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Advising Sovereign Clients on the Renegotiation of their External Indebtedness

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Advising Sovereign Clients on the Renegotiation of their External Indebtedness

JAMES B. HURLOCK*

Over the past decade, relief for the severe debt problems of sovereign states, especially developing countries, generally has been provided through a combination of multilateral and bilateral loans, technical assistance and performance programs administered by the International Monetary Fund (IMF), and renegotiation of all or some portion of the countries' external indebtedness.[1] The debt renegotiation process between sovereign debtors and their creditors has evolved into a highly specialized and complex practice, grounded on the experience of previous renegotiations but responsive to current developments in the volatile international financial system.

This article examines the process of debt renegotiation from the perspective of the legal counsel retained to assist a sovereign in the renegotiation of its external indebtedness. The discussion first considers the internal analysis that a sovereign, in conjunction with its legal advisers, must undertake before deciding whether to renegotiate its debts, and what form such a renegotiation should take. The

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1. Prior to 1973, sovereign states obtained most of their credit from multilateral institutions such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), from bilateral loans from other states, or from the sale of bonds. Dod, *Bank Lending to Developing Countries*, 67 FED. RESERVE BULL. 647, 648 (1981). For a brief historical account of the relationship between international lenders and sovereign borrowers and some of the problems they have encountered, see A. SAMPSON, THE MONEY LENDERS 33-55 (1981). The 1973 oil embargo triggered a dramatic shift in the nature and the level of borrowing by sovereign states and in the relationships among developing countries, multilateral financial institutions and private commercial banks.

As a result, there has been a fourfold increase in the outstanding medium- and long-term indebtedness of developing countries from 1972 to 1982, with the share of the debt owed to private creditors rising from approximately one-half to two-thirds of the total amount. *A Nightmare of Debt: A Survey of International Banking*, ECONOMIST, Mar. 20, 1982, at 99 (separately numbered) (hereinafter cited as *International Banking Survey*); Nowzad & Williams, *External Indebtedness of Developing Countries*, 8 International Monetary Fund, Occasional Paper No. 3 (May 1981).

article then focuses on the process of planning and negotiating a comprehensive debt renegotiation agreement and the steps necessary to implement it. Finally, some general observations will be noted concerning the renegotiation process and certain aspects of its current practice.

I. Selecting Outside Counsel and Deciding to Renegotiate

During the 1970's, the combination of increased energy costs, aggressive use of funds from private commercial banks, and the demand for credit for development projects and for financing existing debt resulted in dramatic increases in external borrowing by developing countries. In the 1980's, the recession in the developed countries and an increase in the worldwide supply of petroleum contributed to decreased demand for exports from developing countries, reduction in the amount of funds to be "recycled" to the developing countries and higher interest rates.[2] Because of the limited foreign exchange that can be raised through sales of developing countries' exports, particularly commodity exports, many of these countries are suffering balance of payments deficits which make them unable to pay the principal of and interest on medium- and long-term loans that were incurred four or five years earlier, and which require further loans to finance current debt service and development projects.[3] Upon finding itself faced with such a severe balance of payments deficit, a developing country is forced to consider the necessity of some form of debt renegotiation and to con-

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2. *See* Mendez, *Recent Trends in Commercial Bank Lending to LDC's: Part of the Problem or Part of the Solution*, 8 YALE J. WORLD PUB. ORDER 173, 179 (1982). "Recycling" refers to the practice which emerged after 1973 by which sums paid to oil-exporting states were deposited with banks which lent the sums back to the developing countries. *See* A. Sampson, *supra* note 1, at 176; Solomon, *Developing Nations and Commercial Banks: The New Dependency*, 12 J. INT'L L. & ECON. 325, 332 (1978). The recent decrease in oil prices has reduced the amount of funds to be recycled by the oil-exporting states and in fact some oil-exporting states have become net borrowers. *See Recycling OPEC's Deficit*, ECONOMIST, Feb. 20, 1982, at 84. These trends have made it more difficult for non-oil producing states to obtain funds and have contributed to the rise in interest rates.

3. *See* Madison, *In Praise of Borrowing*, NAT'L J., Nov. 26, 1983, at 2489. Countries can remedy a balance of payments problem by limiting demand for imports, increasing sales of exports or financing through reserves or borrowed money. *See* H. GRAY, INTERNATIONAL TRADE, INVESTMENT AND PAYMENTS 464 (1979). Because worldwide economic trends have reduced commodity prices and decreased demand for exports, developing countries have been forced to rely on economic austerity programs and external borrowing to meet their balance of payments needs. Much of the borrowing is required simply to meet interest payments on existing debt. *See* Wines, *Banks Taking the Heat for Near-Panic of '82*, NAT'L J., Mar. 19, 1983, at 604.

sider retaining legal counsel to assist in the preparation of a renegotiation plan.

There is no particular pattern to the process by which countries decide to retain legal counsel to assist them in the renegotiation of their external indebtedness and by which they ultimately choose a particular adviser. The decision to employ outside legal counsel may be based on the suggestion of the country's financial advisers or commercial lenders, the country's lack of experience in the area of renegotiation, the use of foreign law to govern the renegotiation agreements, or the country's lack of sufficient personnel to deal with several hundred lenders spread throughout the world.[4] For whatever reason and by whatever process, a growing number of developing countries have retained counsel to assist in the renegotiation process.[5] The growth in the number[6] and complexity of precedents set by earlier negotiations, as well as the likelihood that the commercial lenders who are creditors to a sovereign borrower will be represented by special counsel, make it advisable that a sovereign planning to renegotiate its indebtedness seek the assistance of legal counsel in order to obtain a balanced and workable agreement.[7]

Debt renegotiation can consist of either rescheduling or refinancing, or a combination of the two. Generally, rescheduling extends current maturities on modified terms for some specified period while refinancing provides new credit to pay existing loans. The decision whether to seek to reschedule or to refinance, and the scope of the debtors, creditors and debt to be included in such a plan, is reached only after the sovereign and its advisers undertake a comprehensive analysis of the sovereign's legal system and its external debt portfolio.

