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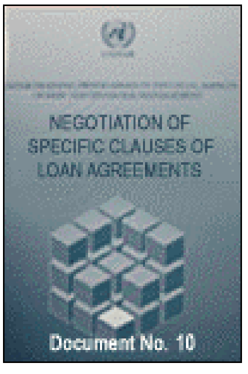
Negotiation of Specific Clauses of Loan Agreements

Paper written following a UNITAR Sub-Regional Workshop on the Legal Aspects of Debt Negotiations for the Government of Vietnam (Hanoi, Vietnam 18 to 21 October 1999)



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PREFACE

This paper provides specific and detailed advice and information to developing country borrowers as to how to approach the subject of negotiating clauses in loan agreements. Additionally, this paper draws from presentations and discussions at a Joint UNITAR/UNDP/UNCTAD/Ministry of Finance National Workshop on the Legal Aspects of Debt Negotiations for the Government of Vietnam (Hanoi, 18 to 21 October 1999). This was also the first workshop conducted by UNITAR as part of its on-going training and capacity building activities in Vietnam in the area of legal aspects of debt, financial management and negotiation.

This workshop was addressed specifically to government officials from Vietnam involved in international loan negotiations and invited thirty four participants from the Ministry of Finance, State Bank of Vietnam, Ministry of Justice, Ministry of Industry, Ministry of Transport and Communications, Ministry of Construction, Ministry of Planning and Investment as well as parastatals involved in borrowing.

The theme of the workshop focused on loan agreements and an appreciation of negotiating specific clauses within these agreements. An attempt was also made to expose participants to issues relating to external borrowing and the development process at a general level, and to a taste of drafting clauses in loan agreements at a specific level. A mix of both lawyers and non-lawyers in the group elicited a lively exchange of views and experiences during the four-day period. The involvement of high-level resource persons with in-depth experience in negotiating loan agreements and yet having different backgrounds and perspectives in international borrowing especially made the workshop discussions interesting and balanced.

In a nutshell, this paper provides practical insight and hints to government officials involved in debt negotiations on a daily basis. This paper should also be useful to the beginner as it provides a wealth of experience from the perspective of a government official who has spent numerous years negotiating agreements from the borrowers' side.

As part of this initiative, UNITAR had the privilege of collaborating with the UNDP Hanoi office, UNCTAD, and the Vietnamese Ministry of Finance (External Finance Department), for which it is greatful. UNITAR also wishes to thank the Swiss State Secretariat for Economic Affairs (SECO, Bern) which is financing UNITAR's contribution to this global training initiative in Vietnam. Last but not least, UNITAR thanks Dr. Vinod K. Agarwal for having contributed to this project by sharing his experience and insight with us.

We hope that this paper will be useful as well as challenging to the readers.

Marcel A. Boisard
Executive Director of UNITAR

LEGAL ASPECTS OF DEBT NEGOTIATIONS

Vinod K. Agarwal*

External commercial borrowing is a complicated process. It is not the loan agreement alone that is sufficient. It involves a number of other documents. The exact kind and number of documents to be executed in an external commercial borrowing depend on various factors including the nature of the lenders, that is, whether it is an international financial institution, a financial institution of a country, an export import bank, a commercial bank or a syndicate of such banks. The extent and the period for which the funds are required by the borrower also play an important role in the process. The purpose of the borrowing is also significant. Further, the different lending institutions follow different practice in the matter of lending funds and the documentation. Of all the international financial institutions, the lending by the Word Bank involves a large number of complicated documents. Main documents, as are relevant for our purpose, are as follows:

1. Loan Agreement (between the Borrower and the Bank)
2. General terms and conditions (wherever applicable)
3. Project Agreement (between the Bank and the Project Authority)
4. Guarantee by the Guarantor
5. Subsidiary Loan Agreement (between the Borrower and the Project Authority)
6. Guidelines: Procurement under IBRD Loans and IDA Credits
7. Standard Bidding Documents: Procurement of Goods
8. Standard Bidding Documents: Procurement of Works (smaller contracts)
9. Standard Bidding Documents: Procurement of Works
10. Guidelines: Selection and Employment of Consultants by World Bank Borrower

GENERAL CONDITIONS APPLICABLE TO LOAN AGREEMENTS

Some International financial institutions have adopted the practice of dividing the documents of loan into two parts. The first part consists of the General Conditions and the other part consists of the main loan agreement and other documents. They have standardized some of the terms and conditions of loan and have printed them as General Conditions applicable to Loan and Guarantee Agreements. These General Conditions are made applicable, through a condition in the loan agreement, to every loan agreement entered into by these financial institutions. Similarly, the General Conditions also provide that they apply to every loan agreement. The advantage of standardization is that terms and conditions which are of common nature need not be negotiated and mentioned in every loan agreement by the lenders. Standardization also saves time and energy. It helps in achieving uniformity in lending and borrowings.

