International ADR

Lenders' Trade Group Adopts Optional Arbitration Clause for Model Latin America Documentation

BY RICHARD M. GRAY

The New York-based Loan Syndications and Trading Association, or LSTA, is the leading industry organization in the Americas for lenders and investors in the syndicated loans market. See www.lsta.org.

The size and importance of that market can be appreciated by noting that the total amount of outstanding loans tracked by the S&P/LSTA Leveraged Loan Index as of Oct. 17, 2017, was about $950 billion. The volume of secondary market trading of syndicated loans reported by the LSTA for the month ending on that date was about $55 billion.

The area is ripe for an arbitration component to deal with disputes.

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In May, the organization delivered, releasing its new model documentation for secondary market trading for par/near par trades with Latin America counterparties. For the first time in any of its model documentation, it included an option for the parties to make a general election for arbitration. This is a potentially significant development for the growth of arbitration in international financial disputes.

To be sure, this single new step in and of itself is somewhat limited. For the time being, it applies only to Latin America secondary market transactions and, even then, only when one of the trading counterparties is located in Chile, Colombia or Peru.

The significance of the move, however, may be best understood as positive progress in light of last year's ICC Commission Report, "Financial Institutions and International Arbitration" (2016)(available at http://bit.ly/2fAynMr), which noted "a marked reticence on the part of financial institutions to use arbitration in international financing transactions," citing syndicated loan transactions as an example. (See p. 17.)

One of the LSTA's continuing core tasks is developing and revising model documentation for the syndicated loan market. In the primary market, this means the loan agreement (also known as the credit or facility agreement) governing the relationship between lenders on one side and borrowers on the other.

Secondary market documentation, on the other hand, governs transfers of loans between lenders and investors, either by outright assignment or by means of participation, and borrowers are not typically parties.

It is not surprising that the LSTA took the step of first introducing an optional arbitration clause in documentation for the secondary market rather than the primary market. Commercial lenders and investors typically have been unreceptive to arbitration clauses in their loan documentation with borrowers. Notwithstanding arbitration's many advantages, they approach the matter in the belief that the heart of the transaction—the borrower's obligation to repay the loan with interest—will always be factually straightforward and legally unambiguous.

From this perspective, they may regard any possible subject matter expertise held by arbitrators as having little value and may see deviating from the trusted courts of New York or England, the customary venues for jurisdiction in international syndicated lending arrangements, as presenting significantly more downside risk than upside potential.

This new step represents a recognition by the LSTA that disputes exclusively among lenders and investors, and not involving borrowers, may be more conducive to arbitration.

LSTA'S MEDIATION ROLE

Historically, these disputes have rarely ended up in court. Litigation-averse secondary market participants often turn to the LSTA as an informal mediator to resolve disputes based upon trading rules and documentation, and the LSTA's guidance in explaining terms or filling gaps has been widely respected.

But an expanding market of Latin American lenders and investors includes institutions that are not LSTA members, and their lesser familiarity with the organization may leave them less willing to defer to its guidance.

At the same time, they are also more accustomed to, and therefore more accepting of, arbitration clauses generally.

Conversely, since it cannot be taken for granted that a Latin American financial institution will agree to New York jurisdiction, a U.S.-based counterparty facing a potential dispute with an institution resistant to the LSTA's advice, might well prefer an arbitral proceeding applying New York substantive law—the customary choice for these transactions—over litigation in unfamiliar civil law courts far away from home.

Also, parties to any particular loan trade may have other continuing business relationships to be protected from damage caused by possibly public, protracted, confrontational litigation.

MARKET ADVISORIES

If the belief that the straightforward nature of borrower-based disputes is one factor militating against arbitration agreements in primary loan documentation, LTSA-issued market advisories demonstrate that disputes involving secondary market transactions are less straightforward.

Market advisories are publicly available statements issued by the LSTA, often after consultation with market participants, providing commentary and guidance on regulatory, legal (and including documentation), and other market developments. In appropriate circumstances, the advisories can act as evidence of market practice or establish precedent for future action.

To date, primary market advisories generally have been reminders about best practices, while a disproportionately large number of secondary market advisories have been interpretive in nature.

Latin Loan Sales And ADR

The market: Syndications of loans in three South American countries.

The process: Arbitration has been introduced in industry association LSTA's model lending agreements for the first time. The association has acted in part as a clearinghouse to help resolve disputes.

The implications: It's a small start but a potentially significant move for international finance dispute resolution in deals between lenders and investors.

In fact, from its first market advisory, issued on April 25, 2006, through Dec. 7, 2017, the LSTA produced a total of 55 advisories, 25%-30% of which addressed issues arising from trades in the context of large bankruptcy cases.

These issues typically involved the allocation of payments out of a bankrupt debtor's assets between the transferor and transferee, where a court order did not neatly fit the terminology or concepts of loan trading, or where the applicable secondary market documentation could not have anticipated the precise terms of a court order.

Examples include record dates that did not accommodate lags between trade and settlement dates, and interest payments on dates or in ways that did not align with how a transferor and transferee might have intended to define their respective entitlements.

The trading documentation is sufficiently technical and the market practice sufficiently specialized to commend resolution of disputes by an institution like the LSTA, or an arbitral tribunal with subject-matter expertise.

PARTICIPATIONS ENCOURAGE ADR

Although not the subject of any existing market advisories, an additional factor favoring arbitration in secondary market disputes arises when trades are structured as participations—which are sometimes preferred by Latin American financial institutions—rather than as outright assignments.

