SYMPOSIUM:
REFINANCING OF THIRD WORLD DEBT*

LOAN AGREEMENTS BETWEEN DEVELOPING COUNTRIES AND FOREIGN COMMERCIAL BANKS—REFLECTIONS ON SOME LEGAL AND ECONOMIC ISSUES

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The third world loans of the American banks are still the most controversial and most worrying part of their international business, even if the wilder fears expressed earlier in 1976 have been discredited. Or, to put it more properly, the experience has not been good, but international banks seem so far to have had sound shock absorbers.

Argentina, Peru, Indonesia, Zaire and other countries have experienced difficulty in meeting their debt repayments at the proper time and have had to persuade their creditors either to refinance existing loans as they have fallen due or to agree to stretch-outs of the original payment schedules.¹

I. INTRODUCTION

A. The Scope of the Article

The theme of this symposium is refinancing the Third World debt. The symposium is restricted to a discussion of loans made by foreign commercial banks. Thus, it does not deal with the general question of international lending to developing countries, the sub-

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¹ Third World Risks, Joust for Supremacy: A Survey of American Financial Institutions, Economist, Jan. 22, 1977, at survey 25 (the survey is separately paginated and begins after page 56) (emphasis added). It was recently observed that "American banks have loaned almost $50 billion to less developed countries. With the increased price of oil, these countries are running larger deficits than the bankers expected." Bailing Out Our Banks Abroad, N.Y. Times, March 6, 1977, § 4 (Week in Review) at 16, col. 1.

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ject of a symposium elsewhere. Also excluded from discussion at this symposium is the question of the official development assistance loans given by the governments of capital-exporting nations and those given by international institutions such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). Nevertheless, some observations must be made at the outset regarding the entire debt problem facing the developing countries and the actions suggested to deal with the problem, especially the suggestions that have come from within the United Nations.

B. The United Nations and the Debts of the Developing Countries

At its Seventh Special Session, the General Assembly of the United Nations addressed itself to the debt-servicing problems of the developing countries as follows:

The burden of debt on developing countries is increasing to a point where the import capacity as well as reserves have come under serious strain. At its fourth session the United Nations Conference on Trade and Development shall consider the need for, and the possibility of, convening as soon as possible a conference of major donor, creditor and debtor countries to devise ways and means to mitigate this burden, taking into account the development needs of developing countries, with special attention to the plight of the most seriously affected countries . . . .

Prior to its fourth session, the United Nations Conference on Trade and Development (UNCTAD) had embarked on a study of the debt problem of the developing countries. The Ad hoc Group of Governmental Experts on Debt Problems of Developing Countries was created by resolution of UNCTAD's Committee on Invisibles and Financing Related to Trade to consider inter alia the debt problems of developing countries and the various possible international measures to be taken and to study the factors affecting the future levels of debt-servicing obligations in country situations without suggesting measures with regard to renegotiation of the debt of individual countries and measures

4. The fourth session of the United Nations Conference on Trade and Development Board (UNCTAD IV) was held in Nairobi, Kenya, in May and June of 1976.
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which could be taken to keep external debt-servicing obligations within manageable levels with the object of avoiding debt crises and consequent harm to the developmental objectives of the developing countries. The resolution further stated that the Group should deal with these problems in a manner that would safeguard both the legitimate interests of the creditors and the developmental objectives of the debtor countries, and have regard also to the fact that debt problems differ from country to country and that solutions should be adapted to specific conditions.5

In its report, the Ad hoc Group, in conformity with its mandate, discussed the economic context in which the significance of debt-servicing payments is to be evaluated,6 the question of avoiding debt-servicing difficulties,7 and suggested certain remedial measures.8 By the time UNCTAD IV was convened in 1976, the developing countries' current account deficits had shot from $9 billion in 1973, to $28 billion in 1974, and to more than $35 billion in 1975.9 It was predicted that the total debt, as opposed to current account deficits, would be in the neighborhood of $180-190 billion by 1976,10 and that the level would continue to increase.11

The primary purposes for such heavy borrowing by the developing countries were taking care of balance of payments problems, investment, procuring working capital and meeting unexpected or disruptive situations. The above cited figures refer to debts, including public loans from capital-exporting states, loans from the IMF and the IBRD, and also loans from the international commercial banks. The developing countries at UNCTAD IV pressed for the following solutions: (1) waiver or cancellation of official debts (principal and the related debt-servicing payments) with respect to the most seriously affected countries; (2) debt relief, in the form of conversion of official debts into grants with respect to the least developed among the developing countries; (3) consolidation of

6. Id. (Agenda Item 3) at 5-9.
7. Id. (Agenda Item 4) at 10-13.
8. Id. (Agenda Item 5) at 14-16. For further discussion, see Corea, The Debt Problem of Developing Countries, 9 J. DEV. PLAN. 53 (1976).
11. For further discussion on the future debt levels, see The Poor World's Debt, ECONOMIST, Oct. 2, 1976, at 78.
commercial debt of certain countries interested in this approach, and rescheduling of payments; (4) the establishment of an ad hoc international fund to refinance, at a commercial interest rate but with maturities of around 15 years; and (5) the convening of a debtor-creditor conference to deal with general principles that would guide the renegotiation of both official and commercial debts.¹²

The industrialized countries which attended UNCTAD IV found it difficult to accept these suggestions. Nevertheless, the developing countries' representatives at the Paris North/South dialogue have continued to press for them.¹³

C. The Case Against a Generalized Approach to the Debt Problems of Developing Countries

It should be observed at the outset that the developing countries whose debt problems are being discussed herein are those which are now being designated as non-oil developing countries. However, non-oil developing countries should not be lumped together into one group when proposing solutions to their debt problems. The UNCTAD study supports this view in the context of debt renegotiation procedures.¹⁴ Economists have unequivocally stated that the deficit problems of the non-oil developing countries are "so


¹⁴. The UNCTAD study agreed that there is some merit in the view that it is not possible to establish general criteria for debt relief applicable to all countries and that debt problems should be treated on an individual case-by-case basis since these problems reflect external or internal conditions peculiar to particular developing countries. Money and Finance and Transfer of Real Resources for Development, International Financial Co-operation for Development, Report by the UNCTAD Secretariat [UNCTAD IV] (May 5, 1976) (mimeo only) 17, U.N. Doc. TD/188 (1975). However, the study concluded that the current debt problems of developing countries are not the result of specific external circumstances peculiar to particular countries, nor do they reflect mismanagement on the part of those countries. The problem has clearly a more general dimension since it springs from maladjustment in the world economy and is beyond the ability of developing countries to control. Id. The case-by-case negotiation of developing countries' debt was one of the specific measures suggested in Part II of Resolution 3202 of the Sixth Special Session of the General Assembly. G.A. Res. 3202(h), 29 U.N. GAOR, Sixth Special Session, Supp. (No. 1) 8, U.N. Doc. A/9659 (1974).
different that a blanket solution could be counterproductive."

Treating the non-oil developing countries as a homogeneous group is, indeed, a mistake. In the context of a discussion of their debt problems, the non-oil developing countries fall into several groups, so designated for various reasons.

In one group, for example, belong the significant debtors such as Argentina, Brazil, Mexico, Peru, the Phillipines, South Korea, and Taiwan, all of whom have heavily borrowed from foreign commercial banks and whose total debt, in 1975, exceeded by fifty per cent the entire current-account deficit of the non-oil developing countries. These countries are considered members of a high-income group, as opposed to the low-income group to which Zaire belongs. However, all of these nations, including Zaire, an equally heavy borrower from foreign commercial banks, belong to a group which bankers themselves have referred to as their "partners" and not simply "debtors." It is evident, therefore, that this group of significant debtors, because of its active participation in the international monetary market, is different from the group of non-oil developing countries which have not borrowed heavily from the international commercial banks and which have not overstretched their general debt commitments.

Commenting, not on the heavy borrowing by these non-oil developing countries, but on the equally soaring loans from Western commercial banks to the Soviet Bloc, a Swiss banker said, "Make a small loan and you have created a debtor. Make a large loan and you have created a partner." An American banker explained that a "very big debtor has great influence over a bank, because he can embarrass it, or even ruin it, by refusing to repay."

