GOVERNMENT LOANS

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I INTRODUCTION

Commercial bank loans to governments exhibit idiosyncracies which flow from the special characteristics of a state as opposed to an ordinary municipal corporation. Three of these differences are as follows:

(1) Sovereign paramountcy States are sensitive to accepting contracts containing provisions which in their view, derogate from their national sovereignty and freedom to govern. Many states are quite content to submit to the practices of the market arena when acting in a commercial capacity whereas others, for historical and cultural reasons, jealously guard their governmental supremacy. This pride, if one may call it that, finds its expression, notably in:

   (a) legal and policy objections to the acceptance of foreign law and forum;

   (b) objections to covenants which restrict the state's freedom to govern, especially in the area of information and economic management; and

   (c) objections to default clauses which expressly contemplate political crises or economic collapse.

(2) Bankruptcy Although states can and do become insolvent in the sense of being unable to pay their foreign obligations as they fall due (equitable insolvency), states are not subject to a mandatory bankruptcy regime. Typically, bankruptcy statutes impose a freeze on creditor suits to prevent piecemeal and chaotic seizures of assets, (sometimes) contemplate rehabilitation proceedings under the control of an officially supervised manager, provide for a realisation of the assets, establish the paramount principle of pari passu distribution amongst creditors, guillotine the running of interest, recapture preferential payments made during the insolvency period, penalise fraudulent trading and other abuses of creditors' rights, and provide for a discharge of an individual debtor so that he can start again

with a clean slate. Ordinary commercial bank loan agreements do contain some provisions reflecting the absence of a bankruptcy statute but it is only in rescheduling agreements that an attempt is made to reflect certain of these bankruptcy policies by express contract, to the extent practicable.

(3) Immunity Until recently states enjoyed a high degree of immunity from suit and enforcement in foreign courts. However, the accelerating trends towards deimmunisation of states when acting commercially has increased the exposure of sovereign borrowers to foreign legal proceedings by disappointed creditors.

(4) Law-making power A state is in charge of its own law-making machinery and can therefore change its laws unilaterally and compel its courts to give effect to the changes. It can pass exchange controls, moratorium decrees and other blocking orders and can expropriate assets within its jurisdiction and cancel investment licences. These assets and licences may form security for a project loan. The efficacy of these measures depends largely on the various foreign "insulation by governing law" and act of state doctrines.

Apart from the above, the credit and documentary approach to government loans enjoys substantial similarities with loans to ordinary companies. Like a company a state has legal personality, it has articles of association in the form of a constitution, it sells its products and services, it buys in supplies, it has a management and employees, it has to authorise its transactions, and it can be subject to takeovers, amalgamations and spin-offs, not always friendly.

II BORROWING VEHICLE

A state can borrow either in its own name or through a wholly-owned "subsidiary", such as a central bank or a state financial institution, with or without the guarantee of the state.

The selection of the borrowing vehicle is nearly always determined by policy considerations but a legal resonance flows from the choice. The following legal factors are relevant:

(1) Veil of incorporation Those countries which honour the veil of incorporation of their domestic companies (such as the United States and the United Kingdom and, to a lesser extent, France) tend to apply similar principles to the legal personality of public entities. In the interests of commercial expediency, the English courts have rigidly upheld the separate personality of a company as distinct from its shareholders even if there is only one ultimate beneficial owner of the shares who has sole control of the company's affairs as its governing director: Saloman v Saloman & Co [1897] AC 22; Inland Revenue Commissioners v Samson [1921] 2 KB 492. The courts tend to lift the veil of incorporation in two main cases relevant in this context:

(a) where the company is the agent of its shareholders, eg where a parent in fact carries on a business through the agency of its subsidiary;
and

(b) where a company is used as a cloak for fraud or evasion.

In the case of state entities, the US and English courts have developed an analogous doctrine to the agency concept whereby a state entity may be treated as an "alter ego" of the state itself and will commonly honour separate legal status of an autonomous legal entity which has a degree of freedom from governmental control in its day-to-day activities and which carries out commercial as opposed to governmental activities. The classic recent English cases are Trendtex Trading Corporation v Central Bank of Nigeria [1977] QB 529 where, in the sovereign immunity context, the Central Bank was found to be a separate legal entity from the Nigerian state, Czarnickow Limited v Rolimpex [1979] AC 351 where a Polish state trading enterprise was held to be not an organ or department of the Polish state and therefore entitled to raise a plea of frustration caused by Polish Government decree, and Empresa Exportadora de Azucar v Industria Azucarera Nacional [1982] where a Cuban state entity was held not to have induced a frustration of a sugar contract where the state itself ordered a breaking of the contract. Whether this rigid adoption of the veil of incorporation doctrine is appropriate in the context of corporatist states is a matter upon which many views can be held. The German view on this would be interesting, having regard to their group enterprise doctrines.

Two exceptions, however, are:

(a) Mellenger v New Brunswick Development Corp [1971] 2 All ER 593 where Lord Denning MR in a somewhat maverick immunity case held that the development corporation was really a part of the Government itself and therefore entitled to immunity under the then prevailing absolute doctrine;

(b) the US case First National City Bank v Banco Nacional de Cuba 406 US 759 (1972) where the American court lifted the veil of incorporation to allow a set-off. This case has a number of special features including the fact that the Citibank claim was based upon the tort of expropriation: US case law, particularly in California, has shown a greater readiness to lift the veil of incorporation in tort cases where the creditor is an involuntary claimant.

