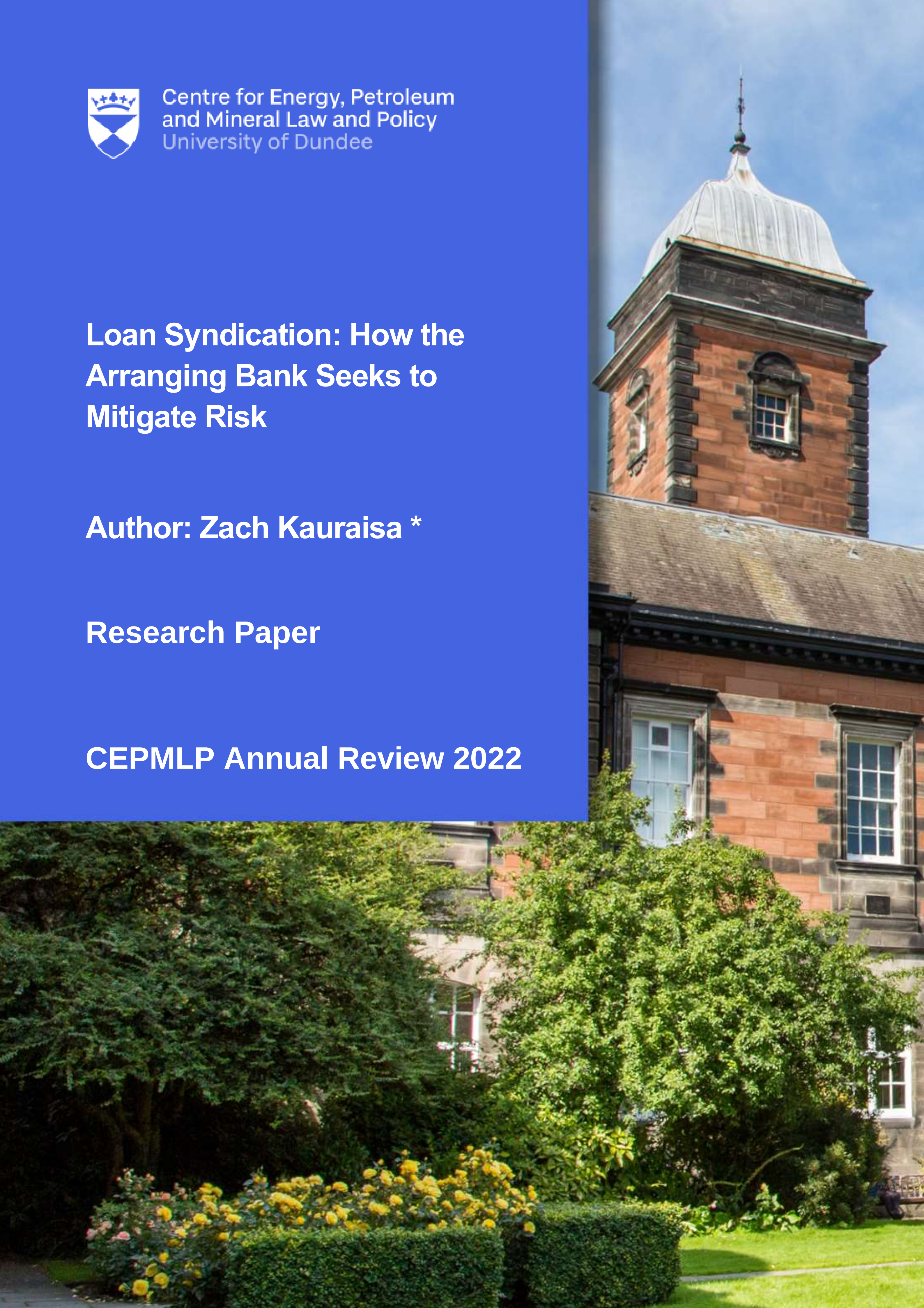
Centre for Energy, Petroleum and Mineral Law and Policy
University of Dundee

Loan Syndication: How the Arranging Bank Seeks to Mitigate Risk

Author: Zach Kauraisa *

Research Paper

CEPMLP Annual Review 2022



* Zach Kauraisa holds a bachelor's degree in law from the University of Namibia and a Master's degree in international oil and gas law (with distinction) from the University of Dundee. He currently works at a leading commercial law firm in Namibia and serves as the Country Director for Namibia at the Africa Energy and Mineral Management Initiative. Email: kauraisaz@gmail.com.