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4. *See* Brown, *The Leading Law Firms in Sovereign Restructuring*, INT'L FIN. L. REV., September 1983, at 4; Stoakes, *The Risks and Benefits of Advising Sovereign Clients*, INT'L FIN. L. REV., March 1984, at 10.

5. For a list of more than 15 countries that have used outside legal advisers to assist in the renegotiation of their external debt, see Brown, *supra* note 4, at 5-6. Among the countries that have chosen to renegotiate without the assistance of outside legal advisers are Cuba, the Dominican Republic, Ecuador, Jamaica, Madagascar and Poland. Stoakes, *supra* note 4, at 13.

6. The "Paris Club," *see infra* notes 21-23 and accompanying text, hosted 56 negotiations involving some 20 debtor countries between 1956 and 1982. *International Banking Survey*, *supra* note 1, at 27.

7. The role performed by outside legal advisers will vary, of course, from case to case and will depend on when counsel first is consulted and the urgency of the sovereign's debt problems. This article assumes that counsel is retained simultaneously with the sovereign's initial decision to seek renegotiation of its debt and on the further assumption that circumstances permit ample time to complete the analysis and review described herein.

A. *Analysis of Legal and Exchange Control Systems*

At the outset, it is necessary for the sovereign and its counsel to review the data available concerning the sovereign's external debt portfolio and legal system, as well as the expressed intention of its creditors, to decide which types of debt are capable of being renegotiated and how much additional credit, if any, will be needed. The difficulty in obtaining accurate information concerning a developing country's external indebtedness is a recurring problem that sometimes is not fully appreciated by all parties involved and is an area that should be addressed by the sovereign and its counsel at the beginning of the renegotiation process. The availability of accurate information largely may determine the nature of the renegotiation plan that ultimately is presented to the international financial community.

Among the topics that the sovereign and its counsel should investigate at this time are the sovereign's borrowing structure and debt registration system. It is important to determine who the borrowers of external indebtedness are—for example, the sovereign itself, governmental entities, private sector companies— and to ascertain the levels of indebtedness of each type of debtor to both public and private creditors.[8] The accuracy of the records of each borrower also should be reviewed to determine if debt figures will need to be verified by their respective lenders. If the sovereign does not have a comprehensive debt registration system already in place, it may be necessary to begin collecting data from the various governmental and non-governmental borrowers in order to reach an informed decision as to which debt to include in the renegotiation plan, and to establish feasible target figures and schedules for completion of the plan.

The sovereign and its counsel also must review the sovereign's exchange control regulations and constitutional and political framework to determine what legislative or executive action may be necessary to implement the renegotiation plan and to assess the likelihood of political opposition to the renegotiation. Depending on

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8. In addition to the overall increase in external indebtedness, during the past decade there has been a shift in the percentage of loans to foreign governments and government-controlled entities as opposed to private foreign borrowers. The increase in the percentage of sovereign loans is due largely to the fact that developing countries, who account for most of the increase in overall indebtedness, tend to channel the loans through governmental entities to private sector borrowers. *See* Reisner, *Default by Foreign Sovereign Debtors: An Introductory Perspective*, 1982 U. ILL. L. REV. 1, 3. Even though governmental entities account for most of the external borrowing in developing countries, several recent renegotiations have included external debt held by private sector borrowers as well as public sector entities. *See infra* notes 10, 12 and accompanying text.

constitutional requirements and political climate, it may be wise to structure the renegotiation plan so as to avoid acrimonious and time-consuming debate in the legislature. The forms of domestic approval utilized also may reduce the exposure of local officials to lawsuits and political pressure.

Review should also be made of the sovereign's payment and exchange control systems[9] to determine the most practicable way to structure future repayments under, and promote internal compliance with, the renegotiation plan. For example, it may be necessary to require non-governmental banks or commercial entities to deposit proceeds of external loans with the central bank in exchange for local currency if such banks are not already required to do so. If a governmental agency is to serve as an intermediary on behalf of private entities, or if some other form of governmental guarantee is to be extended on behalf of private entities, the sovereign should investigate the creditworthiness and registration systems of the entities involved.

B. Formulating a Renegotiation Plan

Once a review of the available data and the legal system is completed, the specific terms of the renegotiation plan can be formulated. The sovereign and its advisers should work to prepare as comprehensive a proposal as possible before approaching the different groups of creditors. Even though all the terms formulated by the sovereign and its advisers are subject to revision in negotiations with the IMF, government lenders and the commercial banks, the preparation of a comprehensive and well-documented proposal frames the issues for negotiation and lays the groundwork for the basic features of a plan. If the sovereign's initial proposals are supported by reliable information made available to the various groups of creditors, many of the most troublesome issues may be resolved merely by explaining the nature of the country's debt portfolio and workable solutions to its problems.

In addition to the basic financial terms of a proposal, such as whether to request any additional credit, or better interest rates and repayment terms, three basic groupings for the renegotiation must be defined: (1) the classes of debtors to be included in the plan; (2) the classes of creditors to be included in the plan; and (3) the type of debt to be included in the plan.

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9. For example, many Latin American countries have extensive regulations governing foreign exchange transactions. *See* Allison, *Capital Controls in Latin America*, in INTERNATIONAL FINANCIAL LAW 163 (R. Rendell ed. 1980).