Effect of veil of incorporation If the foreign courts do not lift the veil of incorporation of a borrowing state entity, then some of the results are:

(a) a lending bank cannot set off a deposit from one public entity against a loan made to another public entity or the state itself (a significant point during the 1979-80 Iranian crisis);

(b) the state itself and other public entities cannot be sued in foreign courts for the liabilities of the borrower nor are the assets of other departments or the government subject to foreign seizures;

(c) it is easier for the state to adopt blocking tactics, eg by stripping the assets of the public entity or by an amalgamation by way of universal succession with another state entity. Universal successions are recognised by the English courts if in accordance with local law: see National Bank of Greece and Athens v Metliss [1958] AC 509. See also the US Supreme Court decision in the reorganisation case of Canada So Ry v Gebhard 109 US 527 (1883).

(2) Bankruptcy A public entity may be subject to the bankruptcy jurisdiction of foreign courts, eg where bankruptcy jurisdiction can be founded, as in England, on the presence of local assets. As regards English liquidation law, it would seem (although there is no authority) that a corporation must share the characteristics of a company formed under the Companies Acts before it can be wound up and that administrative corporations will usually be outside the Act: see Tamlin v Hannaford [1950] 1 KB 18 (case on UK public corporation). The US and Italian bankruptcy codes expressly exclude state corporations, and state corporations are probably outside the French insolvency laws. State entities may however be subject to the West German bankruptcy statute.

The advantages of local bankruptcy may seem somewhat theoretical, but have been considered. For example, during the Iranian crisis many syndicate majorities refused to accelerate loans on the default so that syndicate members with large deposits could not set-off against the unmatured loan and would have to return matured deposits to the borrower: but they might have been able to set-off if the "mutual credits" set-off section of a bankruptcy code could be brought into play.

(3) Deimmunisation Deimmunisation of a public entity is more marked in foreign courts than in the case of the state itself. This is not usually important since commercial lenders, in any event, require waivers of immunity in the case of government loans.

(4) Constitutional objections The use of a public entity as the borrowing vehicle may not attract constitutional objections to submissions to foreign law or forum, eg in those Latin American states which adopt the Calvo doctrine.

(5) Official reserves Where the central bank holds the international monetary reserves of the state, commercial lenders in appropriate cases seek to involve the central bank, usually as direct borrower under the guarantee of the

state, so as to improve the legal access to the official reserves held abroad in the event of a default, ie to improve the lenders' bargaining powers. Sometimes official reserves are held directly by the state itself (occasionally through the central bank as agent or nominee - the strict legal analysis has been difficult to disentangle in some cases).

III CHOICE OF LAW

(1) Factors in choice of law A commercial bank loan agreement, like any other contract, must of course be subject to some system of law and cannot exist in a legal vacuum. The usual practice is to apply an external municipal law, often the law of England or New York. Factors in the choice of law include:

(a) familiarity of the legal system in the international financial markets;

(b) the commercial orientation and stability of the chosen legal system;

(c) a desire to coincide the governing law with the law of the external forum so as to enhance legal predictability, particularly the application by the forum of its conflicts rules;

(d) the application of the law of the market for reasons of convenience, language and expertise; and

(e) finally, and probably most importantly from a legal point of view, the wish to insulate the borrower's obligations from changes in its local law, such as a moratorium or an exchange control.

(2) Connection English law does not require any contact between the contract and the proper law since the English courts recognise that the parties may wish to subject their loan contract to a neutral or familiar legal system in which they have confidence: see Vita Food Products Inc v Unus Shipping Co Limited [1939] AC 277, HL.

(3) Insulation It is an entrenched principle of English conflicts doctrine that, if the contract is governed by an external system of law, then, provided that there is no illegality at the place where payments have to be made or the contract otherwise performed (eg New York if the loan is in US dollars), the English courts will not regard an exchange control, moratorium decree, currency conversion order, or other legislation of the borrowing state prejudicing the obligations as effective to alter the loan agreement. On the other hand, such measures of the borrower's country will be given effect to and absorbed into the loan contract so as to modify it if the loan agreement is governed by the law of the legislating borrowing state. Perhaps there is a rule that the English courts will not

recognise a borrowing state's decree which is discriminatory or grossly oppressive (see the Nazi/Jewish expropriation cases) but it is most unlikely that these rules, if they exist, could be brought into play in the context of normal moratoria and exchange controls.

The principle is exemplified by contrasting English cases. In Re Helbert Wagg & Co Limited [1956] Ch 323, a loan contract was governed by German law; the English court recognised a 1933 German decree converting the sterling loan into German currency and requiring its payment to a local German custodian so as effectively to expropriate the loan. On the other hand, in National Bank of Greece and Athens SA v Metliss [1958] AC 509 a Greek decree reducing the interest rate on Greek mortgage bonds governed by English law was not recognised as effective by the English courts since the bonds were governed by English law and the decree was a Greek measure. See also, to the same effect, Kleinwort & Sons & Co Limited v Ungarische Baumwolle Industrie AG [1939] 2 KB 678, CA where a Hungarian exchange control rendering it illegal for a Hungarian firm to remit money abroad was held to be no defence to the claim of an English bank since English law was the proper law of the contract which was performable in London. The result is that a lender who contracts under the law of the borrower's country takes the risk of that law.

This principle is reflected in varying degrees of intensity in other western jurisdictions.

Where the loan contract is governed by the local law and the borrower is the state itself, it is possible that municipal courts may be less disposed to recognise exchange restrictions which modify the direct obligations of the debtor state itself as opposed to those of a subordinate entity. There appears to be no decision on the subject. The basic principle of private international law, that a creditor contracting under the laws of a debtor state takes the risk of changes in that law, is here in collision with a basic principle of contract law, that one party cannot unilaterally alter its contractual obligations without the agreement of the other party. The question of which principle is paramount must await decision. In the meantime, commercial lenders regard it as dangerous to lend under the borrower's system of law.

