banks considered that it might be vulnerable to disappearance. A clause accordingly provided that, if a percentage of the banks determined that funding deposits were not readily available in the London Interbank Eurodollar market, then further drawdowns were suspended and the banks could call for a mandatory prepayment of existing loans and a cancellation of the commitments, with interest at a rate certified by each bank concerned or the reference banks, unless an alternative interest basis was otherwise agreed during a negotiation period, of typically thirty days.

The current version of the clause now provides that the banks and the borrower are locked in without a compulsory prepayment, although banks still have the right to determine the new interest basis: this must be on the basis of funding costs from some other source that is reasonably selected.

Evidently, the use of the clause has been extremely rare, although it has been used at least once in relation to a very small currency during the first Gulf War (the Kuwaiti dinar momentarily disappeared). It was also reported to have been used during the credit crunch of 2007 to 2009.

XVI

MULTICURRENCY OPTION

Most loans were in U.S. dollars. In many of the loans, the borrower was given the option to select the currency of the loan and to switch currencies at the beginning of interest periods. The new currency had to be readily available in the funding market and freely convertible, or else require a unanimous approval by the banks. There would be a limit on the number of currencies outstanding at any one time.

The amount of the new currency was calculated by reference to the spot rate of exchange between the base currency (usually U.S. dollars) and the new currency two business days before the next interest period. The borrower had to repay the old currency at the end of each interest period so that the currency amounts were adjusted every few months. Hence, the conversion involved actual advances and re-advances.

The object of the multicurrency option was that the interest rate in one currency might be cheaper than in another. Balanced against this was the possibility that the borrower would be undertaking a currency risk.

XVII

TAXES

It was invariably provided that the borrower must pay without any deductions or set-offs and that if the borrower had to deduct taxes, then the borrower would pay extra so that the bank received the full amount.

The exclusion of the right of set-offs meant that sovereign borrowers had to pay their loans in full notwithstanding that they were owed deposits by a lending bank. The object of this was partly "pay now, litigate later" and partly that the exercise of set-offs would interfere with the easy pro rata distribution of the proceeds of repayment by the agent bank to the participating syndicate.

If taxes had to be deducted, then invariably the clause provided that the borrower would gross up payments. In practice, the state was unlikely to impose or withhold any tax on payments by itself or by its central bank.

The clause typically applied only to taxes of the state concerned or of any federation of which it may be a member, although sometimes it did extend to tax deductions on payments elsewhere or even on payments by an agent bank to syndicate members (this was not a deduction by the borrower).

XVIII

INCREASED COSTS

This clause provided in outline that if any law or regulation or official directive increased a participating bank's underlying costs, the borrower would have to compensate that bank as certified by the bank concerned. The clause was mainly aimed at central bank reserve requirements, whereby typically a funding deposit borrowed by a syndicate member in the market would attract a central bank requirement to deposit a percentage of that deposit, for example, ten percent, with the central bank at a nil interest rate. The effect was that the cost of funds to the syndicate member would not be just the cost of the funding deposit, but also the cost of providing a reserve deposit to the central bank. Since the loan was based solely on cost of funds, this risk was a risk of the borrower, although the borrower was entitled to prepay the bank concerned. Very often, the clause was limited merely to changes in law.

Although these clauses have been present from the earliest days of syndicate documentation in the Eurodollar market, it is believed that they have very rarely been implemented, except for domestic loans in the domestic currency.

XIX

ILLEGALITY CLAUSE

This clause provided that if it became illegal for a bank to make a loan, to fund a loan in the market as contemplated, or to have the loan outstanding, the

bank concerned could cancel its commitment and the borrower had to prepay that bank individually.

The clause appears to have originated in the United States in the 1930s and may have been ignited by Trading with the Enemy legislation. The fear was that a bank may be prohibited by an embargo in one jurisdiction, for example, the country of its head office, from continuing a loan, but be contractually obliged to lend under the governing law of the contract resulting in a limping contract. So the clause was a protection against Trading with the Enemy legislation, freeze orders, and blocking orders.