Another distinction exists between non-oil developing countries. Some of the non-oil developing countries have other mineral industries which can be used as collateral for commercial loans. Other non-oil developing countries, which do not have such endowments, must rely upon their ability to maintain a rate of growth capable of creating confidence upon which the lenders can rely. It

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15. The Poor World's Debt, supra note 11, at 79.
16. Id.
17. The case of Zaire is of great interest because the agreement reached to refinance its debts with the commercial bank lenders came about as a result of the 1976 scares about debt defaulting. For further discussion, see note 40 infra and accompanying text.
19. Id.
is thus usually regarded as a sign of economic and political stability if a non-oil developing country gets an unsecured loan from an international commercial bank.

There is also a group of non-oil developing countries whose main problem is not the high costs of servicing debts. These countries, instead, are troubled with inadequate resource transfers, defined as "gross disbursement of grants and loans less debt service payments." This group is clearly to be distinguished from another group made up of countries which have severe problems because of their heavy dependence upon the export of one or two commodities, leaving them with a limited access to the world capital market. This latter group is "extremely vulnerable to being squeezed out of commercial borrowing altogether."

Having examined the concern of the United Nations with the debt problems of non-oil developing countries and the impropriety of a generalized approach to their problems, the remaining sections of this introduction will be devoted to a brief survey of the extent of commercial banks' involvement in this matter, the rationale behind the extensive lending to the developing countries, and related economic issues.

D. The Magnitude of the Foreign Commercial Banks' Loans to Developing Countries and the Economic Rationale

International commercial banks have increased their lending to the non-oil developing countries from virtually nothing in the 1960's to the level of providing about 65% of the total financial needs of the developing countries in 1975. Of the $41 billion deficit of the non-oil developing countries in 1975, $15 billion was financed by private commercial banks, chiefly from the United States and the Euromarket commercial banks. There are certain problems which may be said to exist as a result of the current trend of commercial banks in becoming so involved in financing developing countries' balance of payments deficits. Many observers fear that commercial

21. The Poor World's Debt, supra note 11, at 78-79.
22. Locked in with the Poor, ECONOMIST, Dec. 25, 1976, at 76.
23. The $35 billion deficit of the developing countries in 1975 was financed as follows: $17 billion by official development aid and private investments; $3 billion by borrowing from the IMF and drawing on national exchange reserves; and $15 billion by the private commercial banks. Capital Flows and International Economic Development, 1976 AM. SOC'Y INT'LL. L. PROC. 80, 81.
banks may be compelled to monitor the economic performance of the developing countries to which they lend. This may result in far reaching political consequences involving not only the destinies of the commercial banks themselves, and those of their clients, but also the relationship between the non-oil developing country borrowers and the home countries of the lending banks. Although this problem is considered overblown by some bankers, the following statement is indicative of the seriousness of this issue:

It goes without saying that the sheer magnitude of the banks' loans to LDCs [less developed countries] means that bankers feel duty bound to make increasing demands upon the LDCs that seek their funds. But carrying this to its logical conclusion conjures up age-old fears of domination of the Poor by the Rich; of renewed Dollar Diplomacy by the U.S.; of exploitation of previous colonies by a host of Western nations—and a renewal of all the worst charges that have been heaped upon multinational corporations. And it's not just the borrowers who have such fears; some of the lenders do, too.24

It has been legitimately asked whether private commercial banks, which are evidently only too willing to continue to lend to non-oil developing countries,25 have the ability to manage these loans. The commercial banks may be compelled to undertake the unorthodox task of monitoring the economic performances of the developing countries in order to ensure conditions of repayment of the loans.26 Monitoring loans, as such, has traditionally been done only by the IMF and the IBRD. But, recently a group of private commercial banks entered into a loan agreement which included a right to monitor the economic performance of the developing country.27 Further loans may be conditioned upon the bank finding that

24. Shapiro, supra note 9, at 140.
25. American Banks Take Another Trip Abroad, ECONOMIST, Nov. 20, 1976, at 131; Docked in with the Poor, supra note 22, at 76.
27. In order to negotiate a $300 million balance of payment loan from a syndicate made up of Bank of America, Chase Manhattan, Citicorp, Manufacturers Hanover, Morgan Guaranty and Wells Fargo, Peru recently agreed to a bank monitoring process as a condition to receiving the loan. The banks separated payment of the loan proceeds into two equal installments. The second payment was contingent on Peru's satisfactory implementation of an economic stabilization program. Many observers voiced concern over the prospect of the commercial banks controlling Peru's economic destiny. One observer noted that "[t]o meet
the borrower has maintained an economic performance conducive to loan repayment.

It is important to explore, briefly, the economic realities which seem to have encouraged banks to continue approving large loans to the non-oil developing countries, in spite of a persistent fear of default. One explanation offered for this situation is as follows:

Faced with a build-up of Opec deposits and a decline in loan demand from traditional borrowers, ... [commercial banks] have been desperate to find some other outlet for their cash. They thus increased their net medium-term lending to the developing countries through the Euro-currency market from virtually nothing in the mid-1960's ... to $9.5 billion in 1975. They also increased their net short-term lending in the form of export credits from $1.5 billion in 1972 to $4 billion in 1975. By the end of 1975, private capital markets were providing 65% of the total financial needs of the developing countries . . . .

Commenting on the $20.6 billion which the American banks alone are said to have loaned to the developing countries in 1976, the United States Commerce Department is reported to have acknowledged that "the increase in foreign lending reflected weak domestic loan demand resulting from the recession as well as declining interest rates in the United States, which made yields available

the bankers' terms, for example, Peru sold off its state-owned fishing fleet, devalued its currency, and stopped state subsidies for labor." Bailing Out Our Banks Abroad, supra note 1. The bankers responded that the Peruvians themselves developed and implemented the economic program and that the banks did not dictate any such program to them. Bellivean, What the Peru Experiment Means, INSTITUTIONAL INVESTOR, Oct. 1976, at 145, 148.

28. The banks have continued to make loans even though the political climates of developing countries are believed to be unstable. The following remarks are said to have been made by certain western economists while discussing the problems which may occur if American commercial banks engage in monitoring the economic performance of developing countries borrowers:

"we're talking about LDCs where people don't understand banking or even markets. Most of the enterprises they know are run by the state or beholden to it. And their political leaders may be demagogues of the first order, who'd love to blame their economic problems on somebody. It doesn't take much to whip up the peasantry with stories about the House of Morgan and U.S. imperialism to explain why there's no food." To which another observer adds: "When the going gets tough, either they blame the banks or the home countries. Let's say they blame the banks. That's fine for the U.S. State Department, but terrible for the banks, which may end up getting expropriated or thrown out of the country when they need a villain." Either way, it's likely that if U.S. commercial banks are perceived as having put pressure on foreign governments, it could be a disaster for America's foreign policy.

Shapiro, supra note 9, at 142.

29. Locked in with the Poor, supra note 22, at 76.
elsewhere more attractive."  

The necessary analysis of the extent and the rationale behind the commercial banks' involvement emphasizes also that "third-world borrowers are likely to suffer from payment deficits for years to come and will therefore be chronically short of foreign currency needed to repay." If this condition persists, it is clear that commercial banks are assured of continued demands for loans from their overseas clients which have become profitable outlets for their funds. Thus, commercial banks will continue to be the alternatives to the IMF compensatory financing or the borrowing on the national tranches, for developing countries seeking loans for financing balance of payments deficits.

E. The Sources of Loans for Financing Developing Countries’ Balance of Payments Deficits

With respect to the specific problem of balance of payments deficits, the developing countries have the choice of either approaching the IMF and borrowing on their national tranches, or approaching the commercial banks for the necessary loan. One must wonder why a developing country would prefer approaching commercial banks for loans which generally carry higher interest rates and shorter maturity terms, instead of going to the IMF, whose interest rates are generally lower. Certain explanations are available.