It is not to be expected that the insulation achieved by an external governing law is complete. Among possible chinks in the armour are the following:

(a) Article VIII, section 2b of the Bretton Woods Agreement establishing the IMF (which has been absorbed into the law of most, if not all, of the IMF members) provides:

"Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member".

The intention was to provide for reciprocal recognition of IMF-approved exchange controls of IMF members by the courts of member states regardless of the insulation of a foreign governing law. However, the Article has had a patchy reception internationally, perhaps because many courts have been unwilling to allow a party to escape an obligation completely by relying on an exchange control regulation. It would seem that at present the courts of New York, Belgium and England would be disinclined to treat a single currency loan agreement as within the Article, ie as an "exchange contract", whereas the courts of West Germany, Luxembourg and France appear to adopt a wider view which may catch loan agreements.

(b) A recent US case law has given effect to foreign exchange controls on the grounds (apparently) that failure to do so might prejudice a rescheduling arrangement which reflected executive policy (Allied Bank/Costa Rica case).

(c) Naturally an external claim is of little legal assistance if there are no foreign assets. Nevertheless, in bargaining terms it is preferable to have a legal claim than no claim at all. Legal documents are more about improving bargaining position than implementing strict legal rights.

(4) Public international law On rare occasions, public international law has been applied to commercial bank loan agreements. There appears to be no English reported decision reviewing the choice by the parties of public international law or one of its constituents, such as the general principles of law recognised by civilised nations. However, such a choice has been implied into contracts or honoured in a number of international arbitrations, including those involving members of the English judiciary as arbitrators: see, for example, Sapphire International Petroleum Limited v NIOC [1967] 34 ILR 136 and BP v Libya [1979] 53 ILR 297. While it is considered that English courts would honour such a choice, the objection to international law in the context is that the rules are under-developed and therefore unpredictable. For example, would a choice of public international law provide insulation against municipal exchange control decrees? The World Bank consider that their choice of law clause is a choice of international law (because it expressly excludes all municipal laws) and that it provides effective legal insulation, but the matter is academic so far as the World Bank is concerned. On the existing p.i.l. authorities, the point seems open.

(5) Local law Some states decline to accept a foreign system of law. Thus, both France and Japan prefer to contract only under their local laws on the grounds of sovereignty pride.

The constitutions of some Latin American states prohibit submissions to foreign law and forum, partly as a reaction to the alleged imperialistic interferences by metropolitan powers in the 19th century in their domestic affairs on the pretext of protecting national creditors.

If the commercial lenders are not willing to accept the borrower's system of law, there are at least two possibilities:

(a) A choice of law clause could be omitted entirely and the lenders could endeavour to contrive matters so as to connect the loan agreement with the desired external state, eg by signing it there and by using expressions idiosyncratic of the desired legal system. Where there is no express choice of law, then the forum state will decide which system of law applies in accordance with its own principles. In England, the courts look for an implied intention and, if none can be found, they apply centre of gravity principles. The fact that the borrower is a government does not establish that the law of the borrower's country is to be the proper law of the agreement. "It is an element of weight to be considered but it is no more than that": R v International Trustee, etc [1937] AC 500 at 557. If the loan is to a public entity under the guarantee of the state and the loan agreement itself is governed by external law but the guarantee does not state a governing law, the guarantee may be attracted to the law of the loan agreement: see, for example, National Bank of Greece and Athens SA v Metliss [1958] AC 509, HL. Unfortunately, the presence of the local constitutional prohibition may well be decisive in tipping the scales in favour of the borrower's system of law.

(b) The parties could arrange for the borrower to issue promissory notes evidencing the loan and rely on the mandatory rules in negotiable instruments statutes (eg s 72 of the Bills of Exchange Act 1882) which variously make promissory notes subject to the law of the place where they are issued and for the due date to be governed by the law of the place where payments have to be made (thereby hopefully excluding foreign moratorium decrees).

The objections are, first, the conflicts rules in bills of exchange legislation are frequently ambiguous and, second, promissory notes are inconvenient for complex loan transactions: for example, they may cease to be promissory notes if they contain events of default, a floating rate of interest, a prepayment clause or other conditional or uncertain provisions.

Article 3 of the US Uniform Commercial Code is most liberal in this respect with the Geneva Convention countries (some 40 of them, mainly civil code countries) the most restrictive, with the English regimes falling somewhere in between. Usually the difficulty can be mitigated by the issue of demand promissory notes for principal only but this may be administratively cumbersome and involve unacceptable risks for the borrower (double-claim problem if the notes are wrongfully negotiated).

(5) Optional choice of law Some loan agreements have provided for alternative choices, ie of the borrower's country in the case of suit locally and the law of lender's country in the case of suit externally. It has been held in England that an alternative or optional choice which depends upon some future event will not be treated as a valid express choice of law since there must be a governing law of the contract from the outset so that the parties know what system governs their obligations: see Armagh Shipping Co Limited v Caisse Algerienne D'Assurance et de Reassurance [1981] 1 All ER 498.

IV FORUM

(1) Generally The usual practice is for the borrower to submit to the non-exclusive jurisdiction of an external forum and to appoint a local agent for service of process. This confers virtually automatic English jurisdiction: the express submission probably overrides any forum non conveniens objections.

The external forum is necessary to support the relative insulation achieved by the external governing law. The standards of the courts influence the choice - favourable factors are an experienced and impartial judiciary, commercially orientated court procedures and attitude to deimmunisation.