Contents

1. Introduction

In a traditional loan, a borrower contracts with a single lender, while syndicated loans involve two or more lenders jointly lending to the borrower.[1] An arranging bank originates the loan, negotiates the terms of the contract with the borrower, and organizes a syndicate of lending banks, each of whom provides a portion of a loan to the borrower. This syndicated loan is executed on agreed terms, which are codified in a suite of syndicated loan documents.[2]

The arranging bank is considered an 'informed lender', with respect to the economic condition of the borrower, because it engages with the borrower directly when originating the loan[3]. Obversely, the lending banks, that receive information on the transaction from the arranging bank, are considered 'uninformed lenders' because they do not have the same direct access to the borrower for information gathering purposes[4]. Typically, the lending banks have only as much information on the borrower as the arranging bank discloses. This resulting information asymmetry presents risks because the lending banks will rely on the arranging bank for information on the transaction. The risk carried by the arranging bank is that the lending banks may claim damages in the event of omission or misrepresentation of information. This paper will look at techniques utilised to mitigate such risk, and their levels of efficacy in so doing.

This paper is broken up into three sections: The first section deals with the loan syndication process and outlines the pre-mandate phase, the post-mandate phase, and the post-completion phase. The second section outlines the duties of the arranging bank with respect to preparing the information memorandum and loan agreement. This section also outlines the techniques banks may use to mitigate the risks associated with preparing such documents. The third section briefly concludes on how lending banks respond to such risk mitigation techniques including with recourse to a concentrated syndicate structure to keep a majority of the risk on the arranging bank.

[1] Sufi, A., 2007. *Information asymmetry and financing arrangements: Evidence from syndicated loans.* The Journal of Finance, 62(2), pp.629.
[2] Nevitt, P.K., and Fabozzi, F.J. 2000. *Project Financing 7th Ed*. London, England: Euromoney Books. p. 108.
[3] Supra Note 1
[4] Ibid.

2. Syndication Process, Structure

2.1 Pre-mandate Phase

At this stage, the borrower solicits offers from banks, which provide offers to take the role of an arranging bank. The borrower selects the arranging bank and signs a mandate letter that instructs the bank to form a syndicate and negotiate tentative loan terms.[5] In some instances, the arranging bank may elect to first underwrite all or a portion of the loan and form a syndicate after the fact,[6] by selling portions of the loan to other banks. This situation is known as a loan sale.[7]

2.2 Post-mandate Phase

Once the borrower signs the mandate, the arranging bank proceeds to pitch the loan to other banks. During this phase, the arranging bank will be responsible for drafting the documents used in the formation of the syndicate, and that are listed below:[8]

First, a term sheet that outlines the core terms of the proposed financing is drafted. Secondly, an information memorandum[9], which contains information relating to the borrowers political, economic and financial position, and is used to ascertain the borrowers' creditworthiness. Lastly, a draft loan agreement[10], which will be assessed by the interested lending banks and will be used as the basis for the final syndicated loan agreement.[11]

After the signing of the loan agreement, the loan becomes operational. All the parties involved become bound by the agreement and drawdowns commence shortly thereafter.[12]