One reason for preferring commercial banks' loans is that certain developing countries may want to avoid the IMF's stringent surveillance of the economic performance of the borrowing country. As observed earlier, the commercial banks are preferable because they do not ordinarily wish to monitor the economic performance of their clients. It has been observed that the developing countries resent the surveillance by the IMF, whose personnel are sometimes regarded in a developing country borrower as "police in the ghettos areas." The IMF supervision becomes more stringent as a country borrows on the later tranches. In order to measure the effects of lending to a given country, the IMF and other international lending

31. Locked in with the Poor, supra note 22, at 76. Financial assistance from the oil-exporting Arab nations may change the situation. See Saudis Pledge $1 Billion for Black Africa as 59-Nation Parley Starts in Cairo, N.Y. Times, March 8, 1977, at 1, col. 2.
32. See note 26 supra.
33. Compare, however, the case of Peru discussed in note 27, supra.
institutions such as the IBRD, the International Development Bank (IDB), the Agency for International Development (AID), and even the Commonwealth Development Corporation (CDC) are interested in monitoring the operational effects of the loan, the technical effect, the financial effect, the economic effect, and the socio-

34. The operational effect of the lending, the first critical effect which should be evaluated, is analyzed by asking the following questions:

(1) Were the loan funds spent for the purposes intended? (2) Were the appropriate physical and human inputs actually put into the project? (3) Was the road or plant actually built? Indeed, was the project actually completed? and (4) Was the project completed on time and within cost estimates?


35. The technical effect of international lending deals in large part with the qualitative aspects of the project. Technical effect is analyzed by asking the following questions:

(1) Was the bridge or road technically well constructed? (2) Did the project meet or surpass normal local technical standards? (3) Did the project set new standards of timing, economy or quality of work? (4) Did the project bring any new technology or new methods to the country? and (5) Was any such new technology of a type which could be applied at a reasonable cost elsewhere in the country?

Id. at 600-01.

36. In measuring the financial effects of international lending a banker is expected to be concerned mainly with this basic question: Can the borrower repay the loan as expected? An affirmative answer should indicate that the loan created the desired “effect” from the point of view of the bankers who are all afraid of defaults. Id. at 601.

37. It is difficult to isolate and quantify the economic effect of international lending. The following questions can be asked to ascertain the “macro” economic effect of international lending:

(1) Has international lending really stimulated domestic capital formation or has it been diverted into short-term consumption projects with no growth effects? (2) Has international lending further exacerbated the dichotomy found in most developing countries; that is, has it fostered the rapid development of a small modern sector of the economy while ignoring the larger traditional sector of the economy? (3) Has international lending led to a concentration of economic power and to the fostering of monopoly situations in the borrowing countries? (4) Has international lending led to an “unequal” distribution of income in the developing countries? (5) Has international lending, with its frequent “tied” procurement conditions, meant that the developing countries have had to pay higher prices for the importation of capital and other goods?

Id. at 603.

The following questions can be asked in order to determine the effect at the country economy level, the industrial sector level, and even at the “micro” level of a single important firm:

(1) Has international lending favored transportation or industry over agriculture or mining? (2) Has international lending focused only on the productive sectors while ignoring infrastructure and the social sectors? (3) Has international lending only gone to the high profit, leading-edge industries such as pharmaceuticals while ignoring the basic industries of steel and power production? (4) Has international lending been concerned only with large-scale farmers while forgetting the credit problems of small peasant farmers?

Id. at 603.
political effect. Apart from the reluctance to approach the IMF because of the monitoring practice, certain developing countries are also reluctant to approach the IMF because doing so amounts to an admission that the country has failed to run itself properly.

Other developing countries may avoid the IMF and go to commercial banks, not because of a fear of the IMF's monitoring practice, or of the risk of appearing as having failed to manage themselves properly, but instead to demonstrate that they are capable of putting their houses in order. Commercial banks only lend to countries upon a showing of each country's ability to maintain a healthy economic growth, conducive to the repayment of the loans. A developing country may return to the banks for more loans to demonstrate its political and economic stability, which, in turn may attract foreign investment. This practice could easily lead a country into a serious debt problem. The country may become unavoidably saddled with debt-servicing problems and, as a result, overstretch its borrowing limits. Thus, while borrowing from the IMF may not

38. In determining the socio-political effect of international lending, the subtlest to evaluate and possibly the most important aspect of the lending program, the following questions are pertinent:

(1) Does the lending precipitate the borrowing country into a dependency position with regard to the lender company, country, or international public bank? (Putting the question in the language of the man on the street in the developing country: "Are foreign devils controlling our country as a result of these international loans?") In this regard, ownership is the key issue involved. In many developing countries loan capital, especially from the "official" or public sector, is considered politically neutral or inoffensive because the loan, in effect, takes first claim on nothing more than the local portion of the project's cash flow. Equity capital from foreign sources, on the other hand, is considered politically biased, exploitive, or unnecessary. (2) Does the proposed lending program support or distort national development priorities and plans? (3) Does the lending involve the taking away of scarce national resources, or does the loan involve "foreign exploitation" of the country's national resources? (4) Does the lending improve the ability and the capacity of the country to feed, house and clothe its citizens? (5) Does the lending foster a democratic, popular-participation government? Does it encourage positive government reaction to the citizen's problems?

Id. at 604-05.

In the socio-economic sphere, the following questions are pertinent:

(1) What effect does the lending program have on employment and under-employment, salary levels and working conditions? (2) Does the lending relieve conditions in depressed areas, reduce rural-urban migration, reduce income disparities and, generally, create higher family incomes? (3) Does the lending encourage the development of domestic entrepreneurs and managers? (4) Does the international lending program—public or private—spur the spirit of development and modernization in the country?

Id. at 605.

39. Bellivean, supra note 27, at 146.
be considered ideal in all situations, the alternative of approaching the commercial banks is not a problem-free solution. Because of the legitimate desire of keeping these two options open, it is quite understandable why certain developing countries do not want to accept a generalized approach to the solution of their debt problems and would refrain from supporting a solution that would affect their credit worthiness with the commercial banks.

F. The Case for the Participation of the Commercial Banks and the IMF in a Single Loan Transaction

Actual practice seems to indicate that commercial banks have devised a system in which a developing country client is compelled to go first to the IMF for part of the loan, and then approach the banks for the rest. The IMF involvement is important for the banks in that the necessary surveillance is undertaken by the IMF. The treatment of Zaire's debt problem is a case in point.

Apart from paying $34 million of the $44 million arrears in principal to a neutral financial agency for the purpose of repaying its commercial bank lenders, Zaire was also encouraged by the commercial banks to apply to the IMF for the national tranches to which it is entitled. The IMF loan, with its stringent supervisory conditions, was to bring about $96 million towards the total medium-term debt of $450-500 million. 40

The involvement of the IMF would "provide the bankers with, they hope, a financial traffic cop." 41 The IMF and the other official lending agencies are better placed than the private commercial banks to push countries that have become financially over-extended into making changes in their national economic policies. Accordingly, joint financing programs between the commercial banks and the other international lending institutions are entered into more frequently. Illustrative of this point is the case of Brazil.

The IBRD, in 1975, made a $95 million loan to Brazil, together with two commercial bank loans of $55 million. 42 The service pay-

41. Banks Carry on Lending to the Poor: Zaire Refinanced, supra note 40, at 99.
42. The Poor World's Debt, supra note 11, at 78, 79.
ments were made due to the commercial banks and channeled through the IBRD. It should be noted that this type of joint financing will tend to help only the "well-off." 43

By turning towards various forms of co-financing programs with official lending agencies, commercial banks are demonstrating that they are as persistent in ensuring repayments as they are in their continued lending. Banks will continue to guard against default in payment situations because of the possible multiplier effect which could ruin their banking business. 44

The commercial banks take the position that repayment of their loans must be given priority over the repayment of the loans given by governments and other public lending institutions, which do not pay dividends, are not responsible to the shareholders, and have a freer hand in the use of the public money they loan.

