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Impact of Recent Corporate Collapses on Negotiating and Drafting Syndicated Loans**

Security: A hallmark of the frenetic lending practices of the mid- to late 1980s was that the structures developed for corporate lending were designed, at the behest of borrowers, to achieve the greatest flexibility for borrowers and with minimal interference with their businesses. The structures were also designed to achieve the best taxation results for all parties concerned, with a minimum imposition of stamp or other fiscal duties and with minimum registration or notification to applicable, regulatory authorities.

Unfortunately, in the rush to develop these sometimes sophisticated structures, the effectiveness of the securities granted by the borrowers or their sponsors, the significant, practical, and administrative limitations of enforcement, and the consequences for lenders of the obligations owing to third parties (both cosureties and subordinated creditors) were often not properly analyzed (if they were analyzed at all). The spate of recent corporate collapses has necessitated a very serious reexamination of the fundamental issues of the legal status of the security offered: how and when the security can be enforced and what obligations are owed by the secured lenders to other parties under the proposed lending structure.

Control: The recession has also focused lenders’ attention on the question of the extent of the restrictions lenders can legitimately exercise over certain business activities of their borrowers. In structuring any new financing one needs to find a balance. On the one hand, introducing a form of control in favor of the lenders over the borrower may be necessary, which may lead to the lenders being placed in a position of a fiduciary towards the borrower or being deemed to be a director or officer of the borrower. On the other hand, limiting the rights of the lenders

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to a mere monitoring and observing role may also be important, which may not give the lenders sufficient comfort to proceed with the lending.

Role of Agent and Lenders Inter Se: A third area that has received attention following recent corporate collapses is the role of the agent bank and, in particular, the extent of the fiduciary obligations imposed upon the agent towards the other participants, and the effectiveness of contractual limitations and indemnities in favor of the agent. Lenders are also now much more interested in the rights vested in them individually and in examining the rights vested in the majority lender group and the rights that require unanimous consent before being exercised.

Companies in Difficulty: A number of financings are, in effect, refinancings or workouts for companies in financial difficulties. In these types of financings, lenders must carefully consider some special problems, especially the consideration for the securities being offered and the circumstances under which those securities may be subsequently attacked.

This article examines in some detail the impact of each of these issues on structuring, negotiating, and drafting a syndicate loan. In particular, the article analyzes the value of certain forms of security and problems of enforcement; the extent of control over a borrower’s activities; the rights and obligations of the agent; the position of the lenders inter se; and special problems of refinancing borrowers in financial difficulty.

I. Reexamination of the Value of Securities

A. Importance of Security

The security offered by a borrower for the repayment of any loan, whether it be a single bank financing or a syndicated financing, is a fundamental aspect of the transaction. The form of security and the factors that may affect its enforceability or its value will largely dictate the required inquiries to be undertaken in structuring the financing and the form of the representations and warranties, covenants, and events of default to be included in the loan agreement. The loan agreement should only be prepared once a thorough examination of the proposed security has been undertaken. Of particular importance is that the loan agreement is drafted with regard to the type of security and the problems that may affect the security.

Obviously, the most effective form of security is a legal mortgage of the valuable property of the borrower. However, with the exception of land mortgages and certain special property rights, this form of security has not normally been insisted upon by lenders. Indeed, lenders have been prepared to be satisfied with far less.

Many forms of collateral support exist short of registered legal mortgages over assets. Equitable charges and forms of quasi-security abounded during the 1980s. The collapse of a number of corporations that have granted these forms of support has highlighted some of the difficulties and shortcomings of these securities. In
this context there are two forms of quasi-security that deserve special comment: negative pledge lending and subordination.

B. NEGATIVE PLEDGE LENDING

Perhaps one of the most dramatic developments in the lending practices of the 1980s has been the willingness of lenders to lend large amounts of money simply on the contractual promise of the borrower that it would not grant securities over its assets to any other lender. The theory is simple: the risk of unsecured lending is minimized because the borrower promises to all creditors that its assets will remain unsecured. Therefore, all lenders will be able to share equally in the assets of the borrower, and no one lender will have any priority to the assets. The relevant instrument or agreement would normally limit the overall amount of borrowings that could be undertaken, or at least impose financial ratios that, if breached, would allow an acceleration of the indebtedness. Often, a so-called "negative pledge" agreement will contain a number of other contractual, financial, and other obligations. On occasion, these provisions will extend to an obligation to grant equivalent security if granting security to another lender is proposed. Depending upon how this provision is drafted, under Australian law, this provision may itself constitute an agreement to give a charge that is registerable as a charge under the Corporations Law. It may also give rise to stamp duty at the rate of 0.4 percent of the amount secured. For these reasons, in the Australian context (because it is intended to ensure registration is not required and no stamp duty is payable) the negative pledge is normally not drafted in this way, and the clause only sounds in contract.

The fundamental problem with so-called negative pledge lending is that the obligations granted to the lenders are purely contractual and no proprietary interest is granted over any of the assets of the borrower in favor of the lenders. In these circumstances, the remedies for lenders following a breach of the contractual promise are limited. The lenders would normally be able to accelerate the indebtedness as a result of the breaches (subject to the difficulties in some circumstances of proving the breach) and sue for the recovery of the amount owing pursuant to the terms of the relevant loan agreement. The lenders may also have a right to sue for damages that have arisen as a result of the creation of security in breach of the negative pledge. If a lender, having the benefit of a negative pledge, becomes aware of an attempt by a borrower to grant security in breach of the covenant, the lender would be able to seek injunctive relief to restrain that breach.

1. An exhaustive analysis of negative pledge lending is not within the scope of this article. Useful discussions on this topic are to be found in D. Loxton, Current Aspects of Unsecured Lending—Negative Pledges, 1987 BANKING LAW AND PRACTICE 30; Stumbles, Negative Pledges and Subordination—A Consideration of Some of the Grey Areas, in IBC—PROSPECT PUBLISHING SEMINAR (1987); 2 PHILLIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE ch. 4 (1990); David E. Allan, Negative Pledge Lending—Dead or Alive?, 5 J.I.B.L. 330 (1990).

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In certain circumstances, the lenders may be entitled to sue the subsequent lender in whose favor the security has been granted. The lender must establish that the subsequent lender has intentionally procured a breach of the negative pledge (the tort of intentionally procuring a breach of contract) or conspired with the borrower to breach the contract (conspiracy). In certain circumstances, equitable relief may be available, depending upon the knowledge of the subsequent lender who has taken the security interest in breach of the negative pledge.

It may be practically very difficult, in the case of a simple contractual negative pledge, to establish that the subsequent lender knew of the existence of the negative pledge. Unless this can be established, the equitable relief will not be available to the lender that has relied upon the contractual negative pledge.

In circumstances where the negative pledge takes the form of a contingent contract to deliver security upon the happening of a defined contingency, and that is contained in a mortgage or charge that is registered, the lender having the benefit of the negative pledge may be able to proceed against the subsequent lender. The lender that has the benefit of this security may directly enforce its rights against the subsequent lender because the subsequent lender has taken its security with at least constructive knowledge of the existence of the restrictions contained in the negative pledge.

In light of the decision in Bond Brewing Holdings Limited v. National Australia Bank Limited, it seems clear that only in the most extraordinary circumstances would an unsecured lender, such as a lender only holding the benefit of a negative pledge, be able to persuade a court to exercise its inherent jurisdiction to appoint a receiver over the company's assets, especially in the face of a hostile borrower. A court will only exercise its jurisdiction at the behest of an unsecured creditor if the unsecured creditor can satisfy the court that the action at common law for recovery of the debt or for damages for breach of contract would not be adequate to protect the interests of the creditor. The unsecured creditor would also have to demonstrate that a receivership is a more appropriate remedy than, for example, the granting of an injunction to restrain a disposition of assets in breach of the negative pledge.