The clause still survives as a standard in syndicate credit documentation, although it is thought that it has only rarely been used. The contributors do not recall an example.

XX

REPRESENTATIONS AND WARRANTIES

Credit agreements normally contained an elaborate series of representations and warranties by the borrower.

These were divided into legal warranties, for example, the powers and authorizations of the borrower, due execution by the borrower, the obtaining of all consents, the completion of all necessary filings and registrations, non-conflict with laws or the borrower's constitution or its contract, the legal validity and enforceability of the borrower's obligations, the *pari passu* ranking of loans with other unsecured debt, the validity and admissibility of the agreements into evidence, and the validity of the choice of law and jurisdiction. The borrower would also typically warrant that its financial condition was as stated and that the information memorandum was materially correct and not misleading. It might also warrant there were no material defaults on its other debt.

Early on, clauses were introduced to ensure that the representation and warranties remained true throughout the life of the loan, so that they were said to be "evergreen." Sometimes the repetition only applied at the beginning of interest periods, but it always applied in relation to the conditions precedent for new drawdowns.

Although a great deal of time and negotiation went into these representations and warranties, it is thought that the cancellation or acceleration of a loan on the ground of a breach of one of these representations and warranties was very rare in this period. Most of the statements were extremely bland.

XXI

COVENANTS

Generally there are only three covenants—(1) an obligation of the borrower to supply information reasonably requested by the agent or any bank, plus compliance certificates, (2) a *pari passu* clause, and (3) a negative pledge.

XXII

PARI PASSU CLAUSE

The *pari passu* clause has been standard from the inception of Eurodollar documentation. It then provided, as it still does, that the borrower's obligations are its direct and unconditional obligations and will rank *pari passu* with all its other unsecured liabilities.

Although this clause later gave rise to litigation and controversy, it was, so far as we were aware, assumed at the time that the clause merely provided for the legal ranking of debt. It did not prevent the borrower from, in fact, preferring one creditor over another at a time when it was insolvent. The clause may have originated from the legal subordination or priority of some creditors, legal discrimination (for example, gold clauses), and the allocation of particular revenues of a state in the early days of sovereign lending in the 19th and early 20th centuries.

XXIII

NEGATIVE PLEDGES

The negative pledge was regarded as one of the most fundamentally important covenants in the loan agreement. The clause provided in outline that the borrower would not create or permit to subsist any security interest on any of its assets.

The purpose of the clause was to ensure that the borrower did not create security in favor of one creditor over the unsecured creditors and thereby, allocate assets and revenues to a secured creditor. In practice, borrowers tend to create security when they are in financial difficulties when they are only able to borrow from secured creditors. This is the very time that other lenders wish to ensure that they are not discriminated against. The negative pledge therefore enhances equality between creditors. It also operates as an indirect control on the incurring of excessive liabilities.

It was almost invariably the case that the loans were unsecured and therefore, had to be protected by a negative pledge.

Normally, the negative pledge in sovereign loans applied only to external debt, defined as debt which was payable or optionally payable in or calculated by reference to any foreign currency or owed to non-residents. This limitation was generally acceptable to banks since governments were not normally disposed to charge their assets to secured domestic currency obligations.

Many of the agreements, particularly in the later years, extended the meaning of mortgages, charges, pledges, and the like to include title finance or quasi-security transactions, which had the commercial effect of security but were not security in legal form (for example, sale and lease-back, financial leasing, hire purchase, title retention, and sale and repurchase). Some sought to prohibit contractual set-off arrangements, notably following attempts in the mid-seventies by sovereign borrowers to set up commodity proceeds accounts eligible for a set-off against loans advanced by international banks, for example, Zaire.

It was typical to permit security with majority bank consent, to permit liens arising by operation of law, and sometimes to permit security if the banks were equally and ratably secured.

There was typically also an automatic security clause, which provided that, if the borrower created a violating security, then the banks were deemed automatically secured equally and ratably on the same asset as was mortgaged to the other creditor. There were half-hearted debates about the efficacy of this automatic security clause.

