Session 4: Understanding key legal concepts and the room to manoeuvre

Background Note: Key Clauses in Debt Documentation

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1. Introduction

In negotiating financing agreements (both loans and bonds), the terms and conditions tend be dictated by the lender and/or based on best practice (albeit non-binding) guidelines issued by the Loan Market Association ("LMA") and the International Capital Markets Association ("ICMA"). However, this does not mean that sovereign borrowers cannot negotiate alternative terms and conditions. To assess and make the most of the negotiation process, this document and the accompanying presentation will explain the rationale behind the key clauses and points for negotiation (including carve-outs/exceptions).

While this document outlines some of the key provisions found in lending documentation, it is important to review and understand all provisions (including definitions and boiler plate language) to ensure that the language is indeed fit for purpose, operationally workable, and adequately protects the sovereign borrower.

Further, all of the provisions listed below, while common market practice, are open to negotiation and should not be accepted in the form presented by the banks without due examination.

2. Representations and Warranties[1]

2.1 Representation and warranties are two aspects of the same clause that go together in a credit facility (and other agreements).

2.2 A representation is a statement of fact to induce a party to enter into an agreement.

[1] For more information, please refer to Chapter 2, 1.3 of the Level 2 ALSF Sovereign Debt Handbook.

2.3 A warranty is a promise that the statement is true and is used to indemnify the counterpart if a specific assertion made in order to induce the counterpart into a contract, is false or inaccurate.

2.4 Lenders highly rely on representations and warranties as to the situation of a borrower to assess the risk of the transaction and use them to form the basis of the lender's credit decision. These provisions are intended to encourage prompt disclosure by the borrower and protect the lenders. The breach of a representation or warranty will trigger an Event of Default (see also section 7 *"Events of Default"*).

2.5 In addition, it is a condition precedent to a utilisation (drawdown) of the credit facility that the (repeating) representations are true (in all material respects).

2.6 Commonly used representations and warranties include:

(a) that the intended transactions are a binding obligation for the borrower;

(b) the contemplated transaction has been duly authorized (in the sovereign context, this typically includes regulatory, ministerial, parliamentary or other governmental approvals);

(c) no misleading information has been provided by the borrower;

(d) no litigation, actions, suits, proceedings, claims or investigations are pending, or to the knowledge of the borrower, threatened, affecting the borrower, as to which there is a possibility of an adverse determination, that if determined could result in a material adverse effect; and

(e) no event of default is continuing.

2.7 Representations and warranties that are particular to sovereigns include:

(a) the debt transaction is a commercial action of the State;

(b) compliance with treaty obligations;

(c) the transaction will be within the scope of budgetary limits;

(d) the obligations are backed by the full faith and credit of the sovereign;

(e) the sovereign retains IMF and World Bank membership;

(f) the transaction does not fall within the scope of any debt relief legislation;

2.8 The *pari passu* representation is also commonly encountered. Of note, *pari passu* operates both as a representation and a covenant (see section 4 "*The Pari Passu Clause*" below for a detailed discussed of this language).

2.9 These provisions are not set in stone. Negotiation is expected.

2.10 From the borrowing sovereign's perspective, the key objective is to ensure that each clause is drafted in a manner that is operationally workable.

2.11 Borrowers must consider the types of exceptions and qualifications that they require in order to achieve operational workability.

(a) For example, this can be achieved through the application of certain qualifications to these clauses such as by reference to a knowledge qualification or a materiality threshold. A materiality threshold qualifies a clause by setting a standard for which the breach will be considered 'material' or significant (e.g., by adding a defined concept of "Material Adverse Effect").

(b) *De minimis* (minimum) basket exceptions may also be appropriate in relation to certain provisions. The minimum limit could be set by reference to a monetary amount or a financial measure.

(c) Borrowers should also take great care to ensure that they have systems in place to check the accuracy of each representation before it is made or deemed repeated.

2.12 From the lender's perspective, their requirements tend to fall into four categories:

(a) Credit: Borrowers at higher risk of default (i.e., lower credit quality) will be subject to a more restrictive covenant package.

(b) Jurisdiction: Local law requirements may dictate the addition of certain terms. For example, lenders may be wary of exchange control requirements and how that would affect the credit agreement.

(c) Sector: To the extent the debt incurred is for certain stated purposes, the loan agreement may also be supplemented by provisions relating to the nature of that purpose. Examples include additional environment and insurance representations in connection with project finance documents.

(d) Policy: Lenders may also put forth certain representations as a policy matter across its loan book. Common examples include compliance and regulatory matters such as sanctions, money laundering and corruption issues.