II. THE LEGAL ISSUES

A. Suggested Approach to a Loan Agreement

The commercial banks are not loaning the non-oil developing countries money for meeting chronic debt problems as an act of benevolence, and therefore, the protection of the banks' interest should not be paramount. Commercial banks have found, in the non-oil developing countries, a necessary market for their surplus funds. Thus, they are doing business guided by the usual profit-making motive. Accordingly, the extent of the protection of their rights and interests in a loan agreement must be weighed properly against the equally necessary protection of rights and interests of the developing country recipients of the loan.

The non-oil developing countries have both short-term and long-term economic development problems. Borrowing funds for taking care of economic development problems is a task which each country undertakes in accordance with its particular needs. The expected repayment of loans on schedule may, however, be disrupted because of certain unforeseen events, thus frustrating the achievement of the legitimate goals for which the loan was obtained. Problems such as this, as noted in the UNCTAD study, are the

43. Id. Private banks seem reluctant to move into unfamiliar countries and private institutional lenders, said to be generally conservative, tend to be selective of their borrowers. Id.

44. For further discussion on the question of default generally, see Greene, Financing Foreign Governments and Official Entities, in Off Shore Lending By U.S. Commercial Banks 187, 206 (F. Mathis ed. 1975).
result of "maladjustment in the world economy and beyond the ability of developing countries control." The interest of the developing country borrower in fulfilling the original legitimate economic development goal ought to be fully protected by ensuring that the terms of the loan agreement are flexible enough to take such realities into account.

It is easily seen why, in loan renegotiation, avoiding default situations becomes a crucial issue. Both the lenders and the borrowers have an interest in avoiding defaults in loan payments. The lenders are afraid of the possible multiplier effect of the default which could ruin their business. The borrowing countries are afraid that a default will tarnish their credit worthiness in the eyes of the commercial banks. Care must accordingly be taken to avoid making a loan agreement an instrument which predominantly protects only the interest of the lender. Also to be avoided is the use of the loan agreement as an instrument on the basis of which the developing country borrowers remain at the mercy of constant harassment and humiliation by otherwise avoidable legal actions instituted by lenders claiming breach of one sort or another.

A loan agreement must create a balanced legal relationship between the parties in order to work for the benefit of both. It should not create a legal relationship which is easily made unworkable or which can be terminated prematurely by a party claiming the non-fulfillment of numerous provisions cleverly skewed in its favor in the instrument. Banks are not to be expected to engage in what may plainly be called irrational and counterproductive behavior. Thus, they would not ordinarily insist upon a loan agreement with terms so harsh as to be unconscionable, or seek to terminate prematurely a loan agreement even in the face of a material default by the borrower. It is within this basic framework that the legal issues regarding loan agreements are herein discussed.


46. This fear was expressed by a Brussels-based analyst commenting on the borrowings of the Soviet Bloc. Janssen, supra note 18, at 20. However, the chairman of Citicorp, unconvinced of any multiplier effect, recently commented:

They said floating exchange rates would dry up world trade. But they didn’t. They said the Eurodollar market was a dangerous monster that would destroy us all unless tamed. But it hasn’t. Now they say the developing countries will default on their debts and collapse the whole banking system. Well, we here say it just won’t happen.

B. Loan Agreement Between a Private Bank and a Foreign Government as a State Contract

Commenting on the status of the law in this field about a decade ago, the Committee on the Nationalization of Property, set up by the American Branch of the International Law Association, made the following observation:

No government would suggest that it has a legal right to breach a loan agreement it concludes with the International Bank for Reconstruction and Development. Can it seriously be contended that a government has the legal “right” to breach a loan with the Chase Manhattan Bank? Acceptance of the argument that the former contract is intergovernmental, and consequently governed by international law, while the latter has but one government as a party, and consequently is governed by municipal law, even if formalistically satisfying—as it is not—adds nothing to the rule of international law. 47

This statement was made at a time when a clear distinction was maintained between the status of an agreement made between a state and an international organization, and one made between a state and an alien natural or juridical person. The former, by virtue of not being made subject to any local laws, is governed by public international law and is labeled an international agreement. The latter, by virtue of being subject to the laws of either the state contractor or the local laws of another state chosen by the parties to govern the agreement, is known as a state contract.

The question of the proper law of state contracts was the subject of a sophisticated doctrinal debate between two eminent attorneys, whose writings on the subject have done much in elucidating this area of the law. A detailed discussion of the thesis by Dr. F. A. Mann, that the international law remedy for state contracts is sounded in tort and relies upon a supervening delict independent and distinct from the contract (delictual remedy), 48 or the opposing thesis by Professor R. Y. Jennings, that an international law remedy is sounded in contract (contractual remedy), 49 is beyond the scope of this article. Since that debate, much has happened. It is now possible to suggest that the prevailing view is that a contract be-

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between a state and a foreigner may be governed by public international law, if the parties so intend.50

This development of the law towards the "internationalization" of state contracts, such as a loan agreement between a private commercial bank and a foreign government, must be seen as an effort directed towards affording more protection for the interest of the alien creditors by ensuring a means of enforcing and collecting money through a remedy governed by a legal system which the contracting state cannot freely alter. Local laws could conceivably be altered to substantially change the creditors' rights. Additionally, a state government might possibly repudiate the debt on solid or colorable grounds through domestic legislation.51 For example, assume a state has undertaken in a loan agreement to repay a loan at an interest rate of 11%. The state might, in seeking to ease its internal economic problems, reduce the rate of interest in respect to all loans by one-half. Since the loan agreement was governed by the laws of that state and since that law is thus legitimately changed, it would be difficult for the creditor to claim breach of contract if the state does not thereafter pay the original 11% rate of interest. Clearly in such a case, "though common sense suggests that there has been a breach of contract, there is yet no breach according to the proper law."52

The "internationalization" of state contracts so as to make them subject to public international law would thus prevent such situations from arising. Domestic legislation of a state contractor would not affect the international obligation assumed by the state because of the well-settled rule of public international law, ordained by the Permanent Court of International Justice, to the effect that no state can rely on its own legislation to limit the scope of its international obligation.53 However, it is still open to serious doubt whether, by agreeing to make a contract with a foreign company subject to international law, a state thereby assumes an international obligation. The precise consequences and effects of "internationalization" of state contracts are still unclear and re-

51. For a discussion of the dangers of lending to developing countries as they were articulated fifty years ago, see C. Hyde, The Negotiation of External Loans with Foreign Governments, in 1 INT'L L. A. REP. THIRTY-FIRST CONF. 349 (1923).
Draftsmen have searched for appropriate applicable law clauses.\textsuperscript{54} Clauses which provide for third party arbitration as the method for settlement of disputes have also been used.\textsuperscript{55} However, the designation of applicable law or the choice of a disputes settlement procedure and forum does not end the drafting problems. There is the question of whether sovereign immunity bars all claims by a private lender against a sovereign state borrower, notwithstanding the sophistication of the choice of law and forum clauses present in the loan agreement itself.\textsuperscript{56}

Unlike the question of "internationalization" of state contracts, which commentators have thoroughly discussed,\textsuperscript{57} the problem of the changing attitudes on the concept of sovereign immunity still requires further elucidation, especially in light of the rejection of the prior practice of subjecting contracts to municipal law systems.\textsuperscript{58} The forces which have encouraged the liberalization of state contracts for the purposes of protecting the legal interests of the alien contractor are also behind the current trend towards a relaxed view on the scope of sovereign immunity in the context of state contracts.

C. New Attitudes Towards Sovereign Immunity

The following framework for introducing international bankers to the risks of sovereign immunity was first announced, in 1812, by

\textsuperscript{54} The idea championed by Professor Verdross that a contract can create its own independent legal system, "lex contractus," which exhaustively regulates the relationship between the parties has been criticized as being "doctrinally so unattractive, so impracticable, so subversive of public international law, so dangerous from the point of view of legal policy and so unnecessary that its novelty will not cause surprise." Mann, The Proper Law of Contracts Concluded by International Persons, 35 BRIT. Y.B. INT'L L. 34, 49 (1959), reprinted in F. Mann, Studies in International Law 211, 230 (1973).

\textsuperscript{55} For more discussion of third party arbitration agreements, see Mann, State Contracts and International Arbitration, 42 BRIT. Y.B. INT'L L. 1, 4-6 (1967), reprinted in F. Mann, Studies in International Law 256, 260-62 (1973).