For borrowers of low credit standing, the negative pledge sometimes also applied to public entities that were majority-owned by the state, whether or not they were administrative.

The degree to which the clause was violated will perhaps never be known. But there were instances where sovereign states in financial difficulties did attempt to create non-violating security in return for fresh advances. Inevitably, this security had to be over foreign reserves, such as gold, deposits of foreign currency, or commodity revenues.

From time to time, these efforts were successful, especially when the negative pledge did not prohibit transactions having the commercial effect of a core security interest. Examples were set-offs of commodity accounts.

The real significance of the clause is debatable since, for many sovereign states that became insolvent, the amounts involved were so enormous that there was no question of these states having sufficient reserves to secure the creditors. Instead, in the case of state insolvency, there is by consensus an agreed bankruptcy ladder of priorities without the intervention of security interests.

In a few sovereign and municipal loans, there was a statement that the loan was charged on the general assets or reserves of the borrower or on its consolidated fund. This practice from the 1930s was by no means common and has now fallen out of use.

XXIV

EVENTS OF DEFAULT

The events of default commonly had four main effects by the express terms of the loan contract:

1. an event expressly permitted the banks to accelerate the outstanding loan;

2. an event expressly permitted the banks to cancel their commitments to lend further loans;

3. an event expressly enabled the banks to suspend further loans under the conditions precedent clause; and

4. an event could constitute a default under other credit agreements for the borrower under a cross-default clause.

Apart from non-payment, most of the events of default were early warning signs or anticipatory—a warning light.

In practice, calling a default was a last resort. The ability to call a default was primarily to provide a sanction, to confer a vote on debt capital, and to strengthen the hand of the banks in restructuring negotiations.

The main events of default were non-payment in the required currency and funds at the required place (often with a grace period of two to five business days); a breach of other obligations (often with a grace period of thirty days after written notice of default); a breach of representation or warranty; a cross-default; execution, attachment, or other creditor processes against the borrower's assets; and sometimes, steps being taken to reschedule debt or the stopping of foreign currency payments.

There would sometimes be a material adverse change clause, where the borrower was an emerging country. A material adverse change clause replaced the typical corporate events of default such as actual or declared insolvency. The usual formulation was based broadly on World Bank practice.

The cross-default was then regarded as a leading anticipatory event of default. It provided that if the borrower failed to pay other loans or guarantees when due, or if other loans were accelerated, then this would be an event of default. The thinking was that if the borrower defaulted on another loan, it was only a matter of time before the borrower defaulted on this loan; it therefore, established equality in the race to the courthouse door and non-discriminatory treatment.

The clause was not usually extended to cover mere breaches of other loan agreements without there being a non-payment or acceleration. Such a provision would have allowed creditors to piggy-back onto the tightest of covenants in other loan agreements.

The cross-default clause typically only applied to external debt, defined in the same way as in relation to negative pledges (see above).

For very weak borrowers, the relevant events of default often also extended to public entities. It was also common to include an event of default if the government ceased to be a member of the International Monetary Fund (IMF), if the government ceased to be eligible to use IMF resources, if there was a suspension of payments under a standby or non-observance of performance criteria in a standby, or if a standby ceased to be in effect. This IMF default

would be common in emerging country loans, but not in the case of advanced countries.

XXV

ACCELERATION

If an event of default occurred, the agreement stated that the agent bank could immediately accelerate outstanding loans plus accrued interest and cancel the commitments of the banks to make further loans. There was typically no provision for merely putting loans on demand in order to raise the temperature. But sometimes, the agent had discretion without taking a majority bank vote.

There was no such thing as a no-action clause of the type found in bond trustees, where the trustee had the sole right to take proceedings. Once a payment was missed, any bank could take whatever proceedings it liked to recover that payment, although acceleration required a majority vote.

XXVI

AGENT BANK CLAUSES

In a syndicated credit agreement, one of the banks is appointed as agent to the banks for administrative convenience of the loan.