1. Classes of Affected Debtors

Which classes of debtors will be affected by the renegotiation plan should depend largely upon the results of reviewing the available data described above. Based upon the respective amounts of external indebtedness incurred by the sovereign itself, by governmental entities and by private sector companies, and based upon the severity of the country's balance of payments problems, the sovereign may choose to have all or just some portion of domestic debtors included in the renegotiation plan. Further, the sovereign must decide whether each of the affected debtors should be party to the renegotiation agreement or whether a single government agency or bank should act on behalf of all of the affected parties. Because renegotiation agreements typically include broad waivers of immunity from legal proceedings and prejudgment remedies in foreign courts, the choice of a government agency or bank to serve as agent may be influenced by the extent to which the various entities maintain assets overseas and the desire to protect those assets from attachment or execution if a lawsuit subsequently were brought concerning the renegotiation agreement.

The treatment of private sector borrowers deserves special attention. Given the substantial participation of private sector companies as both borrowers and lenders in many developing countries, often private sector debts have to be included in the basic renegotiation agreement or principles have to be established to govern the renegotiation of private sector debt. Among the options available are: including private sector entities as parties to the renegotiation agreement, and making them either directly responsible for the repayment of their debts or backed by the guarantee of the sovereign; assigning private sector debts to the sovereign's agent, usually a government-controlled bank, for purposes of controlling the flow of foreign exchange; or leaving the treatment of private sector debts to individual negotiation with the foreign lenders under a framework established by the sovereign. Recent debt renegotiations illustrate a number of approaches. Argentina has instituted a scheme whereby public debt instruments may be delivered to creditors either to pay or to guarantee foreign currency loans to private sector borrowers.[10] Mexico has converted approximately $2 billion of private sector debt to government-to-government debt[11] and has established a

10. *See* Cardenas, *How Argentina is Refinancing Its Private Sector Debt*, INT'L FIN. L. REV., June 1983, at 28.

11. Zamora, *Peso-Dollar Economics and the Imposition of Foreign Exchange Controls in Mexico*, 32 AM. J. COMP. L. 99, 134 & n. 162 (1984).

comprehensive foreign exchange program, Fideicomiso Para la Cobetura de Riesgos Cambiarios (FICORCA), under which Mexican private sector companies can obtain dollars at a fixed rate for the repayment of foreign creditors.[12] Peru recently concluded a renegotiation plan that allows foreign creditors to maintain direct relationships with Peruvian private sector borrowers and gives the creditors the option of electing to have the sovereign guarantee the repayment of the debt.

2. Classes of Affected Creditors

The sovereign needs to establish which classes of creditors are to be affected by the renegotiation plan. The basic groups of creditors that the sovereign must consider are international lending institutions (e.g. the IMF and the International Bank for Reconstruction and Development (World Bank)), governments (both as direct lenders and as guarantors of commercial bank debt), public debt holders, and commercial bank lenders and suppliers. International lending institutions and public debt holders usually are excluded from renegotiation plans on policy grounds. International lending institutions are excluded because they provide the basic funding for financial stability[13] and development projects. Public debt holders are excluded because of the reluctance to disturb the structure of the international bond market, the difficulty of identifying the holders of the bonds, and the desire to protect unsophisticated individual investors from the complexities of renegotiation.[14] Likewise, suppliers' credits typically are excluded from debt renegotiations due to the difficulty in identifying and negotiating with the large number of suppliers and the difficulty in allocating the amount of interest to be repaid and the amount of principal to be renegotiated.[15] There are recent examples, however, of commercial banks or sovereigns themselves seeking to include both public bond holders (particularly if it is believed that commercial banks own a large portion of the bonds)

12. *See* El Koury, *Mexico's Foreign Exchange Programme for Private Sector Companies*, INT'L FIN. L. REV., July 1983, at 18; Zamora, *supra* note 11, at 134-40. By taking advantage of the FICORCA program and converting bank debts into floating rate notes, several Mexican private sector companies recently have concluded debt renegotiations that will be exempt from local withholding tax. *See A Tax Break to Help Companies Repay Foreign Debts*, BUS. WK., Mar. 5, 1984, at 45.

13. *See* Wood, *Debt Priorities in Sovereign Insolvency*, INT'L FIN. L. REV., November 1982, at 4, 8.

14. *Id.* Problems concerning the protection of bondholders are discussed in Note, *International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation*, 21 VA. J. INT'L L. 269 (1981).

15. *See* Wickersham, *Rescheduling of Sovereign Bank Debt*, INT'L FIN. L. REV., September 1982, at 8, 9.

and suppliers in renegotiation plans.[16] Hence, there is latitude for including or excluding either class of creditors in the formulation of a renegotiation proposal.

The remaining classes of creditors, holding the vast majority of the debt, are governments and commercial banks. Government-to-government debt, whether incurred as direct loans or through export agency loans or guarantees, generally is addressed in the Paris Club negotiations,[17] or in bilateral negotiations with countries which do not participate in the Paris Club. Depending on the amount of debt outstanding pursuant to export agency programs and the sovereign's ability to pay, the sovereign may consider repaying all or the unguaranteed portion of government-guaranteed debt.

The sovereign, and the commercial banks themselves, generally want to include in the renegotiation plan as much of the debt held by commercial lenders as possible. Special attention should be paid, however, to the extent and status of loans denominated in foreign currencies extended by local branches of foreign banks and by both local and foreign branches of domestic banks. The sovereign may conclude that financial or political considerations favor excluding from renegotiation the external indebtedness owed by one or more of the special categories of commercial lenders described above.

3. Types of Affected Debt

The third major analysis that the sovereign and its advisers should undertake in formulating a comprehensive renegotiation plan is the type of debt to be included. Typically, banks will insist that only principal payments, and not interest payments, be deferred, but there is precedent for including interest payments in a renegotiation proposal when financial conditions so dictate.