The jurisdiction is non-exclusive to preserve the jurisdiction of other competent courts. Double submissions are common, eg England and New York. If the borrower is an EEC domiciliary (which apparently includes EEC states), the EEC Judgments Convention is brought into play (or will be when it is brought into force throughout the 10) and suit must be brought at the domicile of the defendant unless the technical contracting-out provisions of Article 17 are correctly applied (broadly, only EEC court, plus domicile, plus any number of non-EEC courts - but prejudgment attachments in all EEC courts are preserved pending decision at the chosen court).

If the agent for service of process is the ambassador, then (in England) the matter seems to fall between the Vienna Diplomatic Convention and the State Immunity Act 1978. Probably the state can waive any immunity from service the ambassador might have under the Vienna rules - that is, if indeed service received in an agency capacity is immunised (as it probably is under the Convention).

(2) Arbitration Arbitration as a method of settling disputes is not favoured by commercial bank lenders but is occasionally

resorted to in the case of governmental loans where the state borrower is constitutionally prohibited (Brazil) or is unwilling to submit to the jurisdiction of foreign courts. Arbitration is commonly employed by international development banks which have a different attitude to enforcement sanctions.

The objections to arbitration include:

(a) finality of the award (ie general exclusion of rights of appeal);

(b) the fact that, unlike construction contracts, loan agreements are unlikely to involve difficult questions of fact requiring expert adjudication;

(c) arbitration is a condition precedent to enforcement thereby perhaps limiting summary remedies;

(d) the procedures of arbitration are (often intentionally) less formalised so that a rapid resolution can be blocked if one of the parties is not prepared to cooperate;

(e) arbitration is often held in some neutral country where neither party is situated or has assets so that it will be necessary to implement the arbitration award by further proceedings elsewhere, which, despite the New York Convention of 1958, may not be available;

(f) arbitration clauses can involve initial jurisdictional disputes causing delay and expense; and

(g) there is perhaps a tendency for arbitrators to decide disputes ex aequo et bono.

It is for these reasons, amongst others, that the International Centre for Settlement of Investment Disputes (established under the auspices of the World Bank specifically for the purpose of resolving investment disputes between contracting states and nationals of other contracting states) is not used for loan agreements. Also the very countries objecting to foreign courts are the countries which have been reluctant to become signatories to the Convention.

IV STATE IMMUNITY

One hesitates to add to the already vast literature on the subject of sovereign immunity and this section will confine itself to some of the trends in summary.

Six common law states have used legislation to bring in deimmunisation statutes, ie the United States, United Kingdom, Singapore, South Africa, Pakistan and Canada, with Australia considering the matter. On the other hand, the civil code states have turned legal traditions on their head and used the techniques of common law judicial development to deimmunise sovereign states acting commercially: Belgium and Italy got their first in the late 19th century but now Switzerland and Germany are perhaps the leaders with France displaying a hesitant conservatism.

Some of the main features of the law of sovereign immunity are as follows:

(1) Foreign governments and the home government Most states permit the home government to be sued locally but do not permit enforcement (although budget allocations may be constitutionally required). Such action is unlikely to be useful to foreign lenders because of course the local courts will apply mandatory local exchange controls and moratorium decrees. Sovereign immunity is concerned with proceedings against foreign states as opposed to the home government.

(2) Governmental and commercial acts Until recently foreign sovereign states had absolute immunity in many courts. Now the restrictive view of immunity has taken over. This view holds that, if a sovereign descends to the market place, he must accept the sanctions of the market place. In most countries with developed deimmunisation doctrines, a loan is characterised as a commercial activity regardless of the purpose of the loan, eg whether or not it is to be spent on some governmental object such as military barracks.

(3) Subordinate entities of state States differ as to the degree of immunity accorded to political sub-divisions such as provinces. The US legislation treats sub-divisions on the same basis as states themselves whereas the UK legislation gives them the lesser immunity accorded to state-owned corporations (unless promoted by Order in Council). In the UK a state-owned corporation only has immunity if it is acting in the exercise of sovereign authority (whatever that means).

(4) Immunity from judgment and execution of judgment While deimmunisation from jurisdiction is common, deimmunisation from execution against assets is hedged with restrictions: an attack on assets is likely to be much more diplomatically provocative and might invite retaliation, eg by nationalisation of foreign firms in the debtor states. Almost invariably deimmunisation is, in the absence of a waiver, limited to commercial assets of the state.

(5) Prejudgment attachments States differ according to whether or not prejudgment attachments are permitted. The UK and US require an express consent but Germany and Switzerland do not.

(6) Jurisdictional nexus Some states require that the act which is the subject of the proceedings must have some substantial connection with the state of the forum. The jurisdictional nexus requirement is at the heart of the US legislation and Switzerland too requires substantial connection (Liamco case). Germany does not require substantial connection nor

does the United Kingdom, provided that the courts have jurisdiction, either by virtue of their long-arm rules or by virtue of an express submission or actual appearance in the action.

The practice of the markets is to set out an elaborate waiver of immunity clause whereby the borrower:

- waives immunity from jurisdiction (not usually necessary because the act is commercial);

- waives immunity from enforcement and attachment of its assets. In the UK, but not the US, this waiver will deimmunise military assets such as defence contracts;

- waives immunity from prejudgment proceedings such as Mareva injunctions or other prejudgment injunctions or attachments. An express written consent is necessary in both the US and the UK;

- appoints an agent for service of process within the jurisdiction so as to avoid the slow-moving procedures for diplomatic process under relevant immunity legislation and to confer relatively automatic jurisdiction.

In the case of both the US and the UK legislation, an express waiver of immunity from enforcement is required in the case of a central bank, ie its assets are, generally speaking, deemed to be governmental as opposed to commercial and therefore immune from suit.