In the early days, the agency clause was short. It contained an appointment of the agent by the banks as the agent of the banks (not the borrower), provided that the agent bank had the powers and duties conferred by the agreement and contained various clauses excluding fiduciary and monitoring duties. It also gave the agent bank a right of indemnity against the banks. There was provision for removal of the agent bank by syndicate majority decision.

Towards the end of the decade, primarily as a result of the UBAF/EABC litigation (see above), the agency clause was greatly extended, notably in the direction of protecting the agent against liabilities, such as suits by members of the syndicate on the ground, for example, that the agent had a conflict of interest or had not exercised due diligence in relation to the monitoring of the loan, that the agent or arranger should have spotted errors in the information memorandum, or that the agent should have notified an event of default known to it, and so on. For example, an "ostrich" clause was introduced that stated that the agent bank was not deemed to know of an event of default unless the personnel in its agency department had received a written notice stating the event and stating that it was an event of default. This reflected the increasing division of banks into departments.

XXVII

SYNDICATE DEMOCRACY

The concept of syndicate democracy was well-entrenched in early documents. Votes were generally measured according to the amount of the banks' participations (unused commitment plus principal outstandings).

Majorities were either fifty percent or sixty-six and two-thirds percent. There was no additional numerable requirement, for example, a majority of banks by number as well.

Invariably, the powers vested in the majority banks were not nearly as extensive as those that might be vested in bondholders. The banks were sophisticated institutions with substantial commitments in the loan and generally unwilling to delegate management to a majority. Further, because of the club attitudes, there was usually no need to protect the general interest against a maverick creditor who might otherwise obstruct a beneficial arrangement, or so it was considered.

The usual powers of majority included directing the agent bank to accelerate the loans and cancel the commitments following an event of default, waiving a breach of covenant, consenting to the relaxation of a covenant, and sometimes determining whether an adverse change in financial condition was material.

However, the majority could not usually waive a condition precedent to the advance of loans, so that each bank could unilaterally suspend its obligations to advance new money if a condition precedent was not fulfilled.

A majority could not extend maturities, reduce the amount of payments, change the interest rate or currency, increase or extend commitments, change obligors, or determine certain other matters. These were totally entrenched.

XXVIII

PRO RATA SHARING CLAUSE

This clause provided in outline that if any bank receives a greater proportion of its share or payments, it must immediately pay the excess to the agent bank, who will redistribute to the banks pro rata and the paying bank is either subrogated to the claims of the other banks who are paid or will take a pro rata assignment of their claims.

This clause was standard and was an equality clause designed to share individual receipts by one bank but not others, such as receipts by set-off, proceeds of litigation, individual guarantees, or direct payment by the borrower.

The clause was specially favored in government loans because there is no mandatory *pari passu* treatment of creditors on sovereign bankruptcy and no fraudulent preference doctrines. Although in syndicated credits, each bank made its own separate loan, this desire for equality was at the heart of any common venture.

The clause originated in U.S. practice and may have derived from the common occurrence that the main house bank of a corporate borrow often held the deposits of the borrower so that it would be privileged by a set-off on the insolvency of the borrower.

The clauses originally provided for equalizing assignments, subsequently changed to subrogation since assignments might have attracted a stamp duty in the United Kingdom.

It was considered at the time that the clause would usually allow double-dipping. For example, a bank that set off the loan against a deposit may not use up the whole of the deposit. Hence, the bank would acquire loans from the other banks and be in a position to set off again. In this way, the whole of a deposit could be used up.

In the early days, judgment proceeds received by a bank that individually sued the borrower were not excluded from the duty to share. An exclusion was inserted after Morgan Guaranty attached Iranian shares in the German company Krupp during the Iranian crisis in 1979.

The clause had mixed success. The main problem was the unwillingness of banks to share. Thus, the clause is one where the lawyers are commanded to compose the music, but when the band starts up, nobody wants to dance.