Also, the Supreme Court of Victoria in Bond Brewing Holdings clearly holds that a receiver will not be appointed to take charge of the financial or commercial management of the affairs of the company that is insolvent or potentially insolvent.

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2. Swiss Banking Corp. v. Lloyds Bank, 1979 Ch. 548 (1978) (Eng.) (the necessary element to establish this cause of action is that the subsequent lender "knowingly and without lawful justification [induced] the contracting party to breach his contract with another party").


4. Swiss Banking Corp., 1979 Ch. 548.


7. Id.
in circumstances that call for the appointment of a provisional liquidator or an official manager. The only function of a receiver, and the only ground on which a receivership will be granted, is the need to preserve the assets of the company for the creditors pending final judgment, or liquidation, or possibly an agreed workout from the financial difficulties.

Negative pledge lending is not inappropriate in all circumstances. Indeed, in the context of the international capital markets it has been, and will continue to be, an integral market protection for investors to ensure that competing securities are not offered in the same market on better terms as to security. Furthermore, for certain corporates, unsecured lending is viable and the negative pledge is a useful protection in the absence of deliberate breach or the insolvency of the borrower. The negative pledge protects against other creditors gaining an advantage by having security granted. However, as a form of security when compared to the rights that are afforded to a lender by an equitable or legal security, its worth is extremely limited.

C. SUBORDINATION

Subordination is in effect a negative form of security. It may be a condition to a proposed loan that although the lenders are to be unsecured, certain other creditors must subordinate their claims against the borrower to the claims of the lenders. Subordination has been a key technique in the so-called “junk bond” market in the United States and has also been an important component in a number of complicated lending transactions undertaken in Australia.

When assessed as a method of taking effective security, subordination also has a number of difficulties. In some circumstances, difficulties may arise in establishing effective contractual rights in favor of lenders. Whether the technique survives the insolvency of the debtor is open to doubt, and there are concerns as to whether junior creditors under the arrangement may in some circumstances have rights to require the lenders, which have the benefit of the subordination (that is, the senior creditors), to consider their position before exercising their own rights.

1. Classification of Types of Subordination

Subordination may be established either by contractual arrangement, by way of trust, or as part of a security arrangement. So-called “structural subordination” is where the junior creditor is a shareholder of the borrower rather than a lender to the borrower. This type of arrangement is not technically a subordination arrangement.

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In the Australian context, contractual subordination is the most common technique for effecting subordination. This is largely because of the stamp duty and security registration requirements that arise if a form of security, or trust in the nature of security, is established.

2. Method to Establish

One difficulty in establishing a subordination arrangement by contract is to ensure that all parties to be bound are either privy to the contract or at least that all junior creditors are effectively bound by the terms of the contract. In a simple subordination arrangement where an easily identifiable class of junior creditors (such as shareholders in the parent company or the shareholders in each company of a group) are to be subordinated only to a special class of lenders, this is not a major concern. In other cases, adopting a deed poll, a trust deed, or some other method to ensure that the junior creditors are effectively bound by the arrangement to all senior creditors is necessary.

The contractual technique most commonly adopted to effect subordination is to change the character of the junior debt so that it does not become payable unless and until the senior debt is paid in full. Alternatively, where the intent is to subordinate the junior creditors to the claim of all other creditors, the contract provides that the only right of the junior creditor is to share in the surplus assets of the borrower in a winding up after the payment of all other specified debts. The latter method is usual in most public debt instruments such as perpetual floating rate notes and perpetual bonds issued in the euromarket.

3. Insolvency

If a company becomes insolvent, the general principle is that, after the payment of liabilities that have statutory preference, all unsecured debts are to rank equally in priority. The critical question for a subordination arrangement is to ascertain whether the subordination established by contract will be effective to override this statutory provision requiring all unsecured debts to rank equally.

The leading English authority on this point is British Eagle International Airlines Ltd. v. Compagnie Nationale Air France. The case is said to be authority for the proposition that a subordination arrangement may not survive insolvency on the basis that it is inconsistent with the mandatory provisions of the relevant company law. Much debate has surrounded this issue since the decision in British Eagle. The debate largely concerns the question of whether the section should be interpreted narrowly or whether it should only apply to circumstances where the subordination arrangement purports to bind persons not party to the contractual arrangement.

In the Australian context, recent judicial decisions would indicate that a

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10. 1975 1 W.L.R. 758 (Eng.).
properly drawn contractual subordination (which states that the junior creditor's debts has been satisfied) should be effective against the parties who have entered into the agreement as part of a normal commercial arrangement and such an arrangement should not infringe the principle said to be established in the *British Eagle* decision.\(^\text{11}\)

Nevertheless, on the basis of the current law in Australia, stating with absolute conviction that a contractual subordination is free from challenge is impossible. In particular, in the face of a claim made by the liquidator of a junior creditor where the major asset of the junior creditor is the debt owed by the borrower, one could persuasively argue that the effect of the subordination arrangement is to defeat the claims of the creditors of the junior creditors (who were not party to the subordination arrangement).\(^\text{12}\)

### 4. What Obligations Are Owed to the Junior Creditor?

In the course of the multitude of litigation that has ensued from the recent corporate collapses in both Australia and the United States, subordinated creditors have made a number of attempts to argue that their position has been adversely affected by the exercise by senior creditors of the rights vested in senior creditors pursuant to the loan documentation. These claims have been made on the basis of a breach of the terms of the subordination arrangement, or on the basis of a claim that the senior creditors are in a fiduciary relationship with the junior creditors, or that the senior creditors owe some form of general equitable obligation to the junior creditors and that this obligation has been breached.

In those cases where the claims are based on contract, the law is well established. The construction of the contract primarily determines the rights and liabilities of parties to the contract. The process of construction encompasses the determination of both express and implied terms in the contract. The rights so determined are legal rights and the redress available if those rights are infringed is the legal remedy of damages and, in a serious case, a right to discharge the contract and the excuse from further performance.

In addition, Australian law recognizes that the relationship established by contract may be such as to warrant a court of equity to place upon one party to the contract duties that are not undertaken expressly or impliedly in the contract. The circumstances in which these duties are imposed, their content, and the remedies that follow upon a failure to fulfill them have not been exhaustively defined by the Australian courts. In this area of equity, the law is constantly developing. The question of whether these principles can be applied to a contractual subordination arrangement has not been judicially considered in Australia.

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\(^{12}\) It is interesting to note that clause H563A of the Corporate Law Reform Bill, which is currently under review in the Australian Parliament, contains provisions to attempt to give legislative effect to contractual debt subordination. Unfortunately, the proposed provisions are somewhat deficient.
Clearly, on the basis of general principles, a senior creditor could be restrained in acting if it could be shown that the senior creditor is acting in an unconscionable way or is exercising a power under the arrangement for an improper purpose that amounts to a fraud on the power.13

However, on the basis of the current law in Australia, it is suggested that senior creditors under a contractual subordination arrangement are not in a position where they are generally obliged to act as fiduciaries towards junior creditors, and they owe no general equitable obligation to junior creditors. In forming this view, several possible bases of liability need to be considered and dismissed.

Fiduciary Powers: A fiduciary is a person who has undertaken to act for, or in the interests of, another person in the exercise of a power or discretion that will affect the interests of that other person in a legal or practical sense.14 A person could have some fiduciary obligations in relation to a contract notwithstanding that pursuant to the contract the party in most respects is entitled to act without regard to any other party. Furthermore, where, pursuant to a contract, a person is given a certain sphere of action, and in pursuing that action has a right to act to some extent in his own interests, and an obligation to act to some other extent in the interests of other parties to the contract, the person will be a fiduciary to the extent of his obligations to act in the interests of the other person, but not for all purposes in relation to the contract.

Where the person is obliged to act as a fiduciary, the person is obliged to put the interests of the person in whose favor he is required to act before his own. If the fiduciary fails to do this, he is obliged to account for any profits that he has made as a result of his breach of duty (this obligation may be enforced by impressing a constructive trust over any property that the fiduciary has acquired). The fiduciary is also obliged to indemnify the other party for any loss that he has suffered as a result of the fiduciary’s default. The liability to account and indemnify is strict.