[5] Godlewski, C, J. Weill, L. 2007. *Syndicated Loans in Emerging Markets.* Laboratoirede Rechercheen Gestion & Economie. Paper No. 87. Pg 6.
[6] Dentons. 2018. A guide to project finance. Pg 2. Retrieved from https://www.dentons.com/en/insights/guides-reports-and-whitepapers/2013/april/1/a-guide-to-project-finance last accessed: 27/01/2020.
[7] Simons, K. 1993. *Why Do Banks Syndicate?.* New England Economic Review. Pg 1. Retrieved at https://www.bostonfed.org/publications/new-england-economic-review/1993-issues/issue-january-february-1993/why-do-banks-syndicate-loans.aspx (last accessed 29/01/2020).
[8] Brian W. Semkow. *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks*. The International Lawyer Vol. 18, No. 4. Retrieved at https://scholar.smu.edu/cgi/viewcontent.cgi?article=3738&context=til (last accessed 28/01/2020).
[9] Supra Note 5.
[10] Supra Note 5.
[11] Supra Note 2.
[12] Supra Note 5.

2.3 Loan Syndicate Structure

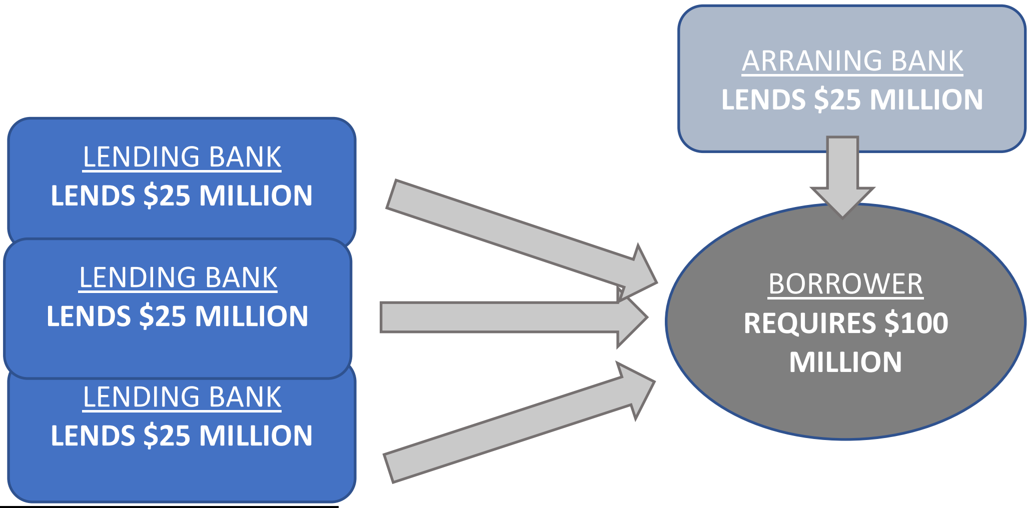
As described above, all the banks provide a portion of the required financing. However, the specific amounts of the financing provided by each bank may differ from transaction to transaction. This difference between the financing provided by the arranging bank and the lending bank results in either a diffused or a concentrated syndicate structure[13]. The larger the portion of the loan that is taken up by the arranging bank, the more concentrated the syndicate. The larger the portion of the loan that is taken up by various lending banks, the more diffused the syndicate. The larger the portion of the financing taken up by any one bank, the greater their exposure to a particular transaction.

The factors that influence the size of the financing provided by the lending banks include:[14]

1. quality of information on the borrower;
2. credit risk of the borrower;
3. reputation of the arranging bank; and
4. loan characteristics such as the use of collateral and term of the loan.