The most celebrated instances were vain attempts by disappointed banks to persuade their colleagues to share when American banks set off Iranian loans against deposits at the time of the Iranian revolution of 1979 and when Argentina paid all but the British banks during the Falklands crisis in the early 1980s.

It is possible that the sharing clause contributed to creditor stability and weakened the power of hold-out creditors during the LDC debt crisis of the 1980s. However, the fact that by then, many of the loans contained a provision that excluded a duty of a bank to share judgment proceeds weakened this inertia effect.

In the resolution of the 1980s debt crisis, the pro rata sharing clause often gave rise to acute problems. For example, when the debtor sovereign nation wished to arrange for an exchange of debt into a local currency that would be used to invest in local companies, this technically sparked off the pro rata sharing clause. The same problem arose in relation to the issue of Brady bonds in the late 1980s.

XXIX

ASSIGNMENTS AND TRANSFERS

A clause typically provided that the borrower could not transfer any of its obligations or assign any of its rights, but the banks could assign all or any of their rights or change their lending offices. There were typically no prohibitions on sub-participations.

Commonly, it was stated that a bank could not transfer without the consent of the borrower if the borrower's liabilities were increased under an increased cost clause, but not under a tax grossing-up clause (since taxes could be controlled by the sovereign borrower itself).

The emphasis upon the importance of transferability first surfaced around 1975, but the innovation of novation certificates appeared for the first time (apparently) in a loan agreement dated May 25, 1984, for a U.S. $500 million loan facility for Ireland led by Citicorp International Bank Ltd. The concept really took hold during and after the LDC debt crisis when banks needed the ability to be able to transfer their lending commitments and to get out of the situation, sometimes by selling the loans to distressed debt funds, popularly known as vulture funds.

Later, capital adequacy rules were introduced by the Basel Committee, which required a clean transfer, including the transfer of obligations to lend. Since most of the loans were single draw-down and not revolving credits, the inability at the time to be able to transfer obligations to lend was not important.

XXX

BOILERPLATE

The agreements contained typical boilerplate clauses, which continue to be found in these documents, including for example:

1. A provision permitting banks to set off the loans against any other obligation owed by the bank to the borrower.

2. A provision that waivers were limited specifically to their terms and that the remedies of the banks were cumulative and not exclusive of those provided in the agreement.

3. A provision of doubtful efficacy providing that if the borrower's payments were converted into a non-contractual currency, for example, by a judgment of a court, the borrower would pay extra to ensure that the bank concerned received the full amount in the contractual currency.

4. A default indemnity providing that the borrower would pay losses including breakage costs resulting from the occurrence of an event of default or acceleration, a non-borrowing after request, or in various other cases. Thus, if the borrower or guarantor paid in a mid-interest period, a bank could suffer a loss on account of funds borrowed because the rate at which it could re-lend the returned funds might be less than the rate it was paying on the deposit it borrowed in the market to fund the loan.

XXXI

CONCLUSIONS

The main conclusions to be drawn from this review are as follows:

1. The overall architecture and contents of the main clauses of sovereign syndicated credit agreements were settled early on in the 1970s. Although there have been an enormous number of detailed

refinements, the fundamental foundations of the documents have not changed very significantly.

2. Most of the refinements that have been added have been designed to meet specific situations. Each crisis tended to give rise to an addition to the document.

3. Documents are not a legal wand to conjure up the treasure at the end of the rainbow in the event of a default by a sovereign borrower. Nevertheless, on the whole, the documents stood up and did what they were supposed to do.

4. The fact that many of the clauses were not actually used during the sovereign debt crisis in the 1980s led some banks to question whether the documents had any use at all and whether it would have been just fine to have lent on the basis of a few promissory notes or even a handshake. It must be admitted that some clauses were more habit-forming than useful, for example, market disruption clauses and illegality clauses. On the whole, we think that the bargaining position between debtors and creditors would have been very different if, for example, sovereign debtors had the benefit of their own governing law, which would thereby have enabled them to impose a legally binding moratorium by their own legislation. In any game of cards, the quality of cards does count, sometimes only a little, but sometimes a lot.