\textsuperscript{56} See generally Harfield, Legal Aspects of International Lending, in Offshore Lending by U.S. Commercial Banks 81 (F. Mathis ed. 1975); Schmidt, Legal Protection of Loans to Developing Country Borrowers, 7 VAND. J. TRANSNAT'L L. 575 (1974).

\textsuperscript{57} See notes 47-56 supra and accompanying text. See generally G. Delaume, Legal Aspects of International Lending and Economic Development Financing (1967).

\textsuperscript{58} Reference is being made here, for example, to the initial practice followed by the IBRD of making loan agreements with member governments subject to the law of New York. This practice has now been abandoned. G. Delaume, supra note 57, at 84-85; R. Lavallo, La Banque Mondiale et ses Filiales: Aspects Juridiques et Fonctionnement 226 (1973). The IBRD now effectively makes a loan agreement with a member government subject to international law and removes it from the reach of municipal law. See 1 G. Delaume, Transnational Contracts: Applicable Law & Settlement of Disputes § 1.10, at 35 (1976).
the United States Supreme Court in *Schooner Exchange v. McFadden*: 59

The jurisdiction of the nation within its own territory is necessarily exclusive and absolute. It is susceptible of no limitation not imposed by itself. Any restriction upon it, deriving validity from an external source, would imply a diminution of its sovereignty to the extent of the restriction, and an investment of that sovereignty to the same extent in that power which could impose such restriction.

All exceptions, therefore, to the full and complete power of a nation within its own territories, must be traced up to the consent of the nation itself. They can flow from no other legitimate source.

This consent may be either express or implied. In the latter case, it is less determinate, exposed more to the uncertainties of construction; but, if understood, not less obligatory.

The world being composed of distinct sovereignties, possessing equal rights and equal independence, whose mutual benefit is promoted by intercourse with each other, and by an interchange of those good offices which humanity dictates and its wants require, all sovereigns have consented to a relaxation in practice, in cases under certain peculiar circumstances, of that absolute and complete jurisdiction within their respective territories which sovereignty confers.

This consent may, in some instances, be tested by common usage, and by common opinion, growing out of that usage.

A nation would justly be considered as violating its faith, although that faith might not be expressly plighted, which should suddenly and without previous notice, exercise its territorial powers in a manner not consonant to the usages and received obligations of the civilized world.

This full and absolute territorial jurisdiction being alike the attribute of every sovereign, and being incapable of conferring extraterritorial power, would not seem to contemplate foreign sovereigns nor their sovereign rights as its objects. One sovereign being in no respect amenable to another; and being bound by obligations of the highest character not to degrade the dignity of his nation, by placing

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59. 11 U.S. (7 Cranch) 116, 136-37 (1812). The judgment was delivered by Chief Justice Marshall. The Exchange, a merchant vessel expropriated by the French government and converted into a warship, was libeled by its former American owners while docked at the port of Philadelphia. The Attorney General, acting for the Department of State, filed with the Court a suggestion that the ship be held immune from suit. Speaking for a unanimous Court, Chief Justice Marshall held that warships of friendly foreign nations, in a port of the United States, are exempt from the jurisdiction of the courts of the United States unless the executive indicates a contrary desire. Subsequently, a suggestion and a certificate of the Department of State, to the effect that it recognizes and accepts a foreign government’s claim of sovereign immunity, was held as binding upon United States courts.
himself or its sovereign rights within the jurisdiction of another, can be supposed to enter a foreign territory only under an express license, or in the confidence that the immunities belonging to his independent sovereign station, though not expressly stipulated, are reserved by implication, and will be extended to him.

Since first announced, this principle has influenced the development of both British and continental jurisprudence. As a result of this influence, capital-exporting states have adopted new attitudes in their application of the principle of sovereign immunity.

This change of attitude is based on the following fact: "As the economic and financial activities of the public sector expand, countries themselves have limited immunity for some operations of the state, so that their own citizens may enjoy legal redress." This development in the domestic sphere has spilled over into the international sphere. Today, capital-exporting states have lead the way in encouraging limitation of the principle of state sovereignty for the purpose of affording legal redress to their nationals doing business with foreign governments.

Two views have been maintained with respect to this concept. The "absolute theory" of sovereign immunity grants to a sovereign state immunity from all suits. Plaintiffs are barred from instituting any claims in court against a foreign government on the grounds that the court lacks jurisdiction to entertain such a suit. The immunity is thus absolute, both with respect to actions in personam and also proceedings in rem, against a sovereign state for execution.

The absolute theory is to be distinguished from the "restrictive theory" of sovereign immunity. Under the restrictive theory, a distinction is made between public acts of a state, acts jure imperii, and commercial activities of a state, acts jure gestionis. A sovereign state is entitled to immunity with respect to acts jure imperii, but is not entitled to immunity from suit with respect to acts jure gestionis. Complete immunity from execution of property, never-

60. See notes 61-87 infra and accompanying text.
62. In Republic of Mexico v. Hoffman, 324 U.S. 30 (1945), both the Department of State and the Supreme Court of the United States refused to recognize the claimed immunity of a vessel owned, but not operated, by a foreign state. In 1952, Jack B. Tate, Acting Legal Advisor of the Department of State, announced that the Department of State would grant certificates of immunity only to public or governmental acts. Such certificates would not be available for private or commercial acts. 26 DEP'T STATE BULL. 984 (1952). In 1955, the Supreme Court, in National City Bank v. Republic of China, 348 U.S. 356 (1955), extended the rule to include the non-recognition of sovereign immunity in cases involving counterclaims limited to the amount of the claims and arising out of the same transaction.
theless, remains.

The development of the restrictive theory of sovereign immunity has become increasingly important in the context of the loan agreements with developing countries, since in most cases the borrowers of the loans are governments themselves. Problems immediately arise over the question of the applicable standard for distinguishing acts *jure imperii* from acts *jure gestionis.* The restrictive theory has been criticized as being too vague in respect to this problem.

Various attempts have been made to delimit the application of sovereign immunity. These efforts can be seen in the European Convention on State Immunity, the Foreign Sovereign Immunities Act of the United States, and in a recent English Court decision. The European Convention on State Immunity set forth the specific cases in which the plea of sovereign immunity would not be available. These include cases:

(i) which the state itself initiates, albeit by way of certain counter-claims;
(ii) to which the state has agreed to submit;
(iii) in which the state has taken steps relating to the merits;
(iv) which “relate to an obligation of the state which, by virtue of a contract, falls to be discharged in the territory of the state of the forum;”
(v) which relate to a contract of employment to be performed in the state of the forum;
(vi) which concern matters arising from the state’s participation in a company, association or other legal entity;

63. The same holds true with respect to East European countries which, although subscribing to the theory of absolute immunity, have agreed to submit themselves to foreign jurisdiction by a number of bilateral agreements with the Western countries. For a discussion of the Eastern European cases, see Lissitzyn, *Sovereign Immunity as a Norm of International Law,* in *Transnational Law in a Changing Society: Essays in Honour of Philip C. Jessup* 192-93 (W. Friedmann ed. 1972).

64. In Victory Transport Inc. v. Comisaria General, 336 F.2d 354 (2d Cir. 1964), cert. denied, 381 U.S. 934 (1965), a “purpose” test was recommended. Under this test, the court determines whether the purpose of the activity in question was commercial or public. The purpose test was found wanting by Congress and was therefore abandoned. See Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1603(d) (1976). Under the Foreign Sovereign Immunities Act the test employed determines whether the true “nature” of the particular transaction in question is commercial or governmental. Id.


(vii) which relate to the industrial, commercial or financial activity of an office, agency or other establishment in the state of the forum;
(viii) which relate to a patent or other industrial property of the defendant state;
(ix) which relate to immovable property in the forum state;
(x) which relate to property arising by way of succession, gift or bona vacantia;
(xi) which relate to redress for injury caused to the person or tangible property in the state of the forum by a wrongdoer present in such territory at the time of the occurrence;
(xii) which relate to arbitration pursuant to a submission in writing;
(xiii) which concern the administration of property in which a contracting state has a right or interest.