One of the first steps in establishing the categories of affected debt is to fix a cut-off date based on the date that the debt is incurred or on the date that the debt falls due, or on some combination of both. For example, the sovereign could propose to renegotiate the principal maturities which (1) relate to debt incurred up to and including the date the proposal is announced to the international banking system and (2) fall due in the three-month, six-month, one-year or other such period immediately following the date of the plan. The length of the period established will depend

16. The issue of rescheduling publicly issued floating rate notes arose in the Polish and Costa Rican renegotiations. *See International Banking Survey*, *supra* note 1, at 28.

17. *See infra* notes 21-23 and accompanying text.

upon the sovereign's expectations concerning ability to pay forthcoming maturities.

As to debt falling due within the established period, the sovereign may choose to differentiate between medium-term debt (debt with an original maturity of one year or longer) and short-term debt. Although there is some reluctance to include short-term debt in renegotiations, especially trade-related debt and letters of credit, because it supports the daily economic life of the sovereign,[18] there is ample precedent for including short-term debt in the overall package. In some cases sovereigns have chosen to include short-term as well as medium-term debt in the renegotiation package, but have established different terms for the short-term portion or for the trade-related portion.

In addition to the basic medium/short-term distinction, there are several special categories of debt that might be analyzed. Some types of debt probably are best excluded from any renegotiation proposal because of their importance to the sovereign or their vulnerability to seizure by creditors. These special categories of debt include secured debt, leases, interbank placements and deposits, private placements, foreign exchange contracts and precious metals contracts.

II. Negotiating the Agreements

After the sovereign and its advisers have completed a thorough review of the sovereign's legal system and external debt portfolio and have decided on the basic contours of a renegotiation proposal, they must approach the various groups of creditors to negotiate the agreements.

Recently, the cornerstone of the renegotiation package has been the sovereign's arrangement with the IMF.[19] As recent experience in Argentina, Brazil, Mexico and Peru illustrates, government and commercial creditors generally insist that some form of IMF facility be in place or scheduled to be in place before agreeing to renegotiate or agreeing to disburse new money under existing credit agreements. The IMF program usually includes access to one of the IMF's credit facilities and establishes performance criteria for the sovereign to

18. *See* Wood, *supra* note 13, at 10-11.

19. In virtually all recent cases of debt renegotiation, the debtor country has adopted an adjustment program supported by a loan of funds from the IMF. *See International Banking Survey, supra* note 1, at 27; Nowzad, *Debt in Developing Countries: Some Issues for the 1980's*, 19 Fin. & Dev. 13, 14 (March 1982) *See also* Economist, Apr. 24, 1982, at 107 (rescheduling of Rumanian debt dependent on renewal of IMF stand-by credit).

meet in seeking to solve its balance of payments problems.[20]

Once consultations with the IMF are underway, the sovereign commences negotiations with official and commercial creditors. Official creditors are approached by representatives of the sovereign acting on their own at meetings of groups of creditors at the Paris Club[21] or a similar creditors' club and through bilateral consultations with governments not members of the creditors' club.[22] The product of Paris Club negotiations is a non-binding agreement between the official creditors and the debtor country that governs the basic terms and procedures for renegotiation of government debt. The Paris Club agreement then is implemented by bilateral agreements between each creditor state and the debtor state. Certain terms of the Paris Club and bilateral agreements have an impact upon negotiations with commercial lenders: terms that deal with commercial debt that is partially guaranteed by a government agency and terms which require that no other creditors receive more favorable treatment than the government creditors.[23]

The final group of creditors to be approached is the commercial lenders. The negotiations with these creditors generally prove to be the most time-consuming. Even in a well-organized renegotiation, free from major controversy, the time required to gain agreement to

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20. Member states that seek access to IMF funds are subject to increasingly strict conditions as the amount requested exceeds certain increments of the member state's quota. Drawings that cause a member to exceed its quota are in the credit tranche, which is divided into units of 25%, and are subject to "conditionality." *See* F. Southpard, *The Evolution of the International Monetary Fund*, in ESSAYS IN INT'L FIN., No. 135, at 18 (1979); IMF SURVEY, Supplement on the Fund, 6-10 (May 1981). If the member state fails to comply with the performance criteria, the IMF may withhold further loans under the original credit arrangement. *See generally* Dell, *On Being Grandmotherly: The Evolution of IMF Conditionality* in ESSAYS IN INT'L FIN., No. 144 (1981); J. Gold, *Conditionality* in IMF Pamphlet No. 31 (1979). The doctrine of conditionality has been criticized by developing countries and some commentators for being overly intrusive and contributing to political and social unrest. *See, e.g.*, NORTH-SOUTH: A PROGRAM FOR SURVIVAL, (REPORT OF THE INDEPENDENT COMMISSION ON INTERNATIONAL DEVELOPMENT ISSUES) 234-39 (1980); Adede, *Loan Agreements Between Developing Countries and Foreign Commercial Banks—Reflections on Some Legal and Economic Issues*, 5 SYR. J. INT'L L. & COM. 235, 243-46 (1978); Solomon, *supra* note 2, at 344-46. Because typical IMF conditions include limitations on expansion of internal credit, restrictions on subsidy programs and other government spending, currency devaluation and modifications of wage and price controls, the country and its citizens often are required to make substantial financial and social sacrifices. *See* Kincaid, *Conditionality and the Use of Fund Resources*, 18 FIN. & DEV. at 18-21 (June 1981); Note, *Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305, 326-28 (1981); *One By One, They Come to Terms*, EUROMONEY, March 1984, at 38.