** Secretary General, International Centre for Alternative Dispute Resolution, New Delhi. This script was prepared for presentation to the participants in the Workshop on the "Legal Aspects of Debt Negotiations" held in Hanoi, Vietnam. This is not an exhaustive commentary on various clauses but only an illustrative commentary.*

Further, the borrowers know them in advance when they prepare for a loan from the Word Bank. The disadvantage to the borrower is that once the terms and conditions are standardized, they become non-negotiable. The lending institutions do not allow any change in the said conditions on the pretext that they have not been prepared for any particular borrower but are applicable to all the loan agreements and to all the borrowers. If they will allow negotiation and consequential changes in the said standardized terms and conditions in one case, they will have to allow negotiations in other cases as well. This will lose the very purpose of standardization of such terms and conditions.

Since these General Terms and conditions are part of the loan agreement, it is necessary to have their knowledge and understanding. They may not be negotiable in the case of some of those international financial institutions which have standardized them. But in the case of other lenders, where these terms and conditions have not been standardized, they form part of the loan agreement and like any other condition of the loan agreement, they are also open for negotiations.

It is not possible to discuss the General Terms and Conditions of all the international financial institutions. The General terms and conditions of most of the institutions are very much similar. Of course, as will be demonstrated, they are not exactly identical. There are some variations in them also. I have selected some representative financial institutions and propose to discuss the General Terms and conditions of these institutions. The first is the International Bank for Reconstruction and Development, commonly known as the World Bank. Its General Conditions Applicable to Loan and Guarantee Agreements contains 12 Articles. Each Article has a number of sub articles. They are as follows:

Article 1. Application to Loan and Guarantee Agreements.
Article 2. Definitions; Headings
Article 3. Loan Account; Interest and other Charges; Repayment; Place of Payment.
Article 4. Currency Provisions
Article 5. Withdrawal of Proceeds of Loan
Article 6. Cancellation and Suspension
Article 7. Acceleration of maturity
Article 8. Taxes
Article 9. Cooperation and Information; Financial and Economic data; Negative Pledge; Project Implementation
Article 10. Enforceability of Loan Agreement; Failure to Exercise Rights; Arbitration.
Article 11. Miscellaneous Provisions
Article 12. Effective Date; Termination.

You will see that most of the relevant provisions relating to a loan transaction have been incorporated in the General Conditions. Therefore, the loan agreements are very skeletal. They contain only a few articles, namely 6 or 7 articles as follows:

Article 1. General Conditions; Definitions
Article 2. The Loan
Article 3. Execution of the Project; Other Covenants
Article 4. Remedies of the Bank
Article 5. Effective Date; Termination
Article 6. Addresses

INTERNATIONAL DEVELOPMENT ASSOCIATION GENERAL CONDITIONS

The General Conditions of the International Development Association are very much identical to the General Conditions of the World Bank except that the World Bank has used the expression "loam agreement", the IDA has used the expression "Development Credit Agreements". They are as follows:

Article 1. Application to Development Credit Agreements.
Article 2. Definitions; Headings
Article 3. Credit Account; Service Charges; Repayment; Place of Payment.
Article 4. Currency Provisions
Article 5. Withdrawal of Proceeds of Loan
Article 6. Cancellation and Suspension
Article 7. Acceleration of maturity
Article 8. Taxes
Article 9. Cooperation and Information; Financial and Economic data; Project Implementation
Article 10. Enforceability of Development Credit Agreement; Failure to Exercise Rights; Arbitration.
Article 11. Miscellaneous Provisions
Article 12. Effective Date; Termination.