3. Covenants[2]

3.1 Covenants are found in both loan and bond documentation and may be positive or negative.

3.2 Positive covenants are promises to do something during the life of a lending arrangement and, in the context of a credit facility, include information and reporting covenants that enable the lenders to monitor the borrower's performance and condition.

[2] For more information, please refer to Chapter 2, 1.6 of the Level 2 ALSF Sovereign Debt Handbook.

3.3 Negative covenants are promises not to do something; they prohibit or restrict activities that could decrease the prospects of repayment and therefore, limit the actions of the borrower.

3.4 A breach of a covenant is an Event of Default, subject to the expiry of any applicable grace period (see also section 7 *"Events of Default"* below).

3.5 In sovereign lending, common covenants include the maintenance of the membership in international financial institutions such as the International Monetary Fund ("IMF"). From a lender's perspective, this is an indication of the borrower or issuer's credit status since, among other things, these organizations typically work closely with the government in performing economic reviews to identify economic and financial vulnerabilities.

3.6 Another key covenant for sovereign borrowers and issuers will be the "use of proceeds" covenant, which regulates the uses the borrower may give to the funds raised from the credit facility or bonds. Standard use of proceeds clauses allow for general budgetary purposes or specific government projects.

3.7 Additional provisions that are regularly encountered include:

(a) required authorisations;

(b) compliance with laws;

(c) negative pledge (as discussed further below);

(d) delivery of information made available to the IMF;

(e) delivery of budget statements;

(f) compliance with public procurement rules or particular rules relating to government project sectors; and

(g) compliance with borrowing limits and requirements of the IMF and World Bank.

3.8 A borrower or issuer should ensure in negotiating covenants that the costs for compliance with the terms are manageable and the covenants will be achievable and not interfere with day-to-day operations.

4. The *Pari Passu* Clause[3]

4.1 The *pari passu* clause is a standard provision included in unsecured debt commitments (both loan and bonds).

[3] For more information, please refer to Chapter 2, 1.7 and Chapter 6, 2.4 of the Level 2 ALSF Sovereign Debt Handbook.

4.2 The meaning of the phrase "*pari passu*" in Latin is "with equal step" or "on equal footing". The clause contains the borrower or issuer's promise to ensure that the lenders will rank equally among each other and the obligation under the debt instrument will always rank equally in right of payment with all of the borrower's other unsubordinated debts. This clause applies both in respect of lenders under the same credit facility/bond prospectus/offering memorandum and lenders owning other debt obligations of the borrower.

4.3 In negotiating the clause, the borrower or issuer should try to: (i) limit the scope of the definition of outstanding debts, (ii) define thresholds to specify what constitutes "material" indebtedness, (iii) distinguish between contractual performance defaults and payment defaults, and (iv) distinguish between different types of indebtedness (i.e., between bonds and loans).

4.4 The International Capital Markets Association (ICMA) has published a sovereign version of the *pari passu* clause that has been drafted to avoid the difficulties that Argentina has faced in the New York courts (*NML Capital Ltd v The Republic of Argentina*). In interpreting the *pari passu* clause, the judge in *NML Capital* found that the clause gave Argentina's holdout creditors the right to prevent Argentina from paying the bondholders who accepted Argentina's restructuring without at the same time paying in full the bondholders who did not (the equal payment interpretation, not just equal ranking).

4.5 The ICMA form of wording contains a proviso that expressly disclaims the equal payment interpretation of the clause:

> *"The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank pari passu, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa."*

5. The Sharing clause[4]

5.1 It is standard practice to include a sharing clause in a facility agreement. It is a key principle of syndicated lending that each lender must be treated equally. The main purpose of this clause is to prevent discrimination by the borrower among lenders by paying some of them and not others. As such, if one lender recovers a higher percentage of its exposure than others, it must share the excess amount between the lenders. Therefore, the borrower will not be able to pay any lender in full until it has paid all lenders in full.

[4] For more information, please refer to Chapter 2, 1.8 of the Level 2 ALSF Sovereign Debt Handbook.

5.2 In the event that lenders benefit from an excess payment made by the borrower, the clause allows the non-paid lenders to recover for amounts distributed. The sharing clause is a covenant among lenders and will thus not be negotiated by the borrower.

6. Negative Pledge[5]

6.1 A negative pledge, found in both loans and bonds, is an undertaking by a borrower or issuer to a lender not to create, or permit to subsist, security over its assets in favour of creditors other than the lender. It is a fundamental clause in both secured and unsecured lending transactions, and as with all covenants, aims to give the lender some control over the activities of the borrower.

6.2 The negative pledge is intended to avoid the creation of preferences over the assets of the borrower in favour of third parties.