Generally, the power of a senior creditor to receive repayment and effectively to exercise the rights vested in the senior creditor in the collection of the debt and to deal with the borrower are not fiduciary. Indeed, even in the case of secured creditors, under Australian law a secured creditor is not a fiduciary in exercising its rights under its security. Although a mortgagee must act in good faith and with reasonable care for the interest of the mortgagor, a guarantor, and any subsequent mortgagee, the mortgagee is entitled to act with regard to his own interests and is not a fiduciary.15 On this basis a junior creditor will have difficulty in justifying any claim, under an unsecured contractual subordination agreement, that a senior creditor owes a fiduciary obligation to the junior creditor.


The law in the United States is more developed in this area. But even under that law, the extension of fiduciary principles to these circumstances (where the relationship that has arisen is as a result of an arm's length bargaining) is anomalous in most circumstances.\textsuperscript{16}

**Equitable Subordination:** Equitable subordination is a legal theory developed in the United States, whereby a bankruptcy court, acting pursuant to the Bankruptcy Code,\textsuperscript{17} subordinates the claim of one creditor to others to whom he would otherwise be either senior or \textit{pari passu}. Three elements seem to be necessary to subordinate a creditor's claim under this doctrine: the claimant must have engaged in some type of inequitable conduct; this conduct must have resulted in injury to other creditors of the debtor or conferred an unfair advantage on the claimant; and subordination of the claim must not be inconsistent with the provisions of the relevant bankruptcy law.\textsuperscript{18}

In the absence of a fiduciary duty, equitable subordination is typically applied against a creditor only where he has committed an act of moral turpitude, thereby causing damages to other creditors. The sort of conduct justifying equitable subordination is typically conduct involving fraud or substantial misrepresentation. In the absence of fraud, a creditor may normally demand repayment of its loan when due, refuse to extend the loan for any cause or no cause at all, and lawfully enforce collection all in its good faith business judgment.\textsuperscript{19}

The theory of equitable subordination does not apply in Australia as such. However, that country has well-established remedies for fraud and misrepresentation. Moreover, remedies based upon equitable estoppel and unconscionability could be utilized in similar circumstances to those in which this doctrine may be applied if a senior creditor has acted in such a way as to misrepresent the position of the debtor to the detriment of the junior creditor. However, this is well short of a general obligation imposed upon a senior creditor to act in the interests (or even to consider the interests) of the junior creditor.

**Guarantee:** One other possibility to impose obligations on senior creditors is to liken the position of a junior creditor to that of a guarantor of the debt to the senior creditor.\textsuperscript{20} Although, under the theory, a senior creditor would not be a fiduciary in relation to a junior creditor, a senior creditor may lose the benefit of the subordination if the senior creditor acts in relation to the debt in certain ways without the consent of the junior creditor.

\textsuperscript{16} Weinberger v. Kendrick, 698 F.2d 61, 78 (2d Cir. 1982).
\textsuperscript{17} 11 U.S.C. § 510(c).
\textsuperscript{18} Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977).
\textsuperscript{19} Bank of New Richmond v. Prod. Credit Ass'n (In re Osborne), 42 B.R. 988, 999 (W.D. Wis. 1984).
\textsuperscript{20} This theory has been mooted for some time. See Dee M. Calligari, *Subordination Agreements*, 70 YALE L.J. 376 (1961); Grant Gilmore, *Security Interests*, in 2 PERSONAL PROPERTY 986 n.10 (1965); Reade H. Ryan, Jr., *Subordinated World of Junkbonds*, 105 BANKING L.J. 4, 16-17 (1988); see also Wood, supra note 8, at 85.
Under Australian law, the effect of varying the principal debt or extending time would, in the absence of a contractual term to the contrary, have the effect of discharging the guarantor from all liability under the guarantee. By analogy, it might be argued that these actions on the part of the senior creditor may remove the restrictions imposed upon the junior creditor. (Note that under U.S. law a surety would only be relieved to the extent he suffers damages as a result of the variation.)

Although the benefit for a senior lender gained under a guarantee and under a subordination agreement has some broad similarities, as a matter of law, the character of the obligations is different. Under a guarantee, a surety assures, for the benefit of a creditor, the repayment of a principal debt. This is quite different from a simple subordination arrangement under which a creditor defers his own debt until another debt is paid. Under this type of arrangement, the junior creditor does not assure the repayment of the senior debt. The analogy to suretyship is stronger if the subordination agreement includes a provision to require the junior creditor to turn over to the senior creditor any dividends it receives from a liquidator in the winding up of the borrower. The obligation to apply the dividends to the senior creditor does give the arrangement a flavor of suretyship. In the Australian context, the obligation is often drafted as an obligation to pay an amount equal to the dividends received (to avoid the argument that the arrangement creates a charge over the future dividends). Even so, the obligation to pay may be considered as on account of the debt owed to the senior creditor, and on this basis the obligation is akin to an unsecured guarantee.

Notwithstanding this similarity that may be present if the subordination includes an obligation to turn over winding up dividends, the question of whether the courts should develop the same protections for junior creditors as have been developed for the benefit of sureties is unclear. Particularly is this the case in the context of large commercial bargains entered into between companies. In commercial matters, junior creditors understand what is being asked of them under a subordination arrangement. Junior creditors should not expect, nor should they imply into such bargains, strict rules that release their liabilities over and above the contract, especially when such rules have been largely designed to protect individual sureties against unintended liabilities.

D. Third-Party Securities

It is quite common in the financing of large groups of companies to lend to one specified company (often the finance or treasury company for the group) on the support not only of the promise from the borrower, but on the basis of cross-linking guarantees from all members of the group. In the Australian context, principally for stamp duty reasons, it has also been common for a special purpose subsidiary to be established as the borrowing vehicle, but on the basis that the real credit support is from the substantive asset owning companies by way of guarantee.
The validity of the guarantees given by members of the group, and consequently the validity of any securities granted to support those guarantees, will depend upon it being established that corporate benefit to each of the guarantors is sufficient to justify the decision of the directors to determine to encumber the assets of the company for the purposes of the lending.\(^21\)

In the exercise of any power, the directors of the company owe fiduciary duties to the members and, particularly where the company is verging on insolvency, duties (which may be of a fiduciary nature) to the creditors of the company, to act for the benefit of the company.\(^22\) If a transaction is not for the benefit of the company, it will amount to an exercise of a power for an improper purpose. Unless it can be established that a tangible benefit accrues to the guarantor in giving the guarantee, then the guarantee may be voidable at the option of the shareholders of the company and perhaps the creditors of the company.

In circumstances where the company is verging on insolvency, the courts will look critically to determine whether the company granting the guarantee is doing so for the purposes of the company. If that is not established, the guarantee may be set aside.\(^23\)

Whether giving a guarantee or security for another’s indebtedness is in a company’s interest is a question of fact. In determining whether the directors of the company are acting for the benefit of the company, the test to be applied is whether an intelligent and honest man in the position of a director of the company concerned could, in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company.\(^24\)

If the borrower is a subsidiary of the guarantor, then one can normally establish that the guarantor has an economic interest in the survival of the borrower (either because of its shareholding in the borrower or because the borrower is part of an integrated group whose success depends upon the survival of all of its parts). Where the borrower is merely an associated company, one needs to look much more closely at all the relevant facts to determine whether the test of corporate benefit has been satisfied.

The following are some of the factors that may be relevant in deciding whether a guarantee passes the corporate benefit test:

- If any of the funds made available to the borrower by the lender are onlent to the guarantor, it may be argued that it would have been for the benefit of the guarantor to assist the borrower to raise the money in order to be provided with the finance. Similarly, if the borrower customarily onlends to other members of the group, it may be argued that the guarantor could reasonably

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expect that some of the funds made available to the borrower may be used to benefit it directly.