Therefore, this discussion with be only with reference to the General Conditions of the World Bank. Whatever can be stated about the General Conditions of the World Bank can be equally said about the General Conditions of the International Development Association.

APPLICABILITY - No doubt, the loan agreements provide that the General Conditions are applicable to them. But, these General Conditions also say that they apply to every loan and guarantee agreement. In this context, Article 1 of these General Conditions is relevant. It is as follows:

> **"section 1.01 – These General Conditions set forth certain terms and conditions generally applicable to loan made by the Bank. They apply to loan agreements providing for any such loan with a member of the Bank subject to any modifications set forth in such agreements."**

From this provision it may be seen that these General Conditions apply to every loan and guarantee agreement entered into by the World Bank. This position is further confirmed by the definition of the word "Loan Agreement" contained in Article II of these General Conditions which is as follows:

> **Section 2.01 – "Loan Agreement" means the particular loan agreement to which these General Conditions apply, as such agreement may be amended from time to time. Loan agreement includes these General Conditions as applied thereto, and all schedules and agreements supplemental to loan agreement."**

It is thus amply clear that these General Conditions are part of every loan and guarantee agreement between the Bank and a borrower.

INCONSISTENCY - It has been mentioned earlier that these General Conditions are non-negotiable. A borrower has no choice. He has to 'take it or leave it'. However, the borrower can manage some relief in this respect from section 1.02 of Article I. According to this provision, if there is any inconsistency between the provisions of these General Conditions and the provisions of the Loan agreement, the provisions of the loan agreement shall prevail. It is as follows:

> **"Section 1.02 Inconsistency with loan agreement: If any provision of a loan agreement or guarantee agreement is inconsistent with a provision of these General Conditions, the provision of the loan agreement or guarantee agreement, as the case may be, shall govern."**

Therefore, the borrower should make an effort to ensure that what changes or amendments it wants should be incorporated in the loan agreement. To the extent of inconsistency between the loan agreement and the General Conditions, the loan agreement will prevail. Though much must not be expected by this method nevertheless, some relief in appropriate situations can be managed.

WITHDRAWAL OF PROCEEDS OF LOAN - I will deal with the relevant provisions of these General Conditions along with the loan agreements of other institutions. For example, I will deal with the default clause contained in the General Conditions when I will discuss the Default clause in other loan agreements. However, these General Conditions contain some provisions on specific subjects which are not contained in other loan agreements. Hence, I would like to deal with them here. One such provision is Article 5. It deals with the withdrawal of proceeds of loan or the withdrawal from the loan account. When a borrower enters into a loan agreement, with an ordinary lender, after the loan agreement is negotiated and signed, and the conditions precedent for draw down have been complied with by the borrower, the funds are made available to him immediately thereafter in accordance with the conditions of the loan agreement. Some times, the funds are given in lump sum i.e. in one instalment and some times the loan agreement provides for their disbursement to the borrower in more than one instalments. The payment of the loan amount to the borrower is not dependent on his incurring expenditure in respect thereof. Further, generally the lenders do not impose any condition of the nature that the borrower shall not spend any amount from the loan in any particular country or give money to any particular supplier.

That is not the case with the World Bank. The loan amount sanctioned by the World Bank is not given to the borrowers as such. Article 4.02 of the General Conditions provide that the funds shall be retained by the Bank and kept in a Central Disbursement Account of the borrower. As has been stated above, the borrower has to first incur expenditure. The said expenditure must also be incurred after following a very rigid procedure under the strict supervision and control of the Word Bank. Only the amount of expenditure so incurred by the borrower can be withdrawn from the loan account. There is one more restriction also. The borrower cannot incur any expenditure in the territories of any country which is not a member of the Bank (other than Switzerland). The said procedure is prescribed in Article V of the General Conditions. Of course, Article V also provides that in exceptional cases the Bank may agree to pay the amounts to be expended for the project in advance. It is as follows:

> **"Section 5.01. Withdrawal from the Loan Account. The borrower shall be entitled to withdraw from the Loan Account amounts expended or, if the Bank shall so agree, amounts to be expended for the Project in accordance with the provisions of the Loan Agreement and of these General Conditions. Except as the Bank and borrower shall otherwise agree, no withdrawal shall be made on account of expenditures in the territories of the country which is not a member of the Bank (other than Switzerland) or for goods produced in, or services supplied from, such territories."**