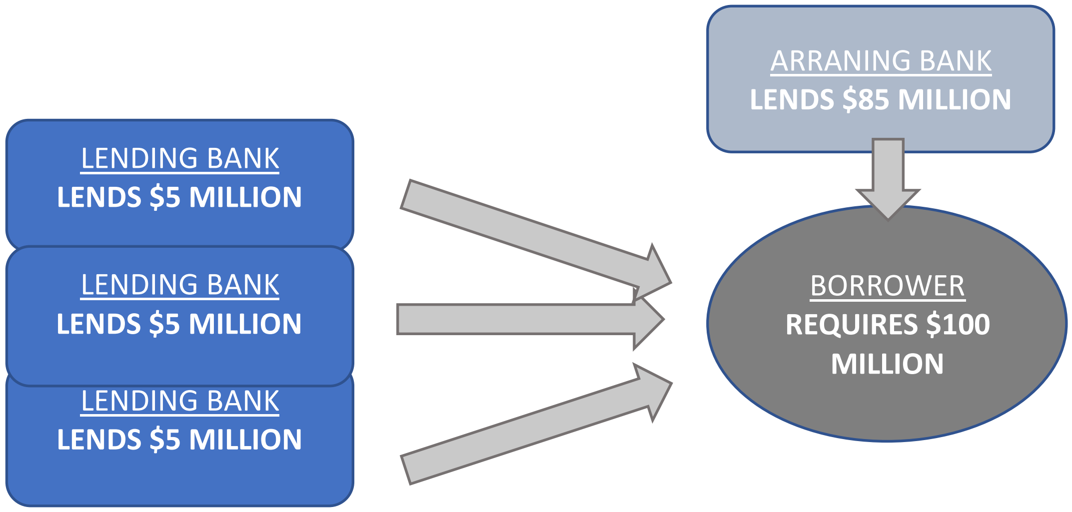
The above four factors directly impact syndicate structure, the more favourable the above factors, the more lending banks are willing to participate in a syndicate.[15] Below are illustrations of syndicate structures.

Example of Diffused Syndicate Structure:



[13] Lee, S.W. and Mullineaux, D.J., 2004. *Monitoring, financial distress, and the structure of commercial lending syndicates*. Financial management, pp.107-130.
[14] Dennis, S.A. and Mullineaux, D.J., 2000. Syndicated loans. *Journal of financial intermediation*, *9*(4), pp.404-426.
[15] ibid.

Example of Concentrated Syndicate Structure:



3. Duties of the arranging bank during the syndication process and associated risks

This section will look at some of the risks associated with the arranging bank's duty of drafting the information memorandum and the loan agreement and the management of those risks, including with respect to risk allocation within the syndicate.

A consistent theme in the risks outlined below relate to the information asymmetry that arises from the arranging bank having more information on the borrower than the lending banks do[16]. The techniques discussed below look at how the arranging bank can mitigate liability for any omission or misrepresentation of the information relayed to the lending banks.

3.1 Information Memorandum

When deciding whether or not to participate in a syndicate, prospective lending banks rely upon the arranging bank to accurately relay the borrower's economic circumstances. Therefore, as the party that prepares and distributes the information memorandum, the arranging bank may be liable for incorrectly relaying information. This position presents a further reputational risk because an arranging bank's ability of the arranging bank to syndicate loans in the future is impacted if the borrower defaults.[17]

Even if the arranging bank expects that other banks will conduct their own credit analysis of the borrower without depending on the arranging bank, the arranging bank may still be held responsible for any omission or material misrepresentation of information.[18] This liability may stem from securities legislation or common law.

[16] Sufi, A., 2007. *Information asymmetry and financing arrangements: Evidence from syndicated loans.* The Journal of Finance, 62(2), pp.629-668.
[17] Gopalan, R., Nanda, V., Yerramilli, .V. 2007. *Lead. Arranger Reputation and the Loan Syndication Market.* Publication Date: 2000 Publication Name: SSRN Electronic Journal Retrieved at https://www.academia.edu/20541964/Lead_Arranger_Reputation_and_the_Loan_Syndication_Market?auto=download (last accessed: 28/01/2020).
[18]Semkow, W, B. *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks*. The International Lawyer Vol. 18, No. 4. Pg 877. Retrieved at https://scholar.smu.edu/cgi/viewcontent.cgi?article=3738&context=til (last accessed 28/01/2020).

3.1.1 Legislation

If the loan transaction can be defined as security under the applicable securities legislation of any jurisdiction, then the information memorandum of the arranging bank will fall under the scope of such legislation. The arranging bank may need to go through rigorous registration, reporting or disclosure requirements that impose a duty of disclosure.[19] Lack of adequate disclosure, exposes the arranging bank to liability from not only the lending banks, but also a regulator.