In spite of the numerous qualifications and exceptions that exist, the effort is clearly to increase instances in which the plea for sovereign immunity would be restricted, thus opening the door for a greater number of legal actions involving sovereign states or their entities.

The Foreign Sovereign Immunities Act is a significant step for the United States, a country that has long adopted the restrictive theory of sovereign immunity. Commenting on the Act, the following observation was made:

The purpose of sovereign immunity in modern international law is . . . to promote the functioning of all governments by protecting a state from the burden of defending lawsuits abroad which are based on its public acts. However, when the foreign state enters the marketplace or when it acts as a private party would, there is no justification in the modern international law of sovereign immunity for allowing the foreign state to avoid the economic costs of the agreements it breaches or of the accidents it creates; the law should not permit the foreign state to shift these everyday burdens of the marketplace onto the shoulders of private parties.

The Act attempts to offer a new definition of acts jure gestionis. Section 1603 defines commercial activity as a regular course of com-

68. Mann, New Developments in the Law of Sovereign Immunity, 36 Mod. L. Rev. 18, 21-22 (1973) (footnotes omitted).
The commercial character of an activity is determined by reference to the nature of the course of conduct or particular transaction, rather than by reference to its purpose. Commercial activity carried on in the United States by a foreign state is defined as commercial activity carried on by such state and having substantial contact with the United States.

Sections 1605 and 1607 deal with exceptions to the jurisdictional immunity of a foreign sovereign state, and enumerate the following cases in which the defense of sovereign immunity will not be accepted in United States courts. They include cases (i) in which the foreign state has waived its immunity, either explicitly or by implication; (ii) involving commercial activity carried out in the United States by a foreign state; (iii) involving an act performed in the United States in connection with a commercial activity of a foreign state elsewhere; (iv) involving an act performed outside the United States in connection with a commercial activity of a foreign state elsewhere, which act causes a direct effect in the United States; (v) in which the rights in property taken in violation of international law are in issue and that property or any property exchanged for such property is in the United States in connection with a commercial activity being carried out by a foreign state in the United States; (vi) in which rights in property in the United States acquired by succession or gift or rights in immovable property situated in the United States are in issue; (vii) in which money damages are sought against a foreign state for personal injury or death, or damage or loss of property, occurring in the United States, having been caused by tortious acts or omissions of a foreign state or its agents modified by certain statutory exceptions; (viii) involving counterclaims arising out of an action initiated by a foreign state in the courts of the United States, having regard however to the specific instances enumerated in the statute; and (ix) attachment of property in the United States in aid of execution to satisfy a final judgment.

71. Id.
72. Id. § 1603(e).
73. Id. § 1605(a)(1).
74. Id. § 1605(a)(2).
75. Id.
76. Id.
77. Id. § 1605 (3).
78. Id. § 1605 (4).
79. Id. § 1605 (5).
80. Id. § 1607.
judgment against a foreign state, provided the property was being used by the foreign state in a "commercial activity" as defined in the statute, or falls within the category of property with respect to which defense of sovereign immunity is already denied for many of the reasons mentioned in (i)-(viii) above. 81

Similar to the result reached in the European Convention, the Foreign Sovereign Immunities Act is designed to further limit the defense of sovereign immunity. Apart from providing a new standard for determining acts jure gestionis, the Act does three other important things. The courts are vested exclusively with jurisdiction over the issue of sovereign immunity. 82 The Act contains an elaborate guide to the methods for obtaining personal jurisdiction over a foreign state defendant. It departs from the traditional American position by providing a remedy of execution to satisfy a final judgment against a foreign state. In sum, the distinction made between acts jure imperii and acts jure gestionis is now codified and expanded for the purposes of allowing more judicial remedies for Americans against foreign sovereign states.

This new attitude towards relaxing the application of sovereign immunity is also reflected in Great Britain, a country which had, for a long time, followed the absolute theory. In 1919, the British Court of Appeal ruled, in the Porto Alexandre case, 83 that a state-owned trading vessel, which was in the possession of a foreign state at the time of its arrest, was entitled to immunity. This theory of absolute immunity guided the English courts until very recently. In 1975, for example, the Court of Appeal, in Thai-Europe Tapioca Service Ltd. v. Pakistan, 84 held that absolute immunity, rather than qualified or restricted immunity, was the rule in England and Wales absent a declaration to the contrary by the House of Lords. However, certain Law Lords advocated the abandonment of the absolute theory.

A step in that direction was taken in 1976, in Philippine Admiral v. Wallem Shipping (Hong Kong) Ltd., 85 decided by the Privy

81. Id. § 1610.
Council of the Commonwealth. The Privy Council, upon referral of the case from the Hong Kong Supreme Court, adopted the restrictive theory in holding that a state-owned merchant ship engaged in ordinary commercial activity was not entitled to immunity as a defense in an in rem proceeding. The next important British decision came in 1977, in Trendtex Trading Corporation Ltd. v. Central Bank of Nigeria. 86

The plaintiffs in Trendtex were one of eighty suppliers who contracted in early 1975 to supply the government of Nigeria with a total of 20 million tons of cement. The defendant bank had provided an irrevocable letter of credit in favor of the plaintiffs for the total purchase price of the cement. In July of 1975, a new administration took over in Nigeria. The new regime, faced with serious congestion of shipping affecting all of its ports, introduced a system of import controls for cement and instructed the bank to refuse payments for consignments which were not actually authorized under the newly introduced controls.

The plaintiffs brought an action against the Central Bank of Nigeria claiming, inter alia, damages of $13,968,190 for the bank's repudiation of the irrevocable letter of credit. An injunction was granted to the plaintiffs ordering the bank to retain the stated sum or its equivalent in order to meet the claim. The bank applied for a discharge of the injunction and moved to set aside the proceedings on the ground that the bank was a department of the Nigerian state and thereby entitled to sovereign immunity.

Applying the absolute theory of sovereign immunity, Justice Donaldson held for the bank, which he regarded as an agent of the government of Nigeria. 87 The Court of Appeal reversed and reinstated the original order, thus allowing the proceedings against the bank. Their Lordships found that the Central Bank of Nigeria was not to be regarded as a department of the state and was, therefore, not immune.

Trendtex does not, however, clearly establish that England has adopted the restrictive theory of sovereign immunity. The three Appeal Justices were not unanimous in their reasoning in denying the immunity defense. Lord Justice Stephenson, while agreeing that the restrictive theory is more just, was unwilling to accept it as a

rule of English law until either the House of Lords or the legislature had so acted.

Master of the Rolls Lord Denning was, however, more emphatic and decisive in his acceptance of the restrictive theory. Joined by Lord Justice Shaw, Lord Denning disagreed with the view adopted by Lord Justice Stephenson that rules of international law could only be considered if incorporated into English law by the decision of the Judges, by acts of Parliament, or by long established custom. In their view, the rules of international law were automatically incorporated into English law unless they were in conflict with an act of Parliament. They both urged that England should not be left behind in the development of new attitudes aimed towards limiting the application of sovereign immunity to offer more protection to those trading with governments or state-enterprises. The Trendtex decision may be said to have laid a firm ground for the abandonment of absolute immunity in England. The case illustrates one crucial problem—who is entitled to immunity, only the governments themselves, or are their political subdivisions, instrumentalities, and agencies included?

The rationale behind the trend towards relaxing the concept of sovereign immunity, and the metamorphosis of the internationalization of state contracts is clear. The two developments in this area of international law are aimed at affording more protection and ensuring effective legal remedies for the nationals of the capital-exporting states. However, these developments are still far from the complete legal protection being sought.


The following is an illustrative checklist of the provisions which are found in loan agreements. The comments are offered in the context of a suggested approach for their use.

1. The Purpose Clause. This clause contains a clear statement of the purpose or purposes for which the loan is required. From the

88. The purposes for government borrowing may include the following:

Economic infrastructure loans, possibly self-liquidating are usually project loans that finance construction, expansion and modernization of airports, subways, railroads, port facilities, and such sophisticated innovations as microwave and other telecommunications projects and atomic energy facilities.