- If a borrower provides the guarantor with skill, management, or other services, the guarantor would be justifiably interested in the financial well-being of the borrower and could be seen to have derived corporate benefit from its entry into the guarantee.
- It may also be argued that the corporate benefit derived from a transaction is the continued financial security of the group as a whole, which in turn is of benefit to the individual members of the group. This argument may succeed when interdependence between the guarantor and other companies within the corporate group is significant. Examples of this interdependence include where cross-shareholdings exist, or where the borrower (or another member of the group who will gain direct benefit from the transaction) is a major supplier or customer of the guarantor, so that the fates of the companies are closely linked.
- The nature of the moneys guaranteed (in particular, whether they are on-loaned) and the ability of a guarantor to meet a demand may also be relevant.

E. Powers of the Borrower to Provide Security

A great deal of learning is emerging regarding the question of the power of a company to borrow and the problems of ultra vires. Lenders are generally aware of the need to make inquiries as to the status of their borrowers and to seek the comfort of a local legal opinion to confirm that the borrower has obtained all necessary corporate and other authorities necessary to ensure the obligations under the loan agreements will be valid, binding, and enforceable against the borrower.

Two matters in this context deserve comment. Both have been highlighted in recent litigation in Australia.

1. Breach of Directors’ Duties

In a recent decision of the Supreme Court of Victoria, Southwall, J., has confirmed that where the directors of a company have provided another person with the company’s funds in breach of their duties as directors, and that person knew that the directors were acting in breach of their duties, the person receiving the funds will hold the funds (and any property acquired with the funds) in constructive trust for the company. If, subsequently, a bank lends money to the person who holds the property or funds in constructive trust for the company, the

25. In the Australian context, see H.A.J. FORD, PRINCIPLES OF CORPORATION LAW ch. 5 (6th ed.); MALLESONS STEPHEN JAQUES, AUSTRALIAN FINANCE LAW ch. 38 (B.L.E.C., 2d ed.).

bank will have its rights (including rights under a security over that property) subordinated to the rights of that company if the bank knew, or ought to have known, of the breach of duty by the directors of the company giving rise to the constructive trust.

The extent of this decision is unclear as is the issue of whether the decision should be confined to its facts (which demonstrated a rather extreme example of breach of duty and the misappropriation of funds). Furthermore, the decision is currently the subject of appeal.

Nevertheless, the decision raises the question as to what inquiries, if any, should lenders make, when lending to a company, as to the source of the other funds available to the borrower. For example, if lenders propose to lend funds to a special purpose joint venture vehicle in circumstances where the participants have subscribed their own funds, and the lenders propose to take security over all of the assets of the special purpose vehicle, should the lenders make inquiries? Do the lenders need to be satisfied that the directors of the participants did not breach a fiduciary duty by investing in the joint venture? The risk is that the breach could give rise to a constructive trust over the participants' interests in the special purpose vehicle that would rank ahead of the lenders' security over the assets of the special purpose vehicle.

Such inquiries may only need to be undertaken where the circumstances should put the lenders on notice that the investment of funds by the participants may not be in the best interests of the participant. The lender should be wary, for example, where the investment has no apparent commercial benefit for the participant or where the investment represents the majority of the assets of the participant, and it is taking up only a minority interest without any form of security or control over the joint venture.

2. Lending to Trusts

Special problems need to be addressed if the proposed lending is to a borrower that acts as trustee rather than in its own right. A trustee is personally liable for all debts it assumes and, in the absence of a specific limitation in the contract, this liability is not limited to the assets of the trust.

A trustee who incurs a debt on behalf of a trust does so as principal and not as agent on behalf of the trust. Nevertheless, if the debt is incurred by the trustee properly in the course of the due administration of the trust and with all due authority, then the trustee has a right to be indemnified out of the assets of the trust for liabilities incurred. The trustee also has a lien over the trust assets, which amounts to an equitable interest in the trust assets. This right of indemnity extends to a right to be reimbursed from the trust funds for moneys paid by the trustee, and the trustee is entitled to have the debt paid directly to the lender from the trust fund.

As a general rule, a creditor of the trustee has a right to be subrogated to the
trustee's right of indemnity and thereby to have an indirect right of recourse to the assets of the trust. However, the right of subrogation depends upon the trustee having a right of indemnity. If the trustee incurs the liability improperly or other than in the due administration of the trust, or if the trustee otherwise acts in a way that the trustee becomes disentitled to the indemnity, then the lender (who can have no better right than the trustee) also loses the right to have access to the trust assets. Consequently, in lending to a trustee, the lenders must determine that the trustee is authorized to borrow the funds in accordance with the trust instrument and that the trustee has an unfettered right of indemnity against the assets of the trust for all liabilities assumed.

What is of greater concern is the proposition that the creditor's right of subrogation to the trustee's right of indemnity may be affected in circumstances where the trustee acts improperly in a transaction wholly unconnected with the borrowing. If a trustee has acted in breach of trust and is liable to make good a loss suffered by the trust as a consequence of that conduct, the proposition is that the trustee's right of indemnity is impaired and cannot be relied upon (even in relation to a duly authorized liability) unless and until the trustee has made good the loss suffered.

If this suggestion is correct, it makes it almost impossible for a lender to be satisfied to lend to a trustee in circumstances where the lender is relying upon the trustee's right of indemnity alone. A modern trading trust often carries on many businesses over a considerable period. If, in relation to each liability incurred, it is a precondition for a creditor to be able to claim against the trust fund that the trustee must have "clear accounts" and not be liable to account to the trust, then every creditor is at risk in what would seem to be a quite unacceptable manner.

If a trustee has properly borrowed money from a lender and invested the money in the due administration of the trust, but some years later commits a breach of trust in a totally unrelated business activity, the theory would suggest that the ability of the lender to recover the money originally borrowed from the assets of the fund is impaired unless and until the trustee first makes good the loss suffered to the trust. If the subsequent loss is enormous and the trustee does not have the capacity to make good the loss, the lender is left with a personal action against an insolvent trustee. The assets of the trust are then available to the beneficiaries of the trust (who most probably enjoyed the benefit of the original loan and who

may well have impliedly or expressly consented to it by being made) free from any claim by the lender.

This result seems to be completely inequitable and an unfortunate consequence of the available law having been developed in the context of personal estates when the executor or trustee has misappropriated the trust funds. This situation is completely different from the modern commercial trading trust.

Some support exists for the view that, depending upon how the contract is made, a creditor may be able to have direct access to the trust funds. The contract must make it clear that the intention of the parties is for the covenant to be treated as one that does not bind the personal estate of the trustee, but only the trust fund in the hands of the trustee.²⁹

It remains unclear whether a theory of direct access, whether based upon unjust enrichment or restitution or some other equitable theory, will be developed in the Australian context. Such a development (or clarification that an unrelated breach of trust does not affect the indemnity of a trustee in respect of a duly authorized borrowing) would seem necessary to demonstrate that the principles of equity are capable of being used to ensure that a logical result, consistent with sensible business practice and commercial morality, is achieved. However, until that trend emerges from the courts, or until some legislative reform takes place, lenders need to be very careful indeed in lending to a trustee except on the basis of legal or other similar security where the need to rely upon the right of indemnity of the trustee does not exist.

F. PARTICULAR PROBLEMS IN ENFORCING SECURITY RIGHTS

In structuring any proposed lending, it is necessary to consider the possible statutory and other restrictions and prohibitions that may affect the enforcement of the security. The following list is not intended to be exhaustive and is based upon Australian law.