21. The Paris Club and its procedures are described in *International Banking Survey*, *supra* note 1, at 27.

22. *Id.*; Note, *supra* note 20, at 328.

23. Note, *supra* note 20, at 328, n.93.

a 75-150 page renegotiation agreement and accompanying documents from as many as 500-600 banks should not be underestimated. If the sovereign is in immediate need of credit to meet a balance of payments shortfall, it may be necessary to approach a small group of government lenders or the steering committee of commercial lenders to obtain interim financing until the renegotiation agreement is completed.

Because of the large number of banks involved in a typical renegotiation, the commercial lenders usually appoint a group of 10-15 of the banks with the largest exposure in the debtor country as a steering committee to deal with the major issues and to act as liaison with the banks at large.[24] The sovereign also approaches a large bank to act as agent or manager of the renegotiation plan. The agent bank usually is responsible for day-to-day negotiations with the sovereign and administers the operation of the renegotiation plan once its terms have been finalized.[25] Other participants in negotiations concerning the commercial bank debt, besides the steering committee banks and the agent bank, include representatives of the finance ministry or central bank of the sovereign, counsel to the sovereign, and counsel to the lenders.

The initial negotiations focus on the basic terms of the renegotiation plan. Once a summary of the principal terms of the renegotiation plan have been agreed to—including the definitions of affected debtors, affected creditors and affected debt, the repayment schedule and interest rates applicable to the rescheduled debt and to new money, if any, and extension fees—the terms are provided to the banks at large for review and comment, and detailed negotiations between the sovereign and the agent bank begin. At this stage, outside counsel to the sovereign and to the lenders often play their most active role. Most renegotiation agreements specify that they are to be governed by U.S. state law or English law.

The following section describes some of the more important and controversial provisions that are negotiated.

A. *Negative Pledge Clause*

The negative pledge clause limits the sovereign's ability to incur future debt that will rank ahead of the obligations governed by

24. *International Banking Survey, supra* note 1, at 27.

25. For a description of some of the responsibilities of the lead bank in a debt renegotiation see Wickersham, *supra* note 15, at 9. For a more comprehensive treatment of the functions performed by agent banks in the sovereign lending process, see Clarke & Farrar, *Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers,* 1982 U. ILL. L. REV. 229.

the renegotiation agreement. The clause is important because it may have an impact upon the sovereign's daily banking and commercial activities.[26] The sovereign's counsel should negotiate a clause that is not too stringent or so vague as to cast doubt on the status of future loan agreements or development projects. A well-drafted negative pledge clause should include exceptions which enable the sovereign to conduct its normal business activities by granting, for example, security in respect to project financings, liens arising by operation of law and statutory liens, liens arising in the ordinary course of banking transactions, and liens securing debt not exceeding a stated aggregate limit.[27] Such exceptions should be acceptable to the lenders since it is in their interest to allow the debtor country to conduct daily banking and trade activities without running the risk of defaulting under the renegotiation agreement. In addition, the sovereign's IMF arrangement imposes on the sovereign a comprehensive program of spending and borrowing limits which accomplishes many of the goals sought by the negative pledge clause.[28]

B. Cross-Default Clause

The cross-default clause links together the various groups of lenders by making it a default under the renegotiation agreement if a default occurs under any other agreement to which the sovereign or any governmental entity is a party. The lenders justify the inclusion of such a clause on the grounds that all creditors of the same class should be treated as equally as possible, and that a cross-default prevents one group of creditors from declaring a default and receiving payment before other creditors.[29] The danger of a narrowly drafted cross-default provision, however, is that an unintentional or technical default under a minor agreement could result in the entire renegotiation agreement being in default and all of the country's debt subject to acceleration.[30] For this reason, the sovereign and its counsel should seek to add grace periods and material-

26. A lawyer with experience as counsel to lenders has noted that "[a]fter the 1978 restructurings of Peru's debt, bankers became aware that the negative pledge provisions could be drafted so restrictively that they precluded transactions which both the country and the banks themselves wished to undertake or had no real intention of prohibiting at the outset." Brown, *supra* note 4, at 7.

27. For a discussion of the negotiation of negative pledge clauses, see Pergam, *The Borrower's Perspective on Euroloan Documentation*, INT'L FIN. L. REV., August 1983, at 14-15.

28. *See* Wickersham, *supra* note 15, at 9.

29. *See* Ryan, *Defaults and Remedies Under International Bank Loan Agreements with Foreign Sovereign Borrowers—A New York Lawyer's Perspective*, 1982 U. ILL. L. REV. 89, 95-96.

30. One observer has noted that the banks themselves have an interest in limiting the

ity standards to the cross-default clause. The agreement, for example, should provide that a cross-default is not triggered unless payment defaults under other agreements account for more than a specified dollar amount.[31]

One form of cross-default clause that is particularly troublesome to borrowers is a provision that gives the lenders the right to accelerate their debt if other lenders are capable of declaring a default, even if they have not done so. The inclusion of such a "capable of" clause makes the renegotiation agreement subject to the most restrictive provisions of any of the sovereign's many loan agreements.[32] If a "capable of" clause were included in the renegotiation agreement, technical violation of a minor and perhaps outdated agreement would trigger the default and notice provisions of the renegotiation agreement, and would require the sovereign to contact each of several hundred lenders even while attempts were underway to remedy the original default. Sovereign's counsel should make sure that the cross-default clause allows the sovereign an opportunity to cure any underlying defaults before the renegotiation agreement is affected.

In addition, the sovereign and the lenders should agree that certain forms of debt or events be excluded from the cross-default provision. The exclusions would include any failure to pay debt payments owed to commercial lenders who are not party to the renegotiation agreement, payments owed to suppliers or other classes of creditors not covered by the renegotiation agreement, and possibly payments owed to government creditors if Paris Club negotiations or bilateral negotiations are not expected to be completed soon after the signing of the agreement with the commercial lenders.