Economic and social infrastructure loans, not directly self-liquidating, are also usually project loans for such purposes as the construction, expansion and modernization of highways, sewer systems, multipurpose dams, water supply systems and bridges.
lender's viewpoint, the clause must be unambiguous so that it becomes easily used as a vehicle for determining the nature of the economic performance expected of the borrower and the economic effects of the loan itself. Thus, it is relevant in the context of what surveillance and supervision the lender may undertake upon the economic development of the borrower. From the borrower's viewpoint, the purpose clause of the loan agreement must reflect the discretion which a sovereign state is usually allowed to exercise in connection with the use of its resources in the manner it deems fit for its national development. In this context, the purpose clause must be flexible enough to allow the borrower to make necessary adjustments in its use of the loan within the scope of its entire development program. Developing countries may be compelled by changing circumstances to make adjustments in their national economic programs. These adjustments need not be a negative concern of the lender. Reasonable flexibility in the application of the loan is desirable for both parties.

2. Repayment Clause. The repayment clause must be carefully drafted in order to protect the lender's interest in repayment. It

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General social welfare loans normally are project loans and finance construction of, for example, schools, health facilities and low-cost housing.

General budget support to central government ordinarily is short-term finance extended in anticipation of budgetary receipts. Usually these loans will be repaid when the normal activities of the public sector of the country result in receipt of foreign exchange revenues, as from petroleum, minerals or commodity exports. Depending upon internal legislation or government policy in the borrowing country, this may be with or without attribution to a capital budget.

Loans to create foreign exchange to finance seasonal export/import variations, in the early years of this type of financing, were commonly restricted to short-term financing of anticipated foreign exchange receipts from exports of a specific crop. Now, frequently, this credit is in the form of bank credit lines, reviewed annually, to provide for seasonal foreign exchange accommodation on the basis of the borrowing country's over-all foreign trade cycle. However, since the first purpose of a country's foreign exchange reserves is to finance just such seasonal swings, the need for this type of financing is prima facie evidence of concern on the part of the financial authorities of the country about the level of net exchange reserves or about conditions in the country which could adversely affect reserves.

Reconstruction and economic development loans may be either project or program types. Interest rates and terms are related to the borrower's needs and general creditworthiness. Purposes include rebuilding following natural and human disasters of earthquake, flood, drought and war, or to finance the elements of economic growth. Loans often are from public sources but frequently from private as well. They may be with or without subsequent attribution to specific individual projects, or they may finance a group of projects which collectively contribute to achievement of the program objectives.

Greene, supra note 44, at 189.

89. See note 37 supra.
must also satisfactorily protect the borrower’s interest by providing for some flexibility in the repayment schedule in order to avoid the harsh impact that unforeseen problems may have on their ability to meet its terms. This clause should include a provision which allows for renegotiation of the loan repayment schedule and terms, thereby avoiding default situations. The inclusion of a renegotiation clause in a loan agreement has, however, been found undesirable by international bankers. They feel that defaults will be avoided by mutual trust and understanding between the lender and the borrower. Although the bankers feel that renegotiation may be a distinctive possibility, they are unwilling to spell out the terms for renegotiation at the time of the drafting of the loan agreement.

The need for flexibility must be seen as a benefit for both the lender and the borrower; both should be interested in the survival of the money market. “Cross-defaults” clauses, “guaranty” clauses, and “negative pledge” clauses, usually found in the loan agreement, are extremes to be avoided since they represent preoccupation with the protection of the interest of the lender only. The proper approach should be to maintain the relationship between the borrower and the lender created out of the terms of the loan agreement, and thus avoid a premature termination of this relationship on technical grounds. Such a termination fails to provide necessary attention to the economic problems of one of the parties, usually that of the borrower.

3. **Applicable Law.** Due to the trend towards the internationalization of state contracts, this question requires frank discussion by both of the parties to the loan agreement. This entire issue revolves around the problem of an adequate remedy. The lender is not willing to risk the value of all of the covenants, guaranties and securities written into the agreement by making the agreement itself subject to the local laws of the contracting developing states, which are often regarded as incapable of ensuring justice and subject to unpredictable alteration. The alternatives are to choose the law of the state of the lender; or the law of the borrower, frozen at the time of the conclusion of the agreement to provide a debatable “legal enclave” for the agreement in the event of subsequent changes in the law; or the laws of a third state. Alternatively, it is possible to make the loan contract subject to public international law, that is, the general principles of law recognized by the major legal systems of the world.

What emerges is a complex picture, observed in the following statement:

> Determination of the applicable law is, in the contractual field, one way to accomplish this objective. Faced with the complexities
of conflicts rules, and subject to certain limitations of which the parties or their counsel should be aware at the outset, the parties to transnational contracts may, by clearly stipulating the law applicable to the relationship between them, have the reasonable expectation that their choice will be left undisturbed. So much the more if the choice of law is coupled with that of an appropriate forum. A stipulation of applicable law may thus serve as a guide to the judge or the arbitrator and place the author of the stipulation in the most favorable position in the event of litigation. In the case of most contracts of adhesion and standardized forms of contracts, this last consideration is probably the consideration paramount. However, it should not be inferred from this remark that stipulations of applicable law, even when they are supplemented by a choice of forum or an arbitration clause, are necessarily and exclusively intended to anticipate the judicial or arbitral outcome of contractual disputes. There are situations in which the parties operate in a climate of trust and cooperation rather than competition and have no wish to see their relations disturbed by unnecessary friction, least of all by a lawsuit. Examples are business relations of long standing conducted in a spirit of good faith that the parties are anxious to maintain and long-term contracts closely associating the parties in the pursuit of long-range objectives. In this type of situation, the initial identification of the applicable law may remove at the outset a factor of potential controversy. It may enable the parties, in full knowledge of the legal perimeter within which they must conduct their relations, to seek an amicable and mutually satisfactory settlement to possible disagreements between them.

In addition to these fundamental objectives of the contractual choice-of-law process, stipulations of applicable law may also serve another purpose. Certainty or at least predictability of results regarding the proper law of the contract may be of little assistance to the parties if, the choice having been made, the content of the proper law is changed to such an extent as to alter significantly the economy of the relationship. This consideration is of the utmost importance in the case of long-term contracts and will require discussion in that context. It may be relevant also in respect of ordinary commercial transactions, particularly in the context of currency fluctuations, such as those which have arisen in recent years.

In the handling of these two aspects of the problem, the parties do not enjoy the same degree of autonomy. Except in special cases involving contracts between private persons and foreign sovereign and subject to the law of the sovereign contracting party where "stabilization" devices are sometimes used, it is generally agreed that the proper law chosen by the parties applies as it exists from time to time and not merely as it stands at the time of the contract. Under the circumstances, anticipating the possible impact of the
time element upon the content of the proper law becomes somewhat of a considerate guess, or more accurately risk, that must be assessed at the time of contracting but with respect to which the parties have preciously little discretion.

4. *Disputes Settlement Clause.* Subject to the freedom of choice to be exercised by the parties, settlement of disputes of a loan agreement between a government and a private foreign bank may increasingly result from arbitration, relying upon an arbitration agreement created by the parties themselves under the contract. These agreements govern the submission of the disputes, the constitution of the tribunal, the validity of the award, its enforcement, interpretation, revision, annulment, the procedures to be followed, and define the applicable law. The International Centre for the Settlement of Investment Disputes, established under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, under the auspices of the World Bank, has attempted to facilitate the use of arbitration in loan agreement disputes, although certain developing countries have not yet found

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90. 1 G. DELAUME, supra note 58, at § 1.01 (footnotes omitted). The point made by Delaume in the quoted text relates also to the question of the internationalization of state contracts by stipulating international law as the proper law. The process of internationalization may, nevertheless, be complicated when the parties, in the exercise of their autonomy, adopt the technique of "dépecage" (segregation of issues), recognized in municipal contract law, and thereby stipulate to two or more applicable laws in a single contract. The parties could thus stipulate international law as the proper law but then segregate certain issues which, for practical reasons, must be governed by some designated system of municipal law. A loan agreement contemplating the issue of bonds would be a good example in which the validity of the main loan agreement would be governed, for example, by international law, while the law governing the bonds would be that of the local markets in which they are issued.