1. Corporations Law

Financial Assistance: Will the proposed loan in any way be used to provide financial assistance for the purpose of, or in connection with, the acquisition by any person of any shares or units of shares in the company or in a holding company of the company? The provision of such financial assistance is prohibited pursuant to section 205 of the Corporations Law³⁰ (which is an extension of the prohibition of a company purchasing its own shares, the rule in Trevor v. Whitworth³¹). A

²⁹. This view is more consistent with the U.S. view as expressed in Restatement (Second) of the Law of Trusts ch. 8 (1957) (see rules 271–271A); see also Austin W. Scott, The Law of Trusts 495 (4th ed. 1987).

³⁰. Except if certain procedures, involving public advertisements, have been undertaken or unless one of the exclusions set out in § 205(8) of the law is applicable.

³¹. [1887] 12 App. Cas. 409 (Eng.).
certificate can be obtained in accordance with section 206(6) of the Corporations Law to confirm compliance with the procedures set out in section 205(10). If a certificate is obtained, it can be relied upon, absent actual knowledge of noncompliance with procedures.

Obviously, in any takeover financing or other refinancing of any share acquisition arrangement, careful consideration needs to be given to the possible application of the prohibition against the provision of financial assistance. If any doubt emerges as to whether the provision may have been breached, a certificate should be included as a condition precedent to lending.

*Loans to Directors:* Section 234 of the Corporations Law prohibits certain loans and guarantees to directors and extends the prohibition to loans and guarantees by associated companies if the directors of the company own 10 percent of the nominal value of the issued shares of the relevant company. Again, a certificate can be obtained pursuant to section 234(10) of the Corporations Law, which can be relied upon unless, in the case of a public company, the person to whom the certificate was provided knew, or had reason to believe, that the certificate was incorrect.

In order for the certificate to be relied upon, it must be provided to the financier prior to the proposed loan or guarantee. However, it should be provided shortly before closing as a court has recently held that a certificate given well before the event may become stale, especially in circumstances where changes are made to the substance of the transaction between the date of the provision of the certificate and the date of closing.\(^3\)

2. *Priority of Securities*

Before taking any securities, the lender should consider the possible priority of other creditors. Depending upon the industry, a governmental authority may have statutory priority in relation to licenses or other relevant property. In Australia, the commissioner of taxation may have priority for unpaid group tax.

The position of other existing or proposed creditors to the group also needs to be carefully considered. It may be necessary to enter into a priority agreement with other secured creditors and, if so, to determine initially the proposed rights of the various creditors.

G. **Environmental Law Concerns**

As in the United States, in Australia, the potential liability of lenders for the environmental defaults of their borrowers is politically very topical. Currently, no enforceable guidelines indicate how the general provisions of the law should extend to lenders who are not directly responsible for the defaults of their borrowers. In

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these circumstances, the potential for liability to be imposed upon lenders is considerable. Lenders need to be very aware of the potential environmental problems associated with the business activities of their borrowers and the problems that may be associated with the property or business taken as security for a loan.

The current legislative provisions could adversely affect lenders in several ways. First, orders to clean up or restrict activities may disrupt the borrower's business and impose enormous costs upon the borrower. Secondly, liability for environmental damage may devalue the security that has been taken by the lender. Significant environmental liabilities can impact not only upon the value of any land mortgaged to a lender, but also on the goodwill, retail sales, and share prices. Thirdly, under the laws in Victoria and New South Wales, a failure by a borrower to pay the cost resulting from a clean-up order may result in a charge being registered over the affected property. This charge, at least in Victoria, operates as a statutory charge that will rank ahead of the interests of the lender.

In addition to the problems that may arise for a borrower and the security, the extended definitions of "owner," "occupier," and persons "concerned in management" of a company may result in a lender becoming directly liable for the environmental damage of its borrower. A lender may become an owner or occupier because of the structure of the financing (a leveraged lease or property trust financing where the trustee is a company owned by the lender); because the lender exercises rights under the security (and thereby becomes an occupier); or because a lender has reserved covenants and powers to such an extent that the degree of control over the activities of the borrower indicates that the lender is a person concerned in the management of the borrower.

Little Australian case law exists on the extent of lender liability for environmental damage. However, the current trend would seem to be consistent with that in the United States. Lenders should insist on certain provisions being included in loan documentation to protect, as far as possible, against the risks of environmental liability. Steps to be taken should include:

- Warranties that address issues such as whether the company has all necessary permits and licenses; whether the company has complied with all relevant authorizations; whether any claims or the threat of any claims are outstanding; and whether the borrower has given all relevant information in relation to the environmental risks and warranties disclosing the extent of due diligence already undertaken by the company.
- Covenants to allow lenders to insist that the borrower carry out any necessary task to protect against environmental liabilities or to allow, in default, the lenders to carry out such tasks.


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• A positive obligation upon the borrower to carry out, upon request of the lenders, an environmental audit of specified secured properties to enable the lenders directly to ascertain the extent of compliance with environmental obligations.

• An indemnity for any liability imposed upon a lender (supported, if appropriate, with security from the borrower or a letter of credit from a third party).

II. Control Over the Borrower’s Business:
Advantages and Dangers

A. Objectives of Lenders

Lenders are now more concerned than in the past to ensure they have the maximum protections available in relation to the continuation of the business activities of their borrower under the same legal structure and ownership as in place at the time the lending is made. The takeover activities of the 1980s have demonstrated that virtually no company is impregnable. The subsequent corporate collapses of many of the acquisition entrepreneurs with, on occasion, the consequent demise of their target companies, has resulted in lenders now having a keen interest to attempt to preserve the status and ownership of their borrowers.

In drafting syndicated loan documentation, lenders argue strenuously for control in each of the following areas.

1. Reporting

Lenders require prompt and accurate financial information in order to monitor the business activities of their borrowers. The requirement of monthly management accounts, quarterly accounts, and both semiannual and annual audited accounts, together with a requirement to report promptly on any abnormal activities is not uncommon. In cases of distressed companies, lenders often require these figures to be assessed independently and commented upon by a reporting accountant (discussed further in part II. E. below).

2. Control Over Ownership and Directors

Restrictions upon the change in shareholding of the borrower and changes to directors are often key topics of focus in the negotiation of a syndicated loan. The restrictions in relation to shareholding will depend upon whether the borrower is a private or a listed company. In the case of a private company, the lenders may argue for a right to approve any change of shareholding. In the case of a publicly listed company, the restriction sought is usually that the company does not become controlled by a new person without the consent of the lenders.

The lenders, on occasion, are keen to ensure the continuation of the existing management expertise of the company. In circumstances where a company is seen to be dependent upon the expertise of a particular managing director or chief
executive officer, the continued participation of that person is also, on occasion, requested by lenders as a condition of the continuation of the loan.

The degree of control vested in the lenders over the composition of the board of directors is of critical importance. If the lenders control the composition of the board, then not only may the lenders have difficulties as deemed directors (as discussed below in part II. B.) or as fiduciaries (discussed below in part II. C.), there would also be a question as to whether the company becomes a subsidiary of the lenders for the purposes of the Corporations Law.  

3. Business Activities

Depending upon the nature of the business of the borrower, lenders are keen to restrict a change in business activities—both the cessation of key businesses and the starting up of new unrelated businesses—and to attempt to limit acquisition of assets, at least to some degree.

4. Asset Sales

For a refinancing of a distressed company or in any work out, a key business strategy for the survival of the company may be to undertake asset sales in order to reduce debt and to increase net worth. The viability of the loan may depend on this program. In these circumstances lenders will want some say in the asset sales or at least in the parameters of the program, the methods proposed to be adopted to determine value, and how and when to sell assets.

The key concern with this renewed interest in monitoring more closely the business activities of the borrower is to ensure both in the drafting of the loan documentation and in the exercise by the lenders of their powers that lenders do not exercise excessive control over the decision-making processes of the borrower. This could enable a court to determine that the extent of control is sufficient to result in the lenders being deemed directors of the borrower, or persons taking part in the management of the company, or otherwise assuming a role that carries with it fiduciary obligations towards the borrower.

