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Syndicated Lending and Uganda's Recent High Court Decision

A new playing field?

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1. Introduction

In a decision with potentially far reaching implications on Uganda's investment climate, the High Court has ruled that it is illegal for a foreign financial institution without a license from the Bank of Uganda to extend credit to a borrower in Uganda. The Court's decision delivered on 7th October 2020 that the recovery of such loans is unenforceable has not only rattled the banking industry, but may disrupt financing of Uganda's strategic projects, notably in the much-anticipated oil industry. To reassure the restive market, the government of Uganda has given its commitment to meet all its current and future syndicated loan repayment obligations notwithstanding the Court's decision in a statement issued on 8th October 2020 by the Secretary to the Treasury.

This publication gives an overview of the structure of syndicated lending, the key players and their respective responsibilities as well as the attendant legal and commercial considerations. It also highlights some of the potential implications of Uganda's Court decision without delving into the merits of the case.

2. Overview of syndicated loans

A syndicated loan is a facility where lenders jointly provide loans for one or more borrowers under the same loan agreement. Loan syndication is a way for banks to share risk in financing larger projects which a single lender may be unable and unwilling to undertake individually. Globally, as of 2015, US $ 4.7 trillion was financed through syndicated loans. Due to the colossal sums involved for large debt financing, it is often difficult for one financial institution to put together such a loan facility without a significant negative impact on their financial position. Although there would be contractual means of mitigating such credit risk even for large loans, it is risky for one creditor to finance large facilities individually. This forms the underlying basis for syndicated loans as one of the ideal multiple lending structures for large finance deals.

Loan syndication however, raises unique legal issues such as what law should apply to the transaction where financing has been sourced from foreign creditors. What powers might multiple lenders have over the assets considering that they might each seek to exercise their authority independently? Even further, how security is managed where there are multiple lenders, presents a unique challenge. Another issue that has just come to the fore in Uganda is whether foreign lenders who are part of lending syndicates need to obtain the approval of the Bank of Uganda prior to conclusion of the lending transactions.

3. Structure and participants

Syndicated lending typically entails different banks combining to each fund a specific sum of money to one or more borrowers. It is structured in such a way that it is to be administered by one or several commercial banks. Typically, when a possible lender has been approached for financing by a borrower, the lender may seek out others to join in financing a single deal to one borrower. This unique structure enables financial institutions to minimize constraints on their balance sheet which frees up their ability to use their money for other purposes. Syndicated loans are also contractually managed through financial covenants, restricting the ability of the borrower to dispose of assets. However, how their enforcement structure operates may vary from ordinary loans.

Due to the number of parties that a syndicated loan might involve, it necessitates collective decision making structures. For instance, trustees are crucial to solving organizational and enforcement difficulties. Security is usually held by a Security Trustee, who may enforce for the lenders as beneficiary in the event of any default. Further, an Agent Bank might be necessary to administer the relationship between creditors and a borrower.

4. Lead Arranger and Agent Bank

The bank that takes the lead is referred to as the Lead Arranger. The lead bank most times transitions into the role of the agent bank once the lending transaction completes. It is also possible for the lead and agent banks to be different. It is the responsibility of the Lead Arranger to do the preparation work of establishing the syndicate after the borrower and the Lead Arranger have negotiated the loan terms. The Lead Arranger's role is crucial in the execution of a syndicated loan. The role of a Lead Arranger varies depending on how it is defined for each transaction in the contractual documents. Lead Arranger's roles can be summarized into three main functions that include:

- Obtaining funding commitments (contributions) from prospective participant banks;
- Assisting the borrower with preparing an information memorandum. An information memorandum entails a due diligence report and the financial modelling of the borrower;
- Documentation (term sheet preparation) including liaison with other participant bank's legal counsel. Regarding the documentation, although the Lead Arranger also negotiates loan documentation, other participant banks are still involved in the process through their in house counsel. Usually the Lead Arranger also underwrites the loan syndicate. Within the financial services, a great deal of prestige is attached to holding the position of Lead Arranger.

There is no necessity for the borrower to interface with each of the members of the syndicate. Typically most of these interactions are managed by the Lead Arranger who may also transition into the role of the agent bank. The agent bank usually part of the lending syndicate assumes the responsibility of administering the day to day running of the loan. In syndicated lending transactions involving local and international lenders, Ugandan banks are normally the agents.