3.1.2 Common Law Duty

A duty to disclose may exist at common law, it would be rooted in the legal theory providing for fraudulent or negligent misrepresentation. This duty creates an environment where an arranging bank could be held liable whether it distributed the memorandum in its own name or on behalf of the borrower. If a lending bank alleges negligence, a claim for damages may be instituted. The factors to be considered when such claim occurs include the extent to which the arranging bank prepared the information memorandum with the borrower and how heavily the lending banks relied on the memorandum.[20]

3.2 Limiting the arranging banks' liability for information memoranda

Although the prospect of liability being attached to the arranging bank in the event of incorrect information in a memorandum seems unavoidable, there are ways to limit liability. The following is a non-exhaustive list of techniques to limit liability.

3.2.1. Due Diligence Defence

This defence allows an arranging bank to negate the application of the duties prescribed by the securities legislation.[21] This defence is executed by strictly complying with the due diligence standards that legislation requires concerning the memorandum, and further insisting that the lending banks do the same.

[19] Supra Note 18.
[20]. Hedley Byrne Co. Ltd. v. Heller & Partners Ltd [1964] AC 465 puts forward the legal theory that highlights these considerations. Although final judgement stipulated that the bank was absolved of liability due to an exculpation/indemnity clause. This case is also cited in Supra Note 15 at 882.
[21] Supra Note 18, at 882.

Additionally, the arranging bank may rely on independent experts for reviewing information received from the borrower to shift some risk to third parties. Further, the use of verified sources of information and the written confirmation of the accuracy of all information used should enhance protection from liability.

3.2.2. Conflicting Duties of Disclosure

In the instance where the arranging bank obtains information about the borrower from a third party on a confidential basis (creating a duty to not disclose), a conflict of duties arises. This conflict is caused by the arranging banks' duty to disclose material information in the information memorandum to prospective lending banks, especially when such information may impact lending decisions.

The arranging bank would need to ask the borrower either to disclose the confidential information or to allow the bank to disclose that information. The disclosure must be made before the closing of the transaction to allow parties enough time to incorporate this new information into their decision making.[22]

3.2.3. Indemnity mechanisms

An arranging bank may use the indemnity clauses or documentation outlined below, in the loan agreement and the information memorandum, to mitigate liability for misrepresentation. Firstly, the arranging bank may want to negate a lending banks' ability to claim that it had been induced by misrepresentation to enter into the transaction.[23] This can be done by getting all the lenders in the syndicate to sign a declaration that they had not relied on the arranging bank for accurate and whole information in the memorandum.

Secondly, the arranging bank could procure a written declaration from the borrower, which states that: (1) the borrower claims that the information provided to the arranging bank is true and whole and the borrower assumes responsibility for any litigation that may stem from the information, and (2) the memorandum was drafted and distributed by the arranging bank as an agent of the borrower.[24] This has the effect of shifting the risk for the information memorandum from the arranging bank as a co-principle, to the borrower with the arranging

[22] Supra Note 18, at 883.
[23] Supra Note 18, at 883.
[24] Supra Note 18, at 883.

bank as its agent. The arranging banks would ordinarily only held at fault for actions that constitute gross or wilful misconduct.[25] The above combination of factors should adequately mitigate the arranging banks' liability with respect to the information memorandum.

3.3 Loan Agreement

Before the loan agreement is executed, the arranging bank distributes a draft loan agreement to the parties to obtain commentary on its adequacy. Oftentimes, because of pressures to complete the transaction on time, the loan agreement will be executed before meaningful discussions on the draft loan agreement can take place.[26] The lending banks will have relied on statements in the term sheet that the final loan agreement will contain the standard protections, identified below, for the lending banks.

