THE USE OF PARALLEL DEBT IN SOUTH EAST EUROPE

16 September 2013

In syndicated lending a group of lenders makes a loan to a borrower (or a group of affiliated companies). Syndicated lending allows a lender to sell its participation in the loan to another lender at any time.

This means that the original lenders that made the loan may change from time to time.

This raises the question how to structure the security for a syndicated loan in a manner that would be least burdensome and costly for the borrower.

In non-syndicated lending the security is established in the name of the single lender.

In syndicated lending this is impracticable for two main reasons: (a) it is not appropriate for each lender to be able to commence in its sole discretion enforcement of the security (as other lenders may not, in the circumstances, want to enforce the security or may want to enforce it in a different manner) and (b) whenever a lender transfers its participation in the loan to a third party, which was not in the lender syndicate prior to that (a new lender), the security would typically need to be amended to record that the transferor is no longer a secured party and that the transferee becomes a secured party instead (called sometimes “re-taking of security”).

A re-taking of security may either be mandatory to preserve the validity or the enforceability thereof by the new lender or be advisable for practical reasons, even if not legally mandatory.

Depending on the type of the security interest re-taking of the security may be costly (e.g. if it involves high costs for recordation of the re-taking in a public register).

In any event, even where there is no high cost for recording the re-taking of the security in a public register the re-taking would still involve costs (e.g. legal fees for drafting and negotiating the re-taking documentation and making any public recordations of the re-taking).

If there are frequent changes of lenders the above costs might become quite significant for the borrower.

This necessitates an appropriate mechanism that avoids the above.

There are two principle solutions: (a) a security trust or (b) a parallel debt.

The first solution means essentially that a security trustee is appointed by the lenders to hold the security for the loan in its own name, but for the benefit of the lenders. The concept of a security trust is a common law concept. It is not recognised in all continental law jurisdictions or is recognised only in limited cases by exception.

The second solution involves the creation of the so called “parallel debt”, which is a debt of an amount equal to the amount owed at any relevant time by the borrower to the lenders under the loan agreement (i.e. principal, interests, fees, expenses, indemnities, etc. as agreed in the loan agreement) owed by the borrower to a third party (called “security agent” or “security trustee”).

The arrangement regarding the parallel debt explicitly provides for that a discharge of an amount owed by the borrower to the lenders under the loan agreement discharges an equal amount owed by the borrower to the security agent and vice versa. This is necessary to give comfort to the borrower that in no circumstances will he owe a double amount.

It is therefore said that the debt owing to the security agent is parallel, i.e. exists in parallel, to the "main debt" owed to the lenders, hence the term "parallel debt".

The way the concept works is that because of the creation of the parallel debt the security agent becomes a creditor on its own legal ground (being the parallel debt). This allows the creation of the security interests in the name of the security agent only. The security agent is the secured creditor of record for the purposes of third parties and recordation in any public register. Thus, any change of lenders in the syndicate does not require re-taking of security because the security is and always remains in the name of the security agent.

The parallel debt is typically included in the so called "intercreditor agreement" between the borrower, the lenders and the security agent setting out the contractual terms as to the circumstances in which the security may be enforced (usually when majority of the lenders so decides), the manner in which it would be enforced and the manner in which the security agent will allocate among the secured lenders any amounts received by it in enforcing the security. If there is no intercreditor agreement the parallel debt may be included in the loan agreement.

The concept of parallel debt has been developed under common law. In cross-border financings in Europe as a norm the loan agreement and intercreditor agreement are governed by English law and hence the parallel debt is also governed by English law.

Lawyers in some continental law jurisdictions have expressed concerns about the validity of parallel debt under local law.

Their main argument focuses around the need for cause (*causa*) for any contract to be valid. In particular, some argue that because the security agent does not extend any money to the borrower under the parallel debt arrangement the debt of the borrower arising from the parallel debt lacks a cause and is therefore invalid.

This argument does not sound very compelling. It is explained above what necessitates the need to put in place a parallel debt arrangement. The reasons are legitimate commercial reasons – to avoid unnecessary costs and other administrative burden for the borrower and allow easier transfer of participations in a lending syndicate. These reasons should in itself constitute sufficient cause for the existence of the parallel debt.

Still there are legal practitioners that question the validity of parallel debt in some continental law jurisdictions.

Some even question the enforceability in local jurisdictions of parallel debt governed by English law (or other foreign law recognising the parallel debt concept) with the argument that it may be contrary to public order in their home jurisdictions.

This seems an extreme position to take, especially given that public order should, in principle, apply to commercial matters only in exceptional circumstances, especially given that the parallel debt arrangement is not intended to and does not endanger any legitimate interests of the borrower, its creditors or shareholders. On the contrary, it is aimed at ultimately saving costs to the borrower and making it easier for borrowers to access financing in general.

In some major continental law jurisdictions (e.g. France) the validity and enforceability of parallel debt arrangements governed by foreign law (English law or the laws of the State of New York) have been tested in court and confirmed by the highest court instances, thus giving legal certainty that parallel debt does work in those continental law jurisdictions. Given that many continental law jurisdictions in Europe have adopted their civil and commercial laws from the laws of France the fact that the French Supreme Courts recognised parallel debt governed by foreign law should give additional comfort to the legal practitioners in those jurisdictions.

In almost all jurisdictions in South East Europe the concept of parallel debt is not expressly regulated by local law. At the same time, in many of these jurisdictions there seem to be no compelling legal arguments against its validity and/or enforceability, especially when the parallel debt is governed by a foreign law (e.g. English law) and it is generally safe to use the concept, although in some jurisdictions certain legal risks with using the concept cannot be excluded.