C. *Borrower or Governmental Agency*

The determination of which entities are included in the definition of "borrower" or of "governmental agency" is important for the operation of the negative pledge clause, the cross-default clause and other events of default. A broad definition of governmental agency increases the risk that a relatively minor default will trigger an event of default, or the cross-default clause, and may inhibit the ability of

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scope of the cross-default clause because technical or minor defaults may force them to list defaulted loans on their books and thus lower earnings. Wickersham, *supra* note 15, at 10.

31. For some policy arguments concerning negotiation of cross-default clauses, see Pergam, *supra* note 27, at 15-18.

32. Because of its restrictiveness, the "capable of" clause has been nominated as the worst clause in the Euromarkets. *See* Carroll, *The Worst Clause in the Euromarkets,* EUROMONEY, June 1981, at 90.

trade and project-oriented companies to grant security to their creditors in the ordinary course of business. In addition, the sovereign may lack the authority to control effectively the borrowing and repayment activities of certain public companies. For these reasons, the sovereign's counsel should review carefully the impact of these provisions on each governmental agency and should seek to limit the operation of these clauses to specific entities where appropriate.

D. Material Adverse Change

The lenders typically want a catch-all event of default clause which permits each individual lender to declare a default if it determines that a "material adverse change" in circumstances threatens the sovereign's ability to repay its obligations.[33] Such a subjective standard leaves each lender with the right to call a default even if none of the other objective events of default has occurred. The sovereign and its counsel should delete such a clause or at least limit the power to declare a default due to a "material adverse change" to the occurrence of objectively stated circumstances, and then only if exercised by lenders holding a specified portion of the debt.

E. Required Banks

The concept of "required banks," or the percentage of banks required to take certain action pursuant to the renegotiation agreement, is important for determining the existence of defaults (such as a "material adverse change"), for accelerating the loans or pursuing other remedies following an event of a default, and for obtaining consents and amendments to the renegotiation plan. Different percentages may be established for taking different courses of action. For example, whereas a majority of the banks may be required to make technical amendments to the agreement, two-thirds or three-fourths could be required to accelerate the loans or declare that a material adverse change has occurred. Again, it is important to consider the large number of banks involved in a typical renegotiation, and the time it may take to contact and receive affirmative responses from a high percentage of the lenders, particularly if certain lenders have political or financial considerations to weigh. Recent practice indicates that many renegotiations become almost continual processes, with constant need for amendments and waivers in light of current conditions. The sovereign must be careful that it is not prevented by an unrealistically high percentage of required bank

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33. *See* Ryan, *supra* note 29, at 98-100.

approval from responding to and taking remedial action in case of changing circumstances.

III. Implementing the Renegotiation Plan

Once negotiations have been completed with the various groups of creditors, a process which can take several months, the sovereign and its advisers review the agreements to determine what steps must be taken to implement the terms of the renegotiation plan. Some of the issues which typically arise at this stage of the renegotiation process involve domestic legal requirements, conditions subsequent to the effectiveness of the agreement, conditions precedent to further borrowings, and dissident banks and lawsuits.

Formal registration, notarization or recording requirements are often imposed by the domestic law of the sovereign. For example, the sovereign's exchange control or debt registration system may require that all external indebtedness be recorded with the central bank or other governmental agency. In addition, some form of executive order or exchange regulations may be needed to validate guarantees issued on behalf of private sector companies or to enforce internal compliance with the terms of the renegotiation plan. Failure to comply with all formalities may undermine domestic compliance with the renegotiation plan and subject the agreements to legal or political attacks from opposition parties or from dissatisfied domestic banks.

The renegotiation agreements themselves may contain conditions that must be fulfilled in order to make the agreements effective or to allow the sovereign to make further drawdowns of credit under the agreement. For example, the agreement may require the sovereign to sign all bilateral agreements concerning government-to-government debt by a certain date, or require that specified percentages of private sector debt, short-term debt or suppliers' credits be renegotiated by a certain date. Such conditions often impose considerable demands on the sovereign and its advisers by making it necessary to negotiate specific terms with each creditor.[34]

Complying with conditions or covenants related to status under IMF programs has proven troublesome for a number of sovereigns. Fulfilling the terms of an IMF austerity program often causes political and financial problems for the sovereign and adjustments to the

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34. The Peruvian renegotiation agreement, for example, required that separate agreements be prepared and signed for approximately $1.7 billion of short-term debt as a condition precedent to further borrowings. The requirement resulted in the preparation of more than 800 agreements and the process took almost a full year to complete.

original IMF arrangement may be required.[35] Depending on the terms of the renegotiation agreement, failure to meet IMF performance criteria or to purchase IMF funds as they become available may result in an event of default under the agreement with the commercial lenders.[36] If a default does occur, the lenders have the right to accelerate all existing loans and to withhold disbursements of any remaining loans under the agreement.

If a default does arise or is anticipated, the sovereign and its advisers should be prepared to consult with the agent bank and, if appropriate, meet with the steering committee and distribute information to the banks at large so as to minimize the risk that any of the lenders will accelerate the underlying loans. Depending on the nature of the default and its impact upon future borrowings, it also may be necessary to seek a waiver of the default or modification of the condition by obtaining the consent of the required banks.

The cross-default clause often includes an exclusion for defaults in payments to commercial lenders who choose not to sign the renegotiation agreement,[37] but prohibits prepayment on other than a *pro rata* basis. This prohibition should be restricted to optional prepayments, since otherwise such a provision could be construed against the commercial lenders as an inducement to breach agreements with dissident banks.[38] Instead, renegotiation agreements typically provide as a covenant that an event of default will result if payments to non-participants in the plan are made on more favorable terms than payments pursuant to the renegotiation agreement.