VI RECIPROCAL ENFORCEMENT OF JUDGMENTS

Notwithstanding deimmunisation and endemic state defaults, there have been few actions against states on loan contracts in recent years and hence little opportunity for development in the area of the reciprocal enforcement of judgments. Presumably states will apply their own rules but it should be noticed that under the EEC Judgments Convention, a judgment against a defendant (presumably including a foreign state) in any of the contracting states will enjoy full faith and credit throughout all of the other contracting states. However, in England s 31 of the Civil Jurisdiction and Judgments Act 1982 provides that a judgment against a foreign state will be enforced only if:

(a) the debtor is not the UK nor the state of the forum;

(b) the judgment is otherwise for a fine, taxes or penalty and (subject to exceptions) is final and conclusive;
and

(c) the forum court had jurisdiction corresponding to the jurisdictional rules over foreign states set out in the State Immunity Act 1978, eg the debtor state submitted to the jurisdiction or the transaction was a commercial one.

There are special rules under the EEC Convention on State Immunity regarding the recognition and enforcement of judgments rendered against a contracting state by a court in another contracting state.

VII COVENANTS

Generally there are only two significant covenants in a government loan agreement, a negative pledge and a pari passu clause (apart from various monitoring obligations, eg to supply certificates of no default and limited covenants as to financial information).

(1) Negative pledge The negative pledge provides that the borrower will not create or permit to subsist any security interests over its assets. In a corporate context, the clause is intended to prevent subordination of the unsecured creditor and to prevent discrimination between creditors. In the case of states, the negative pledge is designed to prevent the allocation of scarce international monetary assets or exportable assets to a single creditor and is therefore a form of pari passu clause.

Usually governmental negative pledges are limited to external debt. This is commonly defined as debt denomination, payable or optionally payable otherwise than in the currency of the borrower or payable to a non-resident (even if in local currency). This formulation reflects the fact that states do not generally charge their assets as security for internal domestic borrowings.

One of the main difficulties with negative pledges is that, if they are limited to a prohibition on security, they will not catch various forms of quasi-security which, although not security in legal form, may be security in substance. Typical examples are set-off accounts for revenues and royalties, swaps, (eg gold, currency and investment swaps), factoring of commodity receivables, title retention and financial leasing.

Where a state is in financial difficulties, its attempt to raise external finance becomes increasingly asset-based and resort is often had to quasi-security transactions. Hence, modern negative pledges sometimes (more noticeably in rescheduling agreements) extend to all manner of preferential arrangements in order to stop the evasive transaction. The effect may be to catch wholly innocent transactions which are in the ordinary course of business and lead to distortion of normal trade.

Typical exceptions from the negative pledge proper are:

(a) liens arising solely by operation of law;

(b) security granted with the prior written consent of the majority banks;

(c) security created in connection with project financings (only if the finance exhibits certain limited recourse restrictions, the project is self-generating and the security is limited to project assets);

(d) purchase money mortgages; and

(e) security over documents of title, insurance policies and sale contracts in relation to commercial goods in the ordinary course of business.

The negative pledge may also permit BIS gold swaps. A difficult problem is whether the wider forms of clause catch counter-trading transactions and, if they do, whether it is appropriate to prohibit counter-trading.

(2) Pari passu clause This states that the obligations of the borrower under the loan agreement rank pari passu with all its other unsecured external debt. In a corporate context, this clause is a statement that on a forced insolvency, debts are, by law, paid rateably. It does not mean that one debt cannot be paid before another in time.

In the state context, the meaning of the clause is uncertain because there is no hierarchy of payment which is legally enforced under a bankruptcy regime. Probably the clause means:

(a) that on a de facto inability to pay external debt as it falls due, one creditor will not be preferred by virtue of an allocation of international monetary assets achieved by a method going beyond contract; and

(b) (perhaps) that there will be no discrimination between creditors of the same class in the event of insolvency.

Apart from proceedings instituted by Citibank against Eximbank in the US in the mid-1970s relating to a Zaire financing involving a proposed allocation of revenues to Eximbank (the proceedings were settled early on), I know of no judicial decision on the clause in a state loan agreement.

VIII EVENTS OF DEFAULT

The events of default in state loan agreements are limited to non-payment, non-compliance, breach of warranty, creditors processes, cross-default, "material adverse change" and an IMF clause. Inevitably, events of default relating to insolvency, bankruptcy, receivership and the like will not be appropriate except (perhaps) in relation to any governmental entities included in the defaults.

(1) Cross-default In practice the cross-default is the most important event of default. This clause states that it is an event of default if the borrower fails to pay other debt when due or other debt is prematurely accelerated. The purpose of the clause is to establish equality in the race

to the court-house door, to give all creditors the ability to be represented at the negotiating table and generally to impose the principle of non-discrimination: a creditor who does accelerate will find all other creditors accelerating at the same time.

Theoretically the cross-default has a domino effect because it enables all creditors to make their debts current at the same time. In reality use of the default is provocative and therefore tends to promote an inertia amongst creditors. As the words of the old song have it, "if everybody is somebody then nobody is anybody" (The Gondoliers).

(a) Debt covered Generally the cross-default covers only borrowings and guarantees of borrowings which constitute external debt (as to which see above). However, there are a number of financial transactions which are borrowings in commercial substance but not in law, ie they are financial credits in fancy-dress. Examples are acceptance credits, deferred purchase consideration for assets, financial leasing, forward purchase agreements and so on. Effective guarantees may be constituted by "take-or-pay", investment, solvency maintenance and debt purchase obligations. A cross-default clause may enlarge the meaning of borrowings and guarantees to include these money-raising and support transactions and strip off the fancy-dress to reveal the naked financial contract beneath.