3.3.1 Negligence

In the above scenario, if substantial changes are made to the draft loan documentation by the arranging bank and borrower, and these changes do not provide adequate protection to the lending banks, liability may be attached to the arranging bank. These desired protections will take the form of standard loan agreement covenants, indemnities and guarantees, in favour of the lending banks.[27]

A loan agreement that lacks the above clauses will breach the duty of reasonable care and due diligence with which an arranging bank must conduct itself.[28] In the case of such breach, a lending bank may institute a claim for damages, provided it can prove that the arranging bank was negligent and that its negligence caused the lending bank to suffer a loss.[29]

---

[25] Mugasha, A. 1997. *The Law of Multi-bank Financing : Syndications and Participations*. Pg 240. Montreal: MQUP. Retrieved from http://search.ebscohost.com.libezproxy.dundee.ac.uk/login.aspx?direct=true&db=nlebk&AN=404468&site=ehost-live&scope=site (last accessed 29/01/2020).
[26] Supra Note 18, at 885.
[27] Fight, A. 2004. *Syndicated Lending*. Amsterdam: Butterworth-Heinemann. Pg 115 Retrieved from http://search.ebscohost.com.libezproxy.dundee.ac.uk/login.aspx?direct=true&db=nlebk&AN=117145&site=ehost-live&scope=site (last accessed 09/11/2021).
[28] Beal v. South Devon Railway Co., (1864) 3 HOC C377 at p 341(Cited in Odianosen, E., How Does a Syndication Agreement Deal with the Conflicting Interests of Lenders. Article 2. At https://www.dundee.ac.uk/media/dundeewebsite/cepmlp-nh/car/CAR%2008_17072017.pdf (last accessed 28/01/2020).
[29] Supra Note 18, at 885.

3.4 Limiting liability for the loan agreement

Similar to the techniques used for the information memorandum, an arranging bank may ensure that the draft loan agreement contains the aforementioned indemnity mechanisms as a first line of defence.

Moreover, if legal action is taken by the lending banks after drawdowns have commenced, the arranging bank may argue that the financial commitment of the banks to the syndicated loan without finalized documentation gives rise to a form of contributory negligence, barring any claim for recovery.[30]

The arranging bank may seek to avoid legal issues with respect to the loan agreement in several ways. Suffice it to say that one of the simplest ways would be to give the lending banks enough time to review and discuss queries with the arranging bank.

3.5 Concentrated syndicate risk mitigation

However, the lending bank(s) may still be reluctant to take on the level of financing risk that the arranging bank seeks to transfer to them, notwithstanding the potentially beneficial impact of open discussions with the arranging bank, in light of extant information asymmetries remaining and/or suspected even further to those discussion. The arranging bank's insistence on its own indemnification, as above, may also be taken as a cautionary signal, and cause of enhanced lending bank risk, leading to a reduced level of risk appetite for the proffered loans.

Hence, prudential behaviour of the lending bank(s) may result in a concentrated syndicate structure such that a majority of the financing risk is, in fact, retained by the arranging bank. Empirical evidence confirms this logical sequence of reasoning and decision-making. Indeed, when information asymmetries exist, evidence shows that lending banks take a smaller portion of the financing, or fewer lending banks participate, leaving the arranging bank to provide a major portion[31]. This is especially the case when the borrower is relatively unknown in the syndicated loan market or if there is a lack of transparency regarding information on the borrower[32]. This concentrated syndicate structure has the impact of

[30] Supra Note 18, at 885.
[31] Supra Note 13.
[32] Supra Note 14.

increasing the exposure of the arranging bank to the borrower, which ultimately shifts risk back to the arranging bank in the event of default. This risk allocation places pressure on the arranging bank to focus on conducting a thorough due diligence on the borrower before the financing is provided and intensely monitoring the borrower after the financing is provided to ensure the security of the transaction[33]. This occurrence makes the transaction less risky for the lending banks.

[33] Supra Note 1.

4. Conclusion

The arranging bank carries risk, with respect to the information memorandum and loan agreement, from its own actions but also the actions of the borrower – where the borrower has provided incorrect information. However, because arranging syndicates can be a lucrative activity, arranging banks take on this risk and have developed tools to mitigate such risks. Although the above techniques limit the liability of the arranging bank, they do not, however, protect the lending banks from the risks associated with information asymmetries. Instead, the result may be a concentrated syndicated structure where a major portion of the financing risk is retained by the arranging bank, even despite that bank's best efforts to spread that risk more broadly across the syndicate. In such circumstances, risk mitigation by that bank is partial, reflecting both (perceived) information asymmetry and other factors, including indemnification.