Banks who choose not to sign the renegotiation agreement may make threats or commence legal action against the sovereign for repayment of their debt according to the schedule set forth in the original loan documents. In such cases, the sovereign and its legal advisers need to consult with the agent bank and review the terms of the renegotiation agreement so as to avoid making a payment that would result in a breach of a covenant and an event of default. The sovereign's legal counsel also may be asked to defend any lawsuits that are actually filed against the sovereign.

IV. General Observations

The current debt crisis is largely the result of what one observer

35. *See supra* note 20 and accompanying text.
36. *See* Ryan, *supra* note 29, at 98.
37. See *supra* notes 32-33 and accompanying text.
38. *See* Wood, *supra* note 13, at 4.

has described as a "tremendous violation of expectations."[39] Yet, sovereign borrowers and their creditors now have begun to realize that to a considerable degree their interests converge.[40] Borrowers and lenders must take a cooperative approach to the debt crisis in order to assure the continued vitality of the international financial system. Continued cooperation requires that both borrowers and lenders take a long-term perspective of the debt crisis and avoid taking drastic actions that inhibit the ability of the developing countries to meet their balance of payments needs and thereby weaken the entire system. For the sovereign borrowers, a long-term approach means avoiding the temptation of announcing a repudiation of all foreign debt or of abandoning austerity programs in favor of simply borrowing more money.[41] For official and commercial lenders, a cooperative approach means continuing to make credit available[42]

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39. *See* Madison, *supra* note 3, at 2489 (quoting Richard N. Cooper, Professor of International Economics, Harvard University, and Under Secretary of State for Economic Affairs during the Carter administration).

40. *See* Clausen, *Let's Not Panic About Third World Debts*, HARV. BUS. REV., Nov.-Dec. 1983, at 106, 112-14; Mendez, *supra* note 2, at 196. The lenders' mutual interest with their sovereign borrowers arises mainly from the extent of the banks' exposure in the developing world. As of June 1982, for example, the nine largest U.S. banks had made loans of $60.3 billion to the 40 non-OPEC developing countries, a figure equal to 222% of those banks' combined capital. Wines, *supra* note 3, at 603. The exposure in developing countries is not limited to the large banks: the U.S. Treasury has identified nearly 400 banks in 35 states and Puerto Rico with foreign loans on their books. *Id.*

41. Among the reasons that developing countries increased their borrowing from commercial lenders during the past decade was a desire to avoid IMF austerity conditions. *International Banking Survey*, *supra* note 1, at 55. For a discussion of other factors contributing to increased reliance on private sources, see Barnett, Galvis & Gouraige, *On Third World Debt*, 25 HARV. J. INT'L L. 83, 90-92 (1984). The IMF austerity programs adopted by developing states as part of recent renegotiation plans may reduce the demand for new credit over the course of the next few years.

42. As A.W. Clausen, current President of the World Bank, has observed:

> If commercial banks and other financial institutions do not provide capital and if the industrialized world does not protect the concept of free trade, the developing nations cannot manage the current short-term difficulties or finance productive domestic investment. The prophecy will be self-fulfilling; they will, in short, become insolvent. Commercial bank loans will turn into losses, and the fastest growing export market for America's industrial goods will vanish.

Clausen, *supra* note 40, at 107. *See also* Bolin & Del Canto, *LDC Debt: Beyond Crisis Management*, 51 FOREIGN AFF. 1099, 1106-12 (Summer 1983) (discussing the importance of finding sources of future credit for developing countries). Concern over the global debt crisis and the well-publicized problems of Mexico and Brazil in particular has resulted in a sharp reduction in the amount of new credit available to developing countries. Smaller lenders, such as regional U.S. banks, have been particularly reluctant to extend new loans. *See* Barnett, Galvis & Gouraige, *supra* note 41, at 95; Madison, *The Third World's Debt Crisis—Maybe Less than Meets the Eye*, NAT'L J., Dec. 4, 1982, at 2068, 2070-71; Wines, *supra* note 3, at 601, 604-606. The hesitation of the regional banks to extend additional credit has created further problems and delays in trying to conclude renegotiation agreements and has contributed to the creation of an active secondary market for participations in syndicated

rather than refusing to make any additional loans to developing countries, or insisting on even higher rates of interest,[43] or on repayments of principal which surpass the country's ability to pay.

At the same time, it is evident that strict adherence to current lending practices is no longer practical or appropriate, and that some far-reaching reforms may be required to diversify the risks currently borne by the developing states and their commercial lenders and to assure continued sources of credit for the sovereign borrowers.[44] The Intergovernmental Group of Twenty-Four, a group of developing countries within the IMF, has proposed a number of reforms to respond to the balance of payments problems of the developing countries.[45] Within the United States, both the Congress and bank regulators have devoted much attention recently to the exposure of U.S. banks in the developing countries, and have con-

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loans. *See A Boom in Broking Out Loans*, EUROMONEY, November 1982, at 37; Brown, *Selling Restructured Debt*, INT'L FIN. L. REV., March 1984, at 9. Although the use of participations may help banks diversify their risks and thus increase overall levels of lending, *see* Mendez, *supra* note 2, at 183-85, the consequences for the renegotiation process of widespread swapping and selling of loans to developing countries are unclear. An active secondary market in such loans may make it more difficult for the sovereign to identify the nature of its outstanding debt and the number of its creditors.