91. The following analysis elucidates upon this point:

In recent years the contractual character of arbitration has become recognized and party autonomy has conquered new grounds theretofore denied to it under the judicial approach to the problem. Modern statutes and treaty provisions, together with enlightened judicial decisions, increasingly and relentlessly have given new dimensions to party autonomy in an effort to cope with the needs of transnational [sic] commerce and eradicate from national systems a former parochialism out of context with the necessities of contemporary economic and commercial relations. Progress, which is still in the making, has not always been smooth and the path travelled has often been uneven and sometimes somewhat chaotic.

2 G. DELAUME, supra note 58, at § 13.01. This is a contradistinction to an attempt to apply the law of a donor country to a loan agreement. For a discussion of the loan agreement between Denmark and Malawi, see F. MANN, supra note 50.

92. For further discussion, see 1 G. DELAUME, supra note 58, at 179; F. MANN, supra note 55.


94. For further discussion, see Broches, *The Convention on the Settlement of
it possible to submit to the jurisdiction of the Centre. However, private lenders still reject arbitration and prefer settlement by competent local courts. Courts are regarded as better suited for the quick resolution of loan disputes. The ad hoc arbitral tribunals take considerably longer to constitute and decide the claim.\footnote{95}

Additionally, the banks seem to have adopted the view that, in a dispute concerning a loan, there is really nothing to arbitrate. Either the borrower is under the obligation to pay the loan and he performs accordingly, or the consequence of failure to so perform as stipulated in the agreement must be allowed to operate as determined by a judge in a court of law. An ad hoc arbitral tribunal, being an institution created by the will of the parties to the dispute would, in their view, tend to consider questions of equity and other factors that may militate against the immediate interest of the banks in securing performance in accordance with the terms of the agreement. Thus, banks would prefer settlement through proceedings before a court of law.

In this context, the issue of sovereign immunity becomes crucial. Certain commercial banks in fact insist upon a sovereign immunity waiver clause in a loan agreement. This is usually rebuffed by the sovereign state borrower as an affront. Indeed, such a requirement is an affront. Mutual trust between the parties would make unnecessary such a clause. The main aim should be to find a meaningful interplay between the applicable law clause and the dispute settlement clause in the agreement.

5. \textit{Representations and Warranties Clauses}. These clauses contain statements made by the borrower as to financial and other pertinent considerations, fixing the responsibility for the truth and accuracy of the statements on the borrower.

6. \textit{Covenants Clauses}. Affirmative covenants are promises by the borrower to perform certain actions, either automatically or at the request of the lender. Their principal purpose is to provide the lender, at the outset of the loan and during its course, with information indicating the general credit worthiness of the borrower. Negative covenants, such as restrictions on working capital, additional borrowings, guarantees, dividends, and cross-default clauses have a basic aim of tightening the hold of the lender over the actions of the


\footnote{95. For further discussion, see 1 \textit{G. DELAUME}, \textit{supra} note 58, at 179-97.}
borrower. Although somewhat restrictive, the extent to which these clauses are used in any individual case is, in practicality, a matter of discretion on the part of the bank.

7. Events of Default Clauses. This section refers to the defaults capable of occurring and their appropriate remedies. Although the breaking of covenants is usually an event of default, loan agreements will generally stipulate that the bank notify the borrower, and in certain instances allow a grace period for correction. In other cases, though, the clause might provide that appropriate remedial action is to take effect at the moment of default.

III. CONCLUSION

In discussing the economic and legal issues concerning the debt problems of the developing countries, in general, and the loan agreements between such countries and foreign, private commercial banks, certain ideas emerge which merit consideration. The non-oil developing countries should not be lumped together in a discussion of their debt problems and suggested solutions. Levels of development and economic potentials are important factors which distinguish the non-oil developing countries from each other, thereby demanding a case-by-case approach. The concept of a generalized solution is to be avoided, except as suggested by UNCTAD.

Additionally, available evidence indicates that many of the loans from the American commercial banks have gone to the non-oil developing countries in the high-income group. These countries are capable of diversifying their economic structures and are able to take corrective measures, if necessary, to restore their balance of payments equilibrium. Using this as a criterion for lending, it would seem that the non-oil developing countries in the low-income group would not be customers of the commercial banks. This is, however, not the case. The banks appear to be so liquid that they are able to loan to almost any of the non-oil developing countries. A situation to be avoided is one in which commercial banks only lend either to the non-oil "rich" developing countries, or only lend to the non-oil "poor" developing countries exclusively. The dangers of this practice have been clearly pointed out in the UNCTAD study.

The tendency to redirect existing aid flows to certain "poor" developing countries, coupled with the increasing concentration of private flows to resource-rich countries would have serious consequences. First, a large number of developing countries would be excluded from such a selective "bailing-out" procedure. Secondly, the amounts of additional assistance that can be made available to
the "poor" developing countries by redistributing a given total, would be hardly enough to sustain current levels of income per capita. Thus, these countries would be condemned to perpetual poverty. Thirdly, countries that may be forced to rely almost exclusively on private capital might experience "immitterizing growth" characterized by lopsided production patterns and income distribution, by heavy external dependence, and by social instability.

In order to counteract these alarming trends, a firm political commitment is required from all developed countries, and especially the major donors, to the objectives of financial co-operation of the Second United Nations Development Decade. In this context, particular emphasis should be placed on (a) the early attainment of the 0.7 per cent target for official development assistance; and (b) the distribution of such assistance among developing countries on the basis of objective criteria including, inter alia, differences in levels of development; capacity usefully to absorb private flows and service the associated debt; and the need to assure equitable distribution of income.96

The commercial bankers should reassess their willingness to grant loans to the non-oil developing countries on short terms and high rates. The money borrowed under such terms cannot easily be used in long-term development projects which take time to repay. The existing lending terms seem to encourage consumption of the loans in short-term activities and not in longer term projects capable of enabling the borrowers to generate new export earnings to repay their debts.

There is clearly a need to combine various sources of funding when dealing with the debt problems of developing countries. There should be an increase in official development loans, improved compensatory financing by the IMF, including additional amounts under the tranches of the countries themselves and the funds from the commercial banks on flexible terms.97

Two tasks lie ahead. The short-term task is to get the loans of the less developed countries rescheduled past the "bunching up" period of the next two years. Thereafter, the economies of the debt-ridden countries must be helped to adjust to the new energy costs. They need not only loans but discipline, pressure and guidance. Private banks, even in consortium, will not have the weight. This is a job for governments and, above all, intergovernmental agencies.98

97. See generally The IMF Tries Again, ECONOMIST, March 26, 1977, at 87.
There does not seem to be anything inimical in demanding discipline from the developing countries if the kind of surveillance required includes an analysis of the various effects of the loan. 99

Practical economic considerations must be given attention in the loan agreements between the commercial banks and the non-oil developing countries. In this respect the parties should seek to create a working relationship; mutual trust among the parties should be the guiding principle.

The discussion in this paper of the debt problems of non-oil developing countries has included an analysis of various legal issues, including the "internationalization" of state contracts, the trend towards the acceptance of the restricted theory of sovereign immunity, and the increasing call for reliance upon ad hoc or permanent arbitration as the mode for the settlement of disputes. All of these issues center on the continuing search for more effective legal protection in the interest of the lenders. This should not lead to the conclusion that only the lenders need have their interests protected. The interests of the borrowers must also be protected by including in the loan agreement flexible provisions allowing room for economic adjustment. Such provisions would lead to the avoidance of default situations and conditions resulting in the outcry of "Wall Street imperialism."

The deliberate development of the law towards affording more protection for foreign private investments should not be seen as a phenomenon only serving the interests of western capital-exporting nations. With the advent of the United Nations' encouragement of technical cooperation among developing countries, 100 it is hoped that the developing countries will increasingly become capital exporters...
themselves. Accordingly, the development of the law towards protecting the interests of the capital exporters will be of benefit to the developing countries as well.