Under agency law, the mandate and scope of an agent, is laid out in a contract. Disputes usually arise on whether there is a fiduciary duty held by an agent bank to the other banks or the borrower.

5. Fiduciary obligations and liabilities of the agent bank

The existence of fiduciary obligations of an agent bank depends the express contractual terms. Common Law, and recent judicial decisions confirm that the duty of an agent is subject to express contractual terms. There is no implied term to pass on relevant information over and above express obligations stipulated under the relevant finance agreements. Generally, the duty to provide any information is only to enable lenders to decide whether to exercise rights under agreement, and not to make business decisions (such as whether to exit). This illustrates the significance of drawing proper finance agreements, to limit to the greatest extent possible the potential liability of an agent bank.

As discussed above, most obligations are contractual and must be spelt out expressly under the loan agreement. From a practical point of view, it is usually preferable that fiduciary duties are excluded. Standard precedent agreements from different loan market associations have an exclusion clause specifically mentioning that agent banks have no obligations (including fiduciary duties) to any of the parties to the different finance agreements.

It has long been held under Common Law (which is applicable in Uganda) – and recently affirmed in Barclays Bank plc v Svizera Holdings plc [2014] EWHC 1020 (Comm.) that standard contractual terms are effective against a borrower's claims of misrepresentation and breach of duty of care against a lender. As such, it is ideal to insert exclusion clauses into any fiduciary obligations arising from finance agreements.

However, scholars, for instance Gavin R. Skene, argue that the complex relationships formed under a syndicated loan have the potential to create a fiduciary relationship between an agent bank and participant banks.

6. Enforcement and protection of minority lenders.

For most syndicated loans, there are usually minority lenders- who contribute a lesser portion of the syndicated loan to be advanced. Their rights are also of ultimate concern. Most matters require consent of the majority (by value or number of institutions) within a loan syndication. However some decisions may be delegated to 'majority lenders' or to the agent bank.

Enforcement in most loan syndicates can only occur if a default has been declared by the agent bank usually on the direction of the majority lenders. If one lender enforces, a pro rata clause may apply. Any lender who recovers more than his share must share any excess pro rata with other lenders. If a lender has set-off, this is intended to benefit all lenders, which has a quasi-security effect.

7. Conclusion

Uganda's court decision locking out foreign financial institutions participating in ordinary and syndicated lending transactions in Uganda unless licensed by the Central Bank is unprecedented and has stunned many in the local, regional and global banking industry. It is may be questioned whether a purposive interpretation of Uganda's Financial Institution

Act envisions the licensing of foreign banks prior to extending credit to Ugandan borrowers in the normal course of banking business in their respective jurisdictions. If indeed this was intention the law, whether foreign banks would submit to the onerous licensing process for the random lending transactions they get involved in advancing credit to Ugandan borrowers.

Government's quest to implement its ambitious infrastructure agenda is constrained by inadequate resources. It is now looking at public private partnerships (PPP) as one of the means of addressing the infrastructure gap. PPP structures themselves rely heavily on significant debt capital that is raised by several local and international financiers in a consortium. It is estimated that over $ 16 billion investment capital will be required to finance Uganda's oil project. The bulk of this will be debt. There is no single local and international bank with the risk appetite and capacity to lend this money to the oil companies acting alone. Besides the inadequate domestic financing, the law also places restrictions on the amount of loans Ugandan banks can disburse. They can only spend part of the customer's deposits and not more than 20% of their loan portfolio should be held by a single client. For this reason, foreign financial institutions are necessary to bridge this gap.

Foreign banks that have already extended debt to local borrowers will even be more restive in view of the Court's ruling that the recovery of "such illegally disbursed loans" is unenforceable in Uganda. The government and other stakeholders in the private sector must come out urgently to resolve this impasse. If not, the country's economic outlook may be affected. Lending transactions that were about to close will no doubt stall as a result of this court ruling. Continuing uncertainty on the matter will undermine confidence in the financial sector portraying Uganda as an unfavourable destination for foreign investment. More importantly, the High Court decision has the potential to delay the start of Uganda's highly anticipated and long awaited oil project.

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Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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