6.3 The scope of the negative pledge cause will be defined by the definition of indebtedness provided in the underlying bond or credit agreement. The borrower can request that the definition of indebtedness include a materiality threshold, for example, above certain amount of debt, or to divide the definition of indebtedness into different groups or categories (depending on the creditors) such as bank indebtedness or multilateral indebtedness.

6.4 Of note, bond-style negative pledges are different from loan-style negative pledges:

(a) In a bond, the negative pledge will typically limit the creation of security in connection with other bonds unless the existing bond is also secured on an equal footing.

(b) In a loan, the negative pledge is typically drafted as a blanket prohibition unless an exemption apply. In other words, the breach of a loan negative pledge cannot typically be cured by granting equal security to the lenders under the loan.

6.5 Borrowers should note that the definition of "Security" is typically very wide. It covers not only classic forms of security such as mortgage, charge, pledge and lien but also commonly "any other agreement or arrangement having a similar effect". This phrase may capture a broad range of arrangements including set-off, retention of title arrangement and so on.

6.6 Borrowers should be cautious with the use of the term "Quasi-Security" in a negative pledge clause. Transactions that may not necessarily fall within the definition of "Security" may nonetheless be caught by the negative pledge clause such as sale and leaseback transactions and set-off arrangements.

[5] For more information, please refer to Chapter 2, 1.6 and Chapter 6, 2.2 of the Level 2 ALSF Sovereign Debt Handbook.

6.7 From a negotiation point of view, borrowers and issuers may decide to accept the breadth of the prohibition but may want to focus on the scope of exceptions instead. In other words, the borrower may seek to ensure that as many categories of security are permitted under the clause.

7. Events of Default[6]

7.1 The Events of Default in both bonds and loans are agreed events upon the occurrence of which the lenders become entitled to accelerate or "call" (require immediate repayment of the debt) the loan or bonds (if holders of a certain amount of aggregate principal outstanding choose to accelerate) or cancel commitments, and claim guarantees and enforce security.

7.2 It must again be emphasised that these Events of Default are negotiable beyond the suggested qualifications listed below. Despite being presented as a standard Event of Default, certain provisions such as the material adverse change Event of Default can often be avoided altogether. It is important to understand, however, that a sovereign debtor's negotiating power will depend on various factors such as its credit rating.

7.3 Common Events of Defaults and key negotiation points include:

(a) payment defaults (of principal or interest);

(i) Consider qualifying the payment default event of default by adding a grace period and a carve-out for defaults caused by technical/administration errors;

(b) breach of other obligations;

(i) Consider qualifying the breach of other obligation event of default by adding a grace period. Lenders may accept a longer grace period here compared to a payment default grace period;

(c) misrepresentation;

(i) Consider qualifying the breach of other obligation event of default by adding a grace period. Lenders may resist and limit the grace period to only representations that are capable of remedy.

(ii) Also consider including a materiality threshold (e.g., only the breach of a representation in a material respect should constitute an Event of Default).

[6] For more information, please refer to Chapter 2, 1.09 of the Level 2 ALSF Sovereign Debt Handbook.

(d) cross default – where a default under another financial arrangement constitutes an event of default under the credit agreement and cross-acceleration – where the acceleration of a debt obligation due to a default under another financial arrangement occurs and constitutes an event of default under the credit agreement;

(i) Consider limiting this to only material financial arrangements (e.g., debt of at least a minimum monetary amount). Borrowers and issuers with more negotiating power (e.g., as a result of having a higher credit rating) may also limit this to only cross-acceleration (potentially also with a minimum threshold amount so that an acceleration of a *de minimis* amount of external indebtedness will not trigger an event of default) or payment acceleration.

(ii) Lenders will want to ensure that they are on an equal footing with all other financial creditors. If another lender has the right to accelerate, the lenders may wish to have the right to accelerate repayment of the credit agreement even if the sovereign has not otherwise defaulted under the specific agreement. In this case, the lender will request both cross-default and cross-acceleration language.

(e) material adverse change ("MAC");

(i) Stronger borrowers may resist this altogether on the basis that the MAC wording is not precise and the lender(s) should only be concerned with an actual payment default which will be covered as a specific default. The borrower can argue that the lenders are adequately protected by all the other representations, covenants and event of defaults and do not need the ability to accelerate on the grounds that there has simply been a material adverse change.

(ii) From a practical perspective, the vagueness of the clause also makes it difficult for lenders to rely on as there can be difficulties in assessing the materiality of an adverse change. Lenders may also be reluctant to wrongly call an Event of Default based on a material adverse change in borderline cases for fear of incurring lender liability.