(b) Crystallisation of cross-default Generally a cross-default crystallises on the actual acceleration of other debt or on non-payment of other debt. A controversial question is whether the default should also crystallise where another creditor has the power to accelerate, eg because an event of default has occurred, even though he does not actually do so. On the one hand, the other creditors are in a powerful position to secure preferential arrangements such as a voluntary prepayment but, on the other hand, the extension of the cross-default might expose the borrower to an acceleration by reason of some trivial breach of covenants in another loan agreement. This is a matter for negotiation.

(2) Material adverse change There are any number of variations of the "material adverse change" clause. Broadly, the clause is intended to replace the liquidation/insolvency/cessation of business/dissolution events of default in a corporate loan agreement and cover such matters as revolution, dismemberment, economic collapse and de facto insolvency - matters which, for political reasons, could not be expressly contemplated on the face of the loan agreement itself.

One form of clause makes it a default "if an extraordinary situation occurs which gives reasonable grounds to conclude, in the judgement of the majority banks, that the borrower will be unable or unwilling to perform in the normal course of its obligations under this agreement". Whatever formulation is adopted, there are generally two limbs to the clause, ie:

(a) an adverse change in circumstances; and

(b) as a consequence, an inability to comply.

The key negotiation questions are whether the adverse change or the inability to comply should be in the opinion of the majority banks or should be objective (or based on reasonable grounds) and whether the inabilty to comply should be certain, likely or merely possible. In practice, it would normally be extremely difficult for lenders to prove probable inability to comply with the predictability required of events of default - at least before any number of other events of default have occurred.

(3) <u>IMF clause</u> An IMF clause may make it an event of default if the state becomes ineligible to use IMF resources or the state loses IMF membership. In rescheduling agreements it may also be an event of default if there is a suspension of purchases or there is non-observance of performance criteria in a standby or a standby ceases to be in effect. The reasons for the stress laid on IMF parallelism include the following:

- the IMF is a lender of last resort
- the IMF has the diplomatic clout to insist on fiscal reform. A default towards the IMF is a default towards nearly 150 members of the international community
- the IMF provides valuable economic consultation
- membership of the IMF is said to connote a degree of adherence to certain rules of monetary conduct and observance of international fiscal responsibility.

It might be observed that breach of an IMF standby may not be within a conventional cross-default clause. It has been argued that IMF standbys are not strictly legally binding documents (so it is not proper to speak of "defaults") and that standbys are not borrowings in law but merely purchases and repurchases of currency.

(4) <u>Governmental entities</u> A default clause will often refer to governmental agencies, eg in the cross-default. The rationale is that if the agencies are really part of the government and are only divided off for administrative convenience, then an agency default is likely to be a warning sign that a default by the government itself is imminent. If the agencies are completely independent of the government, eg commercial companies in corporatist economies, then it may well be that an agency's default is not a danger flag to the government lenders. The test is

whether a default by a particular governmental agency would reflect upon the credit of the governmental borrower. Where governmental agencies are included, then corporate-type events of default in relation to them may be appropriate, eg insolvency or dissolution. These would in any event apply if the borrower itself is a state entity, such as a central bank.

(5) Acceleration Commonly, acceleration is not possible without a majority bank consent. Majority banks are usually 50% by amount of participations but may be 66 2/3% (rarely more). There are no "no-action" clauses prohibiting lenders from taking independent legal proceedings to recover their participations after an acceleration or any unpaid amounts owing to them prior to an acceleration. Unlike bondholders, lenders are not willing to delegate this degree of control over their investment.

In practice, accelerations have been rare, even in provocative circumstances, for a variety if reasons, eg futility, damage to possible future banking and trade relationships, "rocking the boat" and official pressures. The acceleration of a limited number of Iranian loans was intended purely to crystallise a set-off against Iranian deposits which the Iranians were seeking to withdraw.

IX PRO RATA SHARING

Syndicated loan agreements invariably provide that the borrower is to make all payments to the agent bank which must distribute the receipts pro rata to the lenders according to their entitlements. This clause is backed-up by another provision commonly called a pro rata sharing clause. This, broadly speaking, is designed to oblige a bank which independently receives a greater proportion of payment than the other banks to share this payment so as to re-establish pro rata holdings. A bank might receive a special payment, eg because it exercises a set-off, or benefits from some security not available to the other banks, or independently enforces its claim and receives proceeds of execution, or because the borrower ignores the clause requiring payments made to the agent and pays some friendly banks direct but not the others (as in the case of Argentina during the Falklands crisis).

Thus if two banks are each owed 100 and one of the banks has a deposit of 140 which on default it sets off against its participation of 100, then it will have been wholly repaid and be obliged to repay the remaining 40 of the deposit back to the borrower. However, the pro rata clause provides that the bank setting-off must share the benefit of this receipt with the other bank with the result that (after repeating the exercise - "the double-dip") the whole of the deposit is used and the banks then end up with outstanding participations of 30 each.

There are a number of difficult problems in the implementation of these clauses in their two basic forms (equalising interbank assignments and equalising interbank payments) which makes the attempt in the corporate context to improve bankruptcy rules somewhat limited.

On the other hand, where a loan is made to a state, the clause helps to fill the vacuum caused by the absence of an enforced pari passu bankruptcy code. In particular, the piecemeal seizure of the assets of an insolvent state (a seizure frozen on the insolvency of an ordinary corporation) is discouraged by the clause, thereby promoting an orderly retirement of debt and coordinated action by creditors. Preferential discriminatory payments by a state to favoured creditors are inherently objectionable and, it may be argued, the clause merely carries into effect the doctrine of recapturing preferences universally adopted by municipal bankruptcy law. The sharing of deposits is not out of keeping with the pari passu distribution of bankruptcy proceeds - at least in the case of a rescheduling agreement on state insolvency where all the state's major creditors of a particular class are participants. Further, the inhibiting effect of the clause on unilateral creditor action (because the creditor must share the proceeds - at least if the fruit of execution proceeds are not excluded as they commonly are) is consistent with the objectives of insolvency law.