B. Lenders: Can They Be Deemed to Be Directors?

In the Australian context, section 60 of the Corporations Law expands the definition of "director" in the following manner:

[A] reference to a director, in relation to a body corporate, includes a reference to:

(a) a person occupying or acting in the position of director of the body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position;

(b) a person in accordance with whose directions or instructions the directors of the body are accustomed to act. . . .

34. See the definition of subsidiary in division 6 of part 1.2 of the Corporations Law.
Subparagraph (a) of this definition would include a de facto director. The indicia of a de facto director would include attendance at board meetings, voting on board resolutions, representing oneself to outsiders as a director, and participation in management as if one were a director. The concept of a director also involves being one of the group of persons who embody the directing mind and will of the company as contrasted with those who, however senior, receive directions and within various ranges of discretion and authority, carry them out.

Paragraph (b) of the definition characterizes as directors those persons in accordance with whose instructions or directions the real directors of the company act. This paragraph applies to an outside person who "calls the tune" in causing the directors to act. Thus, for instance, it applies to a person who is "de facto but not de jure the power behind the throne."

A person is a director within this limb of the definition, if his will, and not the independent will of the appointed directors, determines the resolutions of the board of directors. In this regard, merely to show control by the person alleged to be a de facto director over the company's working executives is not sufficient.

In order for a lender to be a deemed director, the level of interference with the decision-making processes of the board would need to be extreme. Nevertheless, if the package of controls vested under the transaction documents and the exercise of those powers by the lenders in the course of the loan is such that it can be said that the lenders direct the business activities of the company so that they are in effect the directing mind and will of the company, then this conclusion is possible.

It should be emphasized that to determine the possible liability of a lender, a court will look not only at the terms of the transaction documents, but also at the manner and extent of the exercise of the powers by the lender. Consequently, one cannot successfully avoid these liabilities by clever drafting if in fact the lenders purport to exercise a substantial degree of control over the business affairs of the borrower. In the Australian context, if a lender is deemed to be a director, any attempt to contract out of the liabilities imposed under the Corporations Law upon directors would be void, as would any indemnity in respect of any such liabilities.

C. Other Liabilities of Lenders

1. *Section 592 Corporations Law*

Even if the degree of control vested in the lenders is not sufficient to make them deemed directors, if they exercise too much authority over a company they may be liable for debts incurred if the company is verging on insolvency. Liability arises if, immediately before the time a debt is incurred, either there were reasonable

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37. *Id.* at 64 (per Wells, J.), 71 (per Sangster, J.).
38. Corp. Law § 241.
grounds to expect that the company would not be able to pay all its debts when they
came due, or there were reasonable grounds to expect that, if the company incurs
the debt, it would not be able to pay all its debts as and when they became due.
Section 592 of the Corporations Law extends liability for debts incurred in these
circumstances to directors of the company and to any persons who take part in the
management of the company at the time the debt is incurred. Lenders will be liable
under this section if the degree of interference with the business activities of the
borrower enables a court to determine that at the relevant time they took part in the
management of the company. This test is wider than the test for a person to be a
director contained in section 60 of the Corporations Law.

The concept of management for these purposes probably comprehends activities
that involve policy and decision making related to the business affairs of the
company that affect the company as a whole (or at least a substantial part of
that company). Such activities would suggest management to the extent that the
consequences of the formation of those policies or the making of those decisions
may have some significant bearing on the financial standing of the company or
the conduct of its affairs. Accordingly, lenders who reserve for themselves (and
exercise) a real and direct participation in the policy and central decision making
of the important business decisions of the company face the real risk that they will
be seen as persons taking part in the management of the company.

2. Lenders As Fiduciaries of Their Borrowers

Much has been written on the question of when a lender may assume a fiduciary
relationship with its borrower. As has already been discussed in the context of subordination, U.S. jurispru-
dence recognizes a doctrine of lender liability that covers a wide ambit of topics
including fraud, misrepresentation, equitable subordination, and liability based
upon control.

In the context of the exercise of control, in order for the control to establish
a confidential and therefore fiduciary relationship, the test in the United States
appears to be the exercise of that degree of control that is extensive enough to
result in the merger of identity such that the creditor becomes an alter ego of the
debtor or the debtor becomes a mere instrumentality of the creditor.

In the Australian context, although no general doctrine of a fiduciary relation-
ship between a borrower and a lender exists, such a relationship may arise in

40. See, e.g., R. Cranston, Lender Liability, 64 A.L.J. (1990); D.B. Robertson, The Lender-
Kathryn J. Smith, Themes in the Liability of Banking and Lending Institutions, 64 A.L.J. 331 (1990).
41. See supra part I. C.
1973); Anaconda-Ericsson, Inc. v. Hessan (In re Teltronic Services, Inc.), 29 B.R. 139 (Bankr.
E.D.N.Y. 1983).
special circumstances. In circumstances where a lender purports to exercise an extreme degree of active intervention in the borrower’s affairs, the courts may impose liability on the lender over and above the statutory provisions discussed.

D. WHAT ARE THE DANGEROUS FORMS OF CONTROL?

If one tests the potential for liability of being a deemed director, of being liable pursuant to section 592 of the Corporations Law, or of being liable because a fiduciary obligation arises as a result of the control purported to be exercised or reserved in the lender, against some of the objectives of lenders discussed earlier in this article, some conclusions can be drawn.

Regular Financial Reporting: Observation and monitoring are not sufficient to establish control. Consequently, a requirement to provide information to lenders is unlikely to cause difficulty.

Control of Ownership and Directors: This is a key area of concern. The reservation of the right to approve any change of directors may lead to the result (as already indicated) that the lenders are controlling the composition of the board, and it may be an indication of a real and active control over the policy-making mind of the company. It may be possible for the lenders to have some protection by having a list of acceptable directors or a description of the qualifications for an acceptable director. Nevertheless, the ultimate decision to appoint directors should be left to the discretion of the company or, in the case of the appointment of additional directors, to the existing board.

Business Activities: Clearly a line exists beyond which the activity of a lender will cease to be a legitimate restriction to preserve the assets of the company and will constitute an exercise of management control over the company’s business. If the lenders purport to reserve a right to make strategic decisions in relation to the ongoing business strategies of a company, that may well indicate that the lenders are involved in the management of the company.

Asset Sales: Although a secured lender has a legitimate right to have some say in relation to the disposition of assets subject to the security, a secured creditor will intrude into the function of management if it purports to have a veto over all asset sales or to require asset sales to be made in a particular way. In the case of the company in distress whose major business objective is to undertake a long-term program of asset sales, the problem is particularly acute. In such circumstances, if the lenders impose severe restrictions on how that program is to be undertaken, and reserve the right to approve each significant sale, or reserve the right for the sale not to occur if they disapprove the sale, then the risk is significant that the lenders will be derogating from the directors’ ultimate decision

45. See supra part II. A.
in determining how to run the enterprise. This could result in lender liability for those decision-making processes.

E. REPORTING ACCOUNTANT

One method of attempting to provide some comfort to lenders, while minimizing their risk of being deemed directors or of taking part in the management of the company, is to suggest to the borrower that the borrower appoint an independent adviser (often called the reporting accountant) to perform certain monitoring functions under the loan agreement.

The reporting accountant is appointed by the borrower, not by the lenders, and is appointed for the purpose of giving independent advice in relation to certain specified functions. In exercising those functions, the reporting accountant is acting on behalf of the borrower and not on behalf of the lenders. The contract may include an obligation in favor of the lenders that the reporting accountant will act in accordance with his engagement by the borrower.

The reporting accountant normally reviews management accounts and provides comments upon quarterly and semiannual accounts and perhaps projected cash flow statements. The theory is that the reporting accountant is an independent expert and the lenders should derive some comfort from his independent assessment of the accounting and management information provided by the borrower.