Unlike assignments, where the transaction between transferee and transferor is substantially complete when the trade is settled, a participation is a continuing relationship between the transferor and the transferee until the underlying loan is repaid.

In a participation, the transferor remains the lender of record and, in effect, administers the loan on behalf of the transferee in accordance with a participation agreement between them. The transferor passes along payments to the transferee, and requests and documents as and when received by it under the loan agreement.

The LSTA's Model Participation Agreement for Par/Near Par Cross-Border Trades (available for members at http://bit.ly/2BbZ07t) con-

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International ADR

(continued from previous page)
tains rights and obligations of both parties with respect to their continuing relationship. For example, an option for Section 11.1 requires a transferor to take or refrain from taking action with respect to transferred interests as instructed by the transferee, except when doing so would violate the law or the applicable loan documents, or could result in liability to the transferor for which it does not feel adequately indemnified.

Section 12.1 requires a transferor to "exercise the same duty of care in the administration and enforcement of the Participation and the Transferred Rights [as] it would exercise if it held the Transferred Rights solely for its own account. …"

Loan transactions frequently involve action or inaction relating to enforcement of remedies, amendments, waivers, consents, legal notices and other matters. While it does not happen often, a dispute is quite possible if a transferee suffers damage because a transferor declines to follow its instructions.

While a full analysis of the relationship between the transferor and transferee in a participation is beyond the scope of this article, it is easy to see how the nature of that relationship could cause misunderstandings or disputes that are conducive to arbitration.

Because of the specialized subject matter of many secondary market disputes, and because the LSTA considers their resolution to be more "lore" than "law," it contemplated subjecting any arbitration elected by parties to administration by it under its own existing rules. Those rules provide, among other things, for a panel of three arbitrators selected by the LSTA at random from among its board of directors.

These rules—the LTSA's so-called BISO Arbitration Rules, standing for "Buy-in/Sell-out"—were originally adopted in 2001 for a narrow range of disputes to determine whether cover prices for uncompleted secondary market trades were reasonable. Those rules continue in effect, but to date no arbitration has ever taken place under them.

Accordingly, and to maximize the likelihood of market acceptance, the LSTA's new clause instead provides for arbitration (i) administered by, and under the international rules of, the American Arbitration Association's International Centre for Dispute Resolution, (ii) with, at the parties' option, a tribunal of one or three arbitrators, the latter with two party-appointed arbitrators selecting the chair, and (iii) located, at the option of the parties, in either New York City or Miami.

The ICDR rules were selected because of the ICDR's strong links to both New York and Miami, and a perception that lenders and investors in this market might be most accustomed to seeing ICDR-administered arbitrations for international financial transactions governed by New York law, which is the predominant choice for the LSTA's secondary market documentation.

For example, U.S. market participants were thought to be generally more familiar with the manner in which arbitrator fees are handled on an hourly basis under the ICDR system than under the ad valorem model—fees as a percentage of the value of the case—used by the International Chamber of Commerce. A single arbitral body, rather than a choice among several, was preferred in order to achieve consistency for market participants using the LSTA's model documents.

This contrasts with the approach taken by the International Swaps and Derivatives Association, whose model documentation has broader global reach and therefore includes a menu of acceptable arbitral institutions.

It took about 15 to 18 months of deliberation and circulation of exposure drafts to interested parties, including local counsel in Chile, Colombia and Peru, before the LSTA adopted these new model forms of documentation, although there were many issues to consider in addition to the arbitration clause.

It is noteworthy that participating financial institutions did not raise serious objections to the arbitration clause, and that many used the opportunity for questions to learn about arbitration generally.

The LSTA has indicated that the next set of documents likely to be revised to include an arbitration clause are its model agreements for secondary market trading for par/near par trades with counterparties in Mexico and Argentina. So far, at least one large U.S. bank has reportedly accepted the LSTA's new arbitration clause in one or more secondary market transactions.

Although it is too early to see results, the LSTA has indicated that it will monitor the use and efficacy of its arbitration clause to assess market acceptance and to determine whether changes might be advisable, including options for additional arbitral bodies if there is a compelling need for it.

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Whether the LSTA or the syndicated lending market generally might broaden the use of arbitration agreements of course remains to be seen, but there is reason to be optimistic.

Just as disputes between financial institutions under the LSTA model secondary market documentation may be more conducive to arbitration than disputes with borrowers, so it may be worth evaluating at some point whether arbitration is appropriate for certain types of disputes solely among financial institutions under primary market documentation, such as disputes relating ratable treatment in unanticipated circumstances.

And if lenders and investors give more weight to easier enforcement in foreign jurisdictions of arbitral awards as compared with court judgments, perhaps arbitration with some borrowers is also a possibility.

Consider the approaches taken by the London-based Loan Market Association and the Hong Kong-based Asia Pacific Loan Market Association, which are similar to the LSTA but concern themselves with syndicated loan transactions in Europe and Africa and in Asia, respectively.

Both organizations provide an optional arbitration clause in their model primary market loan documentation for borrowers in developing markets. There is anecdotal evidence that the clauses have been incorporated into signed loan agreements in places where enforcement of court judgments might be problematic, but their use is somewhat limited by the fact that they are structured as sole option clauses—where only the lenders or the administrative agent, but not the borrower, have the option to invoke them—a structure that is unenforceable in some jurisdictions.

In the end, the expanded use of arbitration in syndicated lending, both between financial institutions only, and between financial institutions and borrowers, most likely will depend on increasing comfort with the process and evidence of dependable results.