(f) illegality – which may take the form of an applicable law which would make it unlawful to comply with the agreed obligations;

(i) Borrowers should check whether there is conceptual overlap with the illegality/unlawfulness mandatory prepayment event which may have been added. To the extent the illegality/unlawfulness event is outside the control or jurisdiction of the borrower, it may be more appropriate for this to be a mandatory prepayment event instead of an event of default.

(g) a moratorium being declared in respect of any indebtedness – where the borrower declares a moratorium on a portion or all of its external indebtedness (or other specified category of debt);

(i) Borrowers can argue for a minimum threshold amount (this is uncommon for African bond issuances).

(h) IMF membership cessation.

7.4 If provided in the agreement, defaults can become events of default upon the expiry of a grace period, being the period during which the event of default can be cured or remedied and the default avoided. The grace period is typically relatively short for payment defaults (often two to five business days) and longer for other obligations (often thirty days after written notice of default). Borrowers may attempt to negotiate longer grace periods.

7.5 Key points of negotiation for a borrower will include the length of the grace period and ensuring that there are materiality thresholds for events of default.

8. Sovereign Immunity and Waivers of Immunity[7]

8.1 Sovereigns typically have certain immunities from lawsuit and/or attachment and seizure of assets located abroad.

8.2 In the United States, the relevant legislation is the Foreign Sovereign Immunities Act ("FSIA"), and in the United Kingdom the State Immunity Act of 1978 ("SIA").

8.3 This can be a serious hindrance for creditors for enforcing against assets in the case of default and litigation.

8.4 Despite the fact that the general understanding is that a debt transaction is commercial in nature and that it would be exempt from immunity, it is common practice for the sovereign borrower to waive its immunity.

8.5 Common carve-outs include:

(a) assets located in the country;

(b) diplomatic premises/property;

(c) central bank assets/reserves;

(d) military assets; and

(e) assets forming part of the cultural heritage of country.

9. Collective Action Clauses ("CACs") and Loan Amendments[8]

[7] For more information, please refer to Chapter 2, 2 - 3 of the Level 2 ALSF Sovereign Debt Handbook.
[8] For more information, please refer to Chapter 5, 2 of the Level 2 ALSF Sovereign Debt Handbook

9.1 CACs are contractual provisions that set out voting procedures related to restructurings. These provisions permit a majority or supermajority of holders of a multi-creditor debt instrument, such as a bond, to modify key terms such as payment terms. Collective action clauses are thus an innovative technique used to facilitate sovereign debt restructurings which can potentially dramatically neutralise prospective holdout creditors.

9.2 The ICMA published new model Standard Aggregated Collective Action Clauses (the Model Aggregated CACs) to be included in sovereign bonds governed by English law in 2014. It provides three options to modify or restructure bonds:

(a) Single series modification – an issuer can propose a modification to a single series of its bonds. Approval would be required from holders of 75% of the outstanding principal amount of the bond (for reserved matters) or holders of 50% of the outstanding principal amount of the bond (for other matters).

(b) Multiple series modification – (with "two limb voting"). An issuer can propose a modification to multiple series of its bonds, with the requirement that the modification be approved by (i) holders of 50% of the principal amount outstanding of each individual series **and** (ii) holders of 66 % of the aggregate principal amount outstanding of all bonds to be aggregated.

(c) Multiple series modification – (with "single limb voting"). An issuer can propose a modification to multiple series of bonds, with the requirement that the modification is approved by holders of 75% of the aggregate principal amount outstanding of all bonds being aggregated.

(i) The "Uniformly Applicable" condition must be satisfied for single limb voting meaning that the proposed modifications must be uniformly applicable and on the same terms for holders of all bonds subject to the aggregation.

9.3 In the context of a bilateral loan, a borrower may request to amend a credit facility with the consent of the lender to modify key provisions such as the size of the facility, repayment terms or the financial covenants. In syndicated loans, amendments may require majority (>50%), supermajority (e.g., 66 2/3% or 75%) or unanimous (100%) lender approval depending on the drafting of the credit agreement. Some credit agreements may distinguish between matters that need a higher threshold for consent (i.e., super majority or unanimous) such as for changes to fundamental terms and those that do not.

10. Key Resources

10.1 Understanding Sovereign Debt – Options and Opportunities for Africa (https://alsf.academy/resources/understanding-sovereign-debt-options-and-opportunities-africa)

10.2 ALSF Academy Level 1 Coursebook on Sovereign Debt (https://alsf.academy/resources/sovereign-debt-course-handbook-level-1)

10.3 ALSF Academy Level 2 Coursebook on Sovereign Debt (https://alsf.academy/resources/sovereign-debt-course-handbook-level-2)