On occasion, the reporting accountant is also asked to express views on business plans and major asset sales. The extent of liability for lenders in relation to key decision making will be significantly less if they are prepared to rely upon a covenant that requires the borrower to seek the confirmation of the reporting accountant (who is the agent of the borrower) to the proposed business decision rather than the approval of the lenders. To date, no case law answers the question as to whether this technique of the appointment of an independent reporting accountant reduces the risk of lender liability.

However, the terms of engagement of the reporting accountant should clearly demonstrate that the reporting accountant is engaged to provide advice and to undertake other functions on behalf of the company and not on behalf of the lenders. The lenders should not be able to exercise any real control over the reporting accountant. They may require that the borrower always engage a reporting accountant who is acceptable to them, but if this technique is to have any efficacy, the lenders should not purport to exercise any control over the way the reporting accountant carries out his functions.

Furthermore, the reporting accountant should not seek, nor be given, an indemnity from the lenders in relation to the carrying out of his functions. Although commonly a receiver obtains an indemnity from the appointing lenders, the rights, obligations, and indemnities provided to a receiver are now well established both pursuant to the Corporations Law and pursuant to the common law. This is not the case with the reporting accountant, and the existence of an indemnity may
result in the reporting accountant being seen as the agent of the lenders rather than as an independent person engaged on behalf of the borrower.

III. Role of the Agent

A. Is the Agent Bank a Fiduciary?

In the context of a syndicated loan agreement, an agent bank is appointed as agent of the lenders to carry out certain functions on behalf of the lenders. The agent, in performing these functions under the loan agreement, does not, in general, act as the agent for the borrower. The role of the agent needs to be contrasted with the role of the manager who, pursuant to the terms of a mandate granted by the borrower, acts as its agent for the purposes of procuring participant banks to enter into the syndicate. Where the manager, who assists to procure the assembly of the syndicate, proposes thereafter to act in relation to the loan agreement as the agent, at some point the manager ceases the role as manager on behalf of the borrower and commences to act as the agent for the lenders. These are two separate functions although they are often fulfilled by the same institution.\(^46\)

Although an agent is not generally a trustee for the lenders (except possibly in respect of moneys coming into its hands that it is obliged to account to the lenders), the agent's role for the lenders is both a contractual one and one pursuant to which fiduciary obligations attach. The scope of the fiduciary obligations depends upon terms of the loan agreement. Fiduciary obligations arise because the agent is acting as an agent, although the extent of these duties is at times unclear. Fiduciary obligations may not be avoided altogether by contracting out of them.

The primary fiduciary duties owed by an agent to the lenders are: (1) a duty to exercise such skill, care, and diligence as is reasonably necessary for the proper performance of the duty that it, as agent, has undertaken;\(^47\) (2) a duty to disclose everything in connection with the agency that is material and known by the lenders; (3) a duty not to subdelegate; (4) a duty to avoid a conflict of interest; and (5) a duty not to make secret profits.

Very little case law deals with these principles in the context of an agent bank, and in postulating the position one needs to argue by analogy.\(^48\) Several issues arise from the principles that are relevant in the drafting of a syndicated loan.

1. Obligation to Monitor and Disclose

The principal area of difficulty in this context is the extent to which the agent must monitor the borrower's financial condition and pass on information concern-

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\(^{48}\) For an explanation of some of these principles, see 2A Wood, supra note 1, at 11-16.
ing that condition to the other lenders. The loan agreement usually provides that the agent is not deemed to be aware of a default or the potential event of default and that the agent is only obliged to notify lenders if it is actually aware of an event of default or potential event of default.

The agreement may provide that only certain information must be passed on to all lenders. In the absence of any positive obligation upon the agent to notify the syndicate, the relevant test would seem to be whether the lenders would be materially prejudiced by failure to notify them. In determining whether or not to pass on information, because of the potential for liability and the potential for conflict of interest, an agent should always err on the side of caution should it be aware of information that is relevant and that has not been passed on to the lenders.

If the information is the sort of information that is readily or publicly available to all lenders, then the agent is entitled to assume that the lenders would have access to it as part of their ordinary business, and the obligation to disclose would not arise. If the agent does have actual knowledge, say, as to the fact that the syndicate’s security is inadequate, or that there has been some material deterioration in the borrower’s financial condition, which is relevant to the loan, the failure to pass on that information will constitute a breach of duty. 49

It is doubtful whether the agent has a duty to analyze information provided to it and furnish the results of its analysis to the lenders. A loan agreement should negate any suggestion that the agent has a role other than to provide information. It should also expressly negate any obligation to analyze the financial or other information provided by the borrower or obtained from other sources.

2. Duties to Perform Functions Personally

The obligation upon the agent to perform any of its functions personally does not mean that the agent is not able to perform duties through agents or employees. Again, the loan agreement should expressly provide that the agent is entitled to rely upon advice and opinions of advisers selected by it and is entitled to act through agents or employees. Nevertheless, in delegating its functions to agents or employees and in appointing advisers, the agent will have an obligation to exercise care in its choice of delegate. Further, in relying upon opinions from advisers, the agent would normally only be entitled to rely upon such opinions insofar as they relate to the particular area in which the adviser is qualified. For example, it would be improper for an agent to rely upon lawyers for a detailed analysis of the accounts of the kind normally given by a qualified chartered accountant.

3. Duty to Avoid Potential Conflicts of Interest

Perhaps the key problem for an agent is the potential for conflict of interest. A well-drawn loan agreement will expressly provide that the lenders acknowledge


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and agree that the agent may act as banker to the borrower and may otherwise act also as a lender in the transaction.

A very important question is whether such exculpatory clauses can override, or at least limit, the fiduciary obligation to exercise powers entrusted to the agent for the benefit of the lenders in circumstances where the agent's own interests are in conflict. One view suggests that the courts should recognize the contractual provisions, the limitations on the duties imposed, and the existence in the agreement of the consent of the lenders to the agent also fulfilling its role as a banker or co-lender.  

It seems that the difficulty arises where the agent, in the course of undertaking its role as banker, forms opinions, or makes decisions, or becomes aware of circumstances that may adversely affect or conflict with the interests of the lenders under the syndicate. The conflict of interest that arises can only be effectively waived with full and informed knowledge and consent of the lenders. A clause contained in the loan agreement confirming that the agent can act as banker and as co-lender may not constitute an effective waiver if the circumstances that have arisen require the other lenders to be given further information in order for them to give a proper and informed consent.

IV. Obligations of Lenders to Each Other

A. Concentration on Individual Rights

Lenders are now very focused on what rights they can exercise individually from two, perhaps contrary, points of view. First, individual lenders are keen to preserve autonomy in relation to certain critical rights. Secondly, lenders are concerned that small individual lenders should not be able to frustrate the vast majority of lenders in relation to certain important decisions.

In drafting any loan agreement, the rights that should be exercised individually by lenders, and the rights that should only be exercised with the support of other lenders must be analyzed. A syndicate should not be established as a partnership of lenders. Consequently, a fundamental element of any syndicated loan is that the obligations of the lenders are several and that their rights are also separate (even though there are some mechanisms for joint action to enable efficient enforcement of the individual rights of the lenders). This prime objective of


51. If the lenders are partners, then each lender may owe to the others obligations of "utmost good faith," and there would be joint and several liability between lenders. Lenders that are Australian banks may be in breach of § 63(1) of the Banking Act 1959 (Cl'th) and the syndicate could be a partnership for tax purposes, which would be disadvantageous.
ensuring that the syndicate does not constitute a partnership is important when drafting any syndicated loan.

Key individual rights that need to be addressed follow:

**Right to Sue:** Loan agreements commonly provide that, prior to the final maturity date, a lender would only have a right to sue following an event of default that the majority lenders have agreed to act upon. However, it is considered to be inappropriate to restrict an individual lender from its right to sue for its debt at or after the final maturity date. It may be that the right to sue for the debt is a right without any substance in the case of a secured lending if the security has been granted to a security agent for the benefit of all lenders. In these circumstances, the security arrangement will usually provide that the agent is only entitled to act on the instructions of the majority of the beneficiaries of the security. Consequently, an individual lender may not be able to enforce the security. Nevertheless, to prohibit an individual lender from the right to sue (and perhaps to take action for winding up of the borrower) is to disenfranchise a lender from an important individual right.