These considerations tend to support pro rata sharing clauses in state obligations. In cases of loans to ordinary municipal corporations it is questionable whether the enhancement of the parity principle already enshrined in municipal bankruptcy law is really desirable merely on the ground that the syndicate happen to be parties to the same agreement instead of separate lenders. Nevertheless, the clause is an established and probably irremovable feature of both corporate and sovereign credits.

X GENERAL CLAUSES

Apart from the special aspects noted above, sovereign loan agreements are otherwise generally indistinguishable from ordinary corporate loan agreements. For example, they will contain the four idiosyncratic international eurocurrency clauses, ie an illegality clause, an increased cost clause, a substitute basis clause and (even in governmental obligations) a tax grossing-up clause.

Increased sensitivity is sometimes shown to assignment clauses. Assignments by the banks of their rights generally require the prior written consent of the borrower, not to be unreasonably withheld. As a matter of policy, most banks wish to maintain a relative liquidity of their portfolios. Some borrowers insist that a certificate of the borrower that the assignment is not considered in the interests of the state is to be conclusive. Prohibitions on assignments have bite because of a recent case in the English courts which tends to the conclusion that an assignment in breach of a prohibition is absolutely void and not merely void as against the borrower: see Helstan v Hertfordshire County Council [1978].

A prohibition on assignments will not usually prohibit a grant of sub-participations where the sub-participant is purely in a debtor-creditor relationship with the original bank (payment to original bank, repayment of which is conditional on corresponding receipts from the borrower) and does not take an assignment or rights against the borrower.

XI BOND ISSUES

Over the last 15 years bond issues by states have amounted to considerably lesser sums than the huge amounts borrowed from commercial banks under syndicated loan agreements. They are nevertheless a feature of the international markets.

Foreign states generally enjoy special privileges under securities regulations. Thus, although their issues are usually listed on a Stock Exchange in order to give access to those investors who are prohibited from investing in unlisted securities, the listing requirements, so far as they affect the contents of the prospectus, are minimal. Nevertheless, practice in the markets has established a fairly standard format, giving statistical information about the state and its finances, especially its export trade and external position.

The US <u>Securities Act</u> of 1933 is an odd man out in not exempting foreign government prospectuses from registration requirements.

For political reasons, the appointment of a trustee for a government bond issue is almost never seen and is not required by any securities or listing regulation that I know of - including the US <u>Trust Indenture Act</u> of 1939.

As in all eurobond issues, the negative pledge generally applies only to external listed debt, ie is not a true anti-subordination negative pledge but is merely designed to protect the marketability of the paper against issues of competing secured paper (an unlikely event).

XII STATE INSOLVENCY

As observed above, a state may be regarded as insolvent when it is unable to pay its foreign currency debts as they fall due. It is insolvent in this sense even though it may have ultimate capacity to pay. Only a tiny handful of countries have successfully serviced their foreign debt at all times over the past 150 years (the group is enlarged if one excludes European defaults on US claims in the 1930s - only Finland was up-to-date). Some states have been season ticket holders.

A state whose credit is deteriorating commonly experiences a rapid shortening of its credit terms, a rapid increase in short-term liabilities and finally a complete drying-up of credit. The pattern has been that the state then consults with its main bank and government creditors and issues a moratorium request. This "cut-off telex" is significant because it stabilises the situation by assuring creditors that they are to be equally treated and ends the "pay now" demands.

There is generally a hierarchy of creditors:

(1) Supranational These are generally the IMF, the World Bank and regional development organisations. Supranational creditors do not reschedule (although the IMF may roll over one standby into another and Comecon organisations have been requested to reschedule). The argument is that either they are lenders of last resort or provide development loans which are the foundation of a nation's credit. The real reason perhaps is that they have the necessary diplomatic power to insist on not being rescheduled.

(2) Government debt This is either direct inter-governmental debt or debt produced by the calling of export credit guarantees. Government debt is generally rescheduled on Paris Club principles formulated since an Argentinian insolvency in 1956 when the Club was established. The rescheduling is not development aid and is not concessional; access to the Club is available only in an emergency; and the debtor country must undertake an IMF programme, ie Paris Club members do not monitor the debtor state's economy themselves. Each member of the Club reschedules on a comparable basis implemented by bilateral treaties within the multilateral guidelines laid down by the Club minutes. The Club has no set rules or formal constitution.

(3) Public bond issues The good reasons for their non-rescheduling are:

(a) bondholders are all widows and orphans;

(b) rescheduling is destructive of market confidence generally;

(c) rescheduling is non-concessional and unilateral because bondholders are generally not represented by a trustee.

Perhaps the real reason is that the amounts are usually fairly small in relation to the rest of the defaulted debt and that it is not possible to stop a single bondholder from suing for his money and thereby disturbing the equality principle. A paradoxical effect of the absence of a trustee and trust deed (which commonly contain a "no-action" clause) is to enhance the position of holders of the public debt of a state.

Prior to 1950 most of the external debt of insolvent states took the form of public bonds: these were rescheduled by exchange or consolidation schemes negotiated with quasi-official foreign bondholder councils.

(4) Commercial bank debt Because commercial banks are well organised and subject to official and commercial pressures and because the amount of the debt, if written off, would have a devastating effect on their balance sheets, the international banking community can quickly be organised into rescheduling agreements. Whether short-term debt or letter of credit debt is rescheduled depends upon the severity of the insolvency.