43. Although fixed interest rates were commonly used in loan agreements with developing countries through the early 1970's, floating interest rates are now used in the majority of agreements. The use of floating rates and the increase of interest rates generally have contributed to large increases for developing countries in the cost of servicing their debts. *See* Mendez, *supra* note 2, at 185. The average nominal interest rate of loans to developing countries nearly doubled from 1978 to 1981, rising from 8.7% to 16.5%, but rates decreased somewhat after 1981 before rising again in 1984. *See* Clausen, *supra* note 40, at 109 (chart). For a discussion of how interest rates are calculated for Eurodollar loans, see Mitchell & Wall, *The Eurodollar Market: Loans and Bonds*, in INTERNATIONAL FINANCIAL LAW 53, 62 (R. Rendell ed. 1980).

44. Proposals for fundamental reform of current practices include: (1) the exchange of existing short-term loans for long-term, low-interest notes to be issued by a national or multinational agency (*see Third-World Debt Problem*, N.Y. Times, Mar. 10, 1983, at D5, col. 1); (2) creation of a new institution, allied with the World Bank and backed by the export credit agencies of the major developed countries, that would make long-term funds available to sovereign borrowers (*see* Bolin & Del Canto, *supra* note 42, at 1110-11); and (3) creation of an adjunct to the IMF with broad powers to deal with debt problems (*see* Barnett, Galvis & Gouraige, *supra* note 41, at 131).

45. *Outline for a Program of Action on International Monetary Reform*, in IMF SURVEY, Oct. 15, 1979, at 319. *See also* J. GOLD, LEGAL AND INSTITUTIONAL ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM 17, n.30 (1979). The Commission on International Development Issues ("Brandt Commission"), formed in 1977 at the suggestion of then World Bank President Robert S. McNamara to study global economic and development issues, has issued a report which contains far-reaching proposals concerning both official and commercial lending practices. *See* NORTH-SOUTH—A PROGRAM FOR SURVIVAL, *supra* note 20. For a description of the origins and work of the Commission, see *Monetary Reforms Included in Wide-Ranging Proposals Published in Brandt Report*, IMF SURVEY, Feb. 18, 1980, at 49; Hooke, *The Brandt Commission and International Monetary Issues*, 18 FIN. & DEV. 22-24 (1981).

sidered some far-reaching proposals for reform of regulation of loans to such countries.[46]

Even if such reforms are undertaken, however, it is likely that debt renegotiation will continue to perform an important role in assisting individual states during short-term crises and in assuring the viability of the overall financial system.[47] In order for the renegotiation process to fulfill a meaningful role in the future, both borrowers and lenders must be willing to reevaluate traditional policies that may increase short-term gains but work against long-term stability.[48] The practice of limiting renegotiation agreements to narrow periods of maturities and thereby increasing the need for new negotiations, for example, may result in more fees and higher earnings for lenders,[49] but may divert the sovereign's funds and its limited technical resources from development projects and other domestic programs. Similarly, restrictive cross-default or negative pledge clauses which theoretically give lenders greater control over the sovereign's borrowing activities may in fact inhibit the sovereign's and the banks' ability to engage in trade transactions or to attract short-term capital for daily operations,[50] and contribute to a cycle of frequent defaults and continual negotiations.

Constructive renegotiations also require a willingness to approach each sovereign borrower on its own merits and to evaluate the necessity of "standard" terms or provisions that were included in the most recently concluded agreement. Provisions and terms that may be needed for large debtors such as Mexico or Brazil may be

46. *See* Madison, *IMF Boost No Bailout, Administration Insists*, NAT'L J., Mar. 19, 1983, at 596; Wines *supra* note 3, at 606-607.

47. Although the current case-by-case approach to debt renegotiation has been criticized for being wasteful and disruptive, Barnett, Galvis & Gouriage, *supra* note 41, at 95-96; Mendez, *supra* note 2, at 190, the renegotiations concluded to date have helped debtor states and their lenders avoid a complete breakdown of an individual country or the international financial system. Even if more formalized procedures are developed, it still will be necessary to convene negotiations between the sovereign and its lenders in each instance since those parties have the most interest in and the best knowledge of the issues at stake. *See* Bolin & Del Canto, *supra* note 42, at 1102-03. *See also Third-World Debt Problem, supra* note 44, at D5, col. 3 (observation of Irving Friedman that uniqueness of each country's problems makes general solution unrealistic). Thus, at least until a major reform that transforms the nature of the sovereign debt to be renegotiated, and probably thereafter as well, some form of case-by-case renegotiation along the lines currently practiced will be necessary.

48. For a discussion of the impact of certain loan terms and lending practices on the balance-of-payments situation of the developing countries, see P. DHONTE, CLOCKWORK DEBT 29, 35 (1979); Mendez, *supra* note 2, at 185-87, 196-99.

49. Renegotiation agreements typically provide for the payment of "up-front" charges such as commitment, extension, management and agent fees. *See* P. DHONTE, *supra* note 48, at 35-37; Note, *supra* note 20, at 307 n. 10.

50. *See supra* notes 25-32 and accompanying text.

entirely inappropriate and unnecessary for a smaller country with a different debt portfolio.[51] Likewise, provisions found in standard Eurodollar loan agreements may be unworkable in a renegotiation agreement that must accommodate the conflicting requirements of the sovereign and all of its lenders.[52] Current developments indicate that creative documents and negotiations will be needed to deal with the long-term ramifications of the international debt crisis. Lawyers serving as counsel to sovereign borrowers can contribute to the continued success of the debt renegotiation process by assisting their clients in the preparation of well-informed and realistic approaches to their debt problems, and by working for solutions that promote respect for the rule of law.

51. Of the 15 developing countries that renegotiated debt in 1981 and 1982, eight were low-income African countries. Clausen, *supra* note 40, at 108.

52. *See* Wickersham, *supra* note 15, at 8.