**Funding Return:** The mechanism for calculating the funding return should not be able to be amendable without the individual lender's consent. As with the right to seek repayment on final maturity, another key element of any loan is the return agreed to be provided to an individual lender.

**Power of Amendment:** Clearly certain clauses in a loan agreement should be able to be amended by an agent if the amendments are necessary to correct a manifest error. Other amendments can legitimately be made if the majority lenders require the amendments to be made. However, certain amendments should not be forced upon an individual lender without its consent. These clauses should at least be those that enshrine individual rights, the percentages required to constitute the majority lenders and similar rights.

**B. ** **MAJORITY LENDERS**

Over the last several years, a great number of existing loan agreements have required that decisions be made by majority lenders. There have also been a number of syndicates in which different lenders have different views. This has resulted in a keen review of the appropriate provisions to be included in the definition of "majority lenders." The issues that are canvassed are: whether the majority should be based upon a simple majority or some higher amount; whether the majority should be based simply upon the amount outstanding or whether undrawn commitments should be taken into account; and, whether in addition to a majority of principal amount, there should be a minimum number of lenders to constitute the majority.

An important balance needs to be struck in defining majority lenders. On the one hand, ensuring that large lenders do not dominate or oppress minority lenders is important. On the other hand, lenders who are taking a minor exposure to the
borrower should be unable to veto the decisions that are in accordance with the wishes of by far the majority of lenders.

C. FACTORS IN EXERCISING DISCRETIONS

Although, for reasons similar to those canvassed elsewhere in this article in relation to junior creditors, lenders who rank equally do not generally owe to each other fiduciary obligations; lenders have an implied obligation to exercise any power given pursuant to the loan agreement for the purposes for which it is given and not for a collateral or private purpose. This does not mean that the relevant power cannot be exercised if to exercise the power in a particular way would be adverse to the interests of another lender. However, each lender must act honestly and reasonably to conclude that the action proposed is consistent with the interests of the syndicate as a whole and is consistent with the objective of recovering the debt owed to the lenders.

It is not clear what sort of consideration would in these circumstances amount to bad faith or capricious behavior that could be set aside as a fraud on the power. For example, where a major bank has exposure to a number of companies in a broad group, is the bank as a lender in a syndicate entitled to consider its overall position in determining how to act even if the lender considers that the proposed action would not be in the best interests of the particular syndicate? Based on general principles, the bank in these circumstances would be acting for a collateral or ulterior purpose in determining a course of action that is not in the interests of the syndicate simply because the bank determines that the course of action is in its own best interests, having regard to its overall exposure.

D. LENDER COMMITTEES

In large syndicated loans with many lenders and in the case of many workout facilities, it becomes administratively unworkable to have to refer all decisions to all lenders. In these types of facilities, a lender committee ordinarily is established. The lender committee is usually established in accordance with a voting mechanism set out in the relevant loan agreement. The committee should be representative of the lenders comprising the syndicate.

Aware of the possibility of being held to be the agent for the lenders (with the consequential fiduciary obligations attached to that position), members of the committee are reluctant to have vested in them real and significant powers. The committee is usually restricted to a monitoring or information-providing role except in unusual circumstances.

52. Logue v. Shoalhaven, S.C. [1979] 1 N.S.W.L.R. 537 (Austl.). The concept of "fraud on a power" derives from cases considering the obligations of trustees exercising powers of appointment, see, e.g., Vatcher v. Paul, 1915 App. Cas. 372 (P.C. 1914) (appeal taken from Jers), but has been extended and now clearly applies to powers outside a trust arrangement.
Where the circumstances require the committee to exercise real decision-making powers, those powers need to be carefully drafted, addressing the problems of the committee usurping the powers of the lenders under the loan agreement.

Where appropriate (because of the number of lenders or the circumstances of the borrower) for the committee to be vested with real powers, members of the committee usually request an indemnity from all lenders for any liabilities that attach as a result of the exercise of their powers. This indemnity is requested on a pro rata basis having regard for the exposure of each lender.

V. Special Problems in Refinancing Companies in Difficulties

A number of financings that have been undertaken in recent years are in effect refinancings of companies that are, or that, but for the injection of new capital by a sponsor, have been companies in serious financial difficulties. In structuring any such refinancing and the terms of any securities for any such refinancings, special considerations need to be taken into account.

A. Risk of Preference

In a situation where a lender who has been part of a previous syndicate agrees to be part of the new financing, two risks need to be addressed. The first is whether the repayment of the lender's participation in the old syndicate could be attacked as a preference. The second is whether the lender's interests in the new security could be attacked as a preference.

By reason of the incorporation of the relevant bankruptcy provisions into the Corporations Law, a repayment to a lender, or a new security granted to a lender, will be void against a liquidator if the winding up of the borrower commences within six months of the repayment, or of the execution of the security, if the repayment, or the granting of the relevant security, is construed to have been in favor of the lender, in its capacity as a creditor, and the effect of the repayment, or the granting of the new security, is to grant to that lender in that capacity, a preference, priority, or advantage over other creditors.

It may be possible in certain circumstances to establish that the security is entered into in good faith, for valuable consideration, and in the ordinary course of business. If these factors can be established, they constitute a defense pursuant to section 122 of the Bankruptcy Act.

In circumstances where a lender increases its exposure under the refinancing, there can be no question of a preference in relation to the repayment of its participation in the old syndicate. Payment does not have the effect of giving a

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54. Bankruptcy Act 1966, § 122 (Cl'th).
creditor a preference if it is in connection with a re-advance of the same or a greater amount such that the indebtedness owing by the borrower increases.\(^5\)

Also, even if either the repayment or the grant of the new security creates a risk that could cause a preference to be granted to the continuing lender, both events could not be impugned. Which event may be impugned depends upon which, according to the facts or circumstances, has the effect of preferring the continuing lender as a creditor.

In relation to the grant of new security, the grant of the charge does not confer a preference upon a lender to the extent that the charge secures moneys in excess of those owing under the old syndicate (that is, new moneys). To the extent that the charge secures the same amount as that under the old arrangement, the charge could give rise to a preference (notwithstanding that the obligation now arises under the new agreement rather than under the old syndicate arrangement).\(^6\)

Finally, a charge will only be affected to the extent that it creates a preference and not otherwise. A charge may be partly avoided without being avoided in whole.\(^7\)

**B. Consideration**

In any refinancing of any existing debt where the refinancing is taking place on better terms for the lenders, it is critical that the consideration for the further assurances is both identified and expressed. If the consideration is a forbearance to sue, there should be real evidence that the lenders are both entitled to sue for the recovery of the debt and have taken steps to do so. If the consideration is an extension of the term of the loan, then again this should be adequately documented; and any suggestion that there has been any implied extension before the new security has been agreed to be given should be expressly negated.

In circumstances where there may be some suggestion that the new security offered to the lenders is not offered in both good faith and for valuable consideration, a further question that needs to be considered is whether the security may be set aside as a “settlement of property” within the meaning of section 120 of the Bankruptcy Act. If the granting of the new security does constitute a settlement, then it can be set aside by the liquidator of the company (as the settlor disposing of the property) if winding up proceedings commence within two years after the date the settlement comes into effect.

Although it has been previously thought that section 120(1) is not applicable to companies, recent authority has suggested that the express wording of section

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The question, therefore, is whether a security granted in favor of a lender can fall within the concept of a settlement of property. Section 120(8) of the Bankruptcy Act defines a settlement of property to include any disposition of property. Consequently, security such as a general law mortgage or an equitable mortgage may be caught within the section. However, whether a charge or other form of security that does not involve the transfer or assignment of any property would amount to a settlement of property in the relevant sense is doubtful.