Bibliography

Cases

Beal v. South Devon Railway Co., (1864) 3 HOC C377

Hedley Byrne Co. Ltd. v. Heller & Partners Ltd [1964] AC 465

Books

Fight, A. 2004. *Syndicated Lending. Amsterdam: Butterworth-Heinemann*. Retrieved from http://search.ebscohost.com.libezproxy.dundee.ac.uk/login.aspx?direct=true&db=nlebk&AN=117145&site=ehost-live&scope=site (last accessed 29/01/2020)

Mugasha, A. 1997. *The Law of Multi-bank Financing : Syndications and Participations*. Montreal: MQUP. Retrieved from http://search.ebscohost.com.libezproxy.dundee.ac.uk/login.aspx?direct=true&db=nlebk&AN=404468&site=ehost-live&scope=site (last accessed 29/01/2020)

Nevitt, P.K., Fabozzi, F.J., 2000. *Project Financing* 7th Ed. London, England: Euromoney Books

Journal Articles

Abubakari, H. 2012*. Alignment of the interest of lenders in a syndication agreement: is it truly a concept in search of a principle?*. Article 84. At https://www.dundee.ac.uk/media/dundeewebsite/cepmlp-nh/car/CAR%2016_29062017.pdf (last accessed 29/01/2020)

Cresswell, P.J., et al. 1992. *Encyclopaedia of Banking Law*, Butterworths, London para5351, in Qu, C., The Fiduciary Role of the Manager and the Agent in a Loan Syndicate,12 Bond L. Rev. 15, (2000).

Dennis, S.A. and Mullineaux, D.J., 2000. Syndicated loans. *Journal of financial intermediation*, *9*(4), pp.404-426.

Godlewski, C, J. Weill, L. 2007. *Syndicated Loans in Emerging Markets*. Laboratoirede Rechercheen Gestion& Economie. Paper NO. 87.

Gopalan, R., Nanda, V., Yerramilli, .V. 2007. *Lead. Arranger Reputation and the Loan Syndication Market.* Publication Date: 2000 Publication Name: SSRN Electronic Journal Retrieved at https://www.academia.edu/20541964/Lead_Arranger_Reputation_and_the_Loan_Syndication_Market?auto=download (last accessed: 28/01/2020)

Lee, S.W. and Mullineaux, D.J., 2004. Monitoring, financial distress, and the structure of commercial lending syndicates. *Financial management*, pp.107-130.

Odianosen, E. 2005*. How Does a Syndication Agreement Deal with the Conflicting Interests of Lenders*? Article 2. At https://www.dundee.ac.uk/media/dundeewebsite/cepmlp-nh/car/CAR%2008_17072017.pdf (last accessed 28/01/2020)

Semkow, W, B. *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks.* The International Lawyer Vol. 18, No. 4. Retrieved at https://scholar.smu.edu/cgi/viewcontent.cgi?article=3738&context=til (last accessed 28/01/2020)

Simons, K. 1993. *Why Do Banks Syndicate?*. New England Economic Review. Retrieved at https://www.bostonfed.org/publications/new-england-economic-review/1993-issues/issue-january-february-1993/why-do-banks-syndicate-loans.aspx (last accessed 29/01/2020)

Sufi, A., 2007*. Information asymmetry and financing arrangements: Evidence from syndicated loan*s. The Journal of Finance, 62(2), pp.629-668.

<u>Internet sources</u>

Dentons. 2018*. A guide to project finance*. Retrieved from https://www.dentons.com/en/insights/guides-reports-and-whitepapers/2013/april/1/a-guide-to-project-finance (last accessed: 27/01/2020)

Centre for Energy, Petroleum and Mineral Law and Policy
University of Dundee

Centre for Energy, Petroleum and Mineral Law and Policy
University of Dundee
Nethergate
Dundee
DD1 4HN

e: dundee.ac.uk/cepmlp