This system of disbursement of loan amount is very advantageous to the Bank. So long as the Borrower has not incurred the expenditure, the loan amount is retained by the Bank. In many cases, the implementation of the Projects by the Borrower countries does not take place within the pre-determined time limit. It generally gets delayed for some reason or the other. Some times, the delay extends to several months or even years. Further, in cases where the Borrower has cancelled the project for which the loan was sanctioned by the Bank for any reason, the loan amount is not disbursed and remains with the Bank. The Bank gets advantage of this delay. It can use those funds in any manner it likes till disbursement. As per the figures of the Bank, it has billions of dollars undisbursed loan amount available with it. This system of disbursement also avoids the possibility of the Borrower diverting or using the money for any purpose not approved or sanctioned by the Bank.

Currency Provisions - The other provisions which requires consideration is regarding currency. The Word Bank does not disburse the loan amount in one currency. The loan amount is disbursed from the Central Disbursement Account in the currency or currencies in which the expenditure has been incurred by the borrower. Thus, the disbursement from this account could be in one or more than one currencies. Article 4.01 provides as follows:

> **"Section 4.01. Currencies in which withdrawals are to be made – Except as the Bank and the borrower shall otherwise agree, withdrawals from the Loan Account shall be made in the respective currencies in which the expenditure to be financed out of the proceeds of Loan have been paid or are payable; provided, however, the withdrawals in respect of expenditures in the currency of the member of the Bank which is the borrower or the guarantor shall be made in such currency or currencies as the Bank shall from time to time reasonably select."**

These General Conditions further provide that for the purpose of withdrawal of loan amount in different currencies and the currency required for the repayment of the said amount, the bank shall purchase such currencies at the cost of the Borrower.

So far I have dealt with the General Conditions of the Word Bank. I now propose to discuss the General Conditions of some of the regional financial institutions. The two important regional financial institutions, namely, the Asian Development Bank and the African Development Bank have also adopted General Conditions. Their General Conditions are also very much similar to the General Conditions of the World Bank. Similarly, financial institutions of some of the countries have also prepared General Conditions.

So far as the national lending institutions are concerned, the General Conditions of the Saudi Fund for Development are also similar to the General Conditions of the World Bank and therefore, they need no discussion.

The Overseas Economic Cooperation Fund of Japan (hereinafter referred to as the Fund) has also prepared General Terms and Conditions. In some respects they are different from the General Conditions of the Word Bank. Unlike World Bank, these General Terms and Conditions have only 10 Articles. Of course, these Articles again have a number of sub- articles. The Articles are as follows:

Article I:	Introduction; Inconsistency
Article II:	Definitions; References to Articles and Sections; Headings
Article III:	Loan; Repayment; Interest; Overdue Charges; Method of Payment
Article IV:	Fund's Review and Misprocurement
Article V:	Disbursement
Article VI:	Remedies; Failure to Exercise Rights; Non-Exemption; Prohibition Of Assignment; Non-Discrimination; Administration
Article VII:	Guarantee for Loan
Article VIII:	Arbitration
Article IX:	Applicable Laws; Taxes and Expenses; Notices and Requests; Execution
Article X:	Effectiveness and Termination of Loan Agreement

Just as in the case of the Word Bank, Article 1 of these General Terms and Conditions also provide that they apply to the loans made by the Fund. It is as follows:

> **Section 1.01. The purpose of these General Terms and Conditions (hereinafter referred to as "the General Terms and Conditions") is to set forth the terms and conditions generally applicable to loans made by the Fund."**

Similarly, in the case of inconsistency between the conditions contained in these General Terms and Conditions and the loan agreement, the provisions of the loan agreement prevail. The relevant provision is as follows:

> **"Section 1.02. *Inconsistency with Loan Agreement*. If any provision of the General Terms and Conditions is inconsistent with any provision of the Loan Agreement, of which the General Terms and Conditions constitute an integral part, or any provision of the Guarantee, if any, such provision of the Loan Agreement or the Guarantee shall prevail."**

If we compare the above list of Articles and the list of Articles contained in the General conditions of the World Bank, we find many significant differences between the two.

The General Conditions of the World Bank do not specifically provide for a Guarantee agreement. No doubt, the General Conditions of the Word Bank contain a definition of