The negotiation is effected through a steering committee comprised of the main bank creditors. The main legal risks for these steering committees include:

(a) agency fiduciary duties - hence they insist their role is purely liaison;

(b) insider information and disclosure problems;

(c) legal hostility to secret deals;

(d) Hedley Byrne liability; and

(e) tort of procuring a breach of contractual relations, eg by inciting a borrower not to pay other creditors except on equal terms.

In practice, these risks are largely theoretical and difficulties do not seem to have arisen.

(5) Trade debt Trade debt is usually not rescheduled, partly for pragmatic reasons and partly because trade debt can usually be unilaterally "pipelined" by the introduction of exchange controls by the debtor state. Because the debt concerned is generally governed by the law of the debtor state, the modification of maturities by the exchange control will generally be recognised by foreign courts. Sometimes this pipelining of trade debt is put on an orderly basis under a supplier's arrears programme, eg Turkey, and sometimes may be formal, eg Nigeria.

(6) Priorities A fundamental principle of insolvency is the doctrine that the creditors are paid pari passu. Since there is no bankruptcy regime to enforce this principle in the case of states, it has to be achieved by contract. The most significant clause in this context is the "most favoured debt" clause which provides that if any other foreign currency debt having the same maturity as the rescheduled debt is paid out more quickly, then the borrower must repay the rescheduled debt. The clause will then go on to exclude certain categories of debt which can be paid in priority, eg IMF debt, trade debt, foreign exchange contract obligations, interest, public bonds and other agreed categories. One effect of the mfd clause (which also appears in Paris Club minutes) is to encourage all eligible creditors to come into the rescheduling. The clauses are difficult to monitor.

(7) Economic management Rescheduling agreements almost invariably do not impose direct economic controls upon the debtor state or attempt to write an economic austerity programme. The two main techniques for securing improved economic management are:

(a) requirements as to compliance with an IMF programme; and

(b) the "short-leash" approach to rescheduling, ie the banks reschedule only limited amounts at a time, such as the maturities during the current and the following year, there being the implied sanction that subsequent maturities will not be rescheduled unless satisfactory progress is made.

This orderly procedure is in sharp distinction to the rounds of state insolvency prior to the 1920s where direct intervention by creditor nations was common. Thus Tunis, Greece, Morocco, Santo Domingo and Nicaragua were all placed under foreign receiverships with the creditor nations taking control of public finance and the customs house. The Ottoman Debt Council was in place from 1881 to 1944 and the Egyptian Caisse de la Dette Publique from 1880 to 1940. Perhaps the creditor nations were more solicitous of empire than of private creditors.

A rescheduling agreement itself is very similar to a gigantic syndicated credit containing clauses found in normal syndicated credits but much elaborated. All bank creditors sign and it is generally a condition precedent to the agreements effectiveness that a high (specified) threshold of eligible debt is attained. Often new money is required. The grant of security, the sale of territory and the transfer of producing assets to a state corporation issuing shares to foreign creditors are all theoretically possible, but politically and practicably out of the question.

If the mechanics of the rescheduling involve a refinancing of the defaulted debt, the roll-over may technically spark off pro rata sharing clauses in syndicated credits if not all members of the syndicate choose not to reschedule (generally they have little choice in commercial terms). Objections by sub-participants in loans which have been laid off by the various untidy sub-participation methods (mainly assignments and sub-funding) have given rise to a little litigation but have commonly been resolved by negotiation.

Apart from deimmunisation by comprehensive waiver clauses and the usual submissions to external law and forum, the exposure of the state to foreign creditors is increased by virtue of:

(a) requirements for centralisation of the international monetary assets so as (inter alia) to render them more accessible;
and

(b) cross-guarantees of the state, the central bank and certain public sector entities thereby removing the effect of the veil of incorporation.

This increase in technical legal exposure is compensated by majority bank controls of acceleration and by pro rata sharing clauses which together seriously inhibit unilateral action.

States can of course (and, to a limited extent, do) reorganise their trade to limit the exposure, eg by setting up new state-trading organisations which hide behind the veil of incorporation and by ensuring that title to goods sold or purchased passes intraterritorially but it may be difficult to protect official reserves or to disturb the accepted mechanics of letters of credit.

Where a state is insolvent, the private sector will not be able to service external debt because no foreign currency is available: this is the "transfer risk" and is distinguished from the credit risk of these private obligors. The problem has been met sometimes by nationalisation (particularly of the banking sector) but more often by novation offers whereby the private sector debt can be transferred to the state or the central bank: each private obligor pays the local currency amount of its external debt to the state and the foreign creditor accepts a rescheduled government debenture. Bankruptcy proceedings can be disastrous for foreign creditors if (somewhat unusually) foreign creditors are subordinated or if (almost universally) the foreign currency debts are converted into local currency at the date of the bankruptcy: this can result in a rapid diminution of the foreigner's claim if the local currency is depreciating, as it usually is.

XIII STATE SUCCESSION

State insolvency is often associated with the general political turmoil and a change of government. A change of government does not release the state of debts incurred by a former government, even if the contracting government was unconstitutional or did not achieve international recognition: Republic of Peru v Dreyfus Bros & Co [1888] Ch D 438 and Tinoco Arbitration [1923] 1 UNRIAA 369. There may of course be recognition problems, particularly where two factions in control of their own portions of the territory are competing for power or a secession is attempted: in this context a trend in transferring the determination of recognition questions from the executive to the judiciary is apparent in the major European countries.

Where the change in government is accompanied by a change in sovereignty over territory, such as partition, dismemberment or unification, the law of state succession is invoked. Aside from the International Law Commission provisions on the subject, there appear to be no clear rules, except perhaps with regard to "odious debt", eg debt incurred to finance a revolution against, or the military suppression of, the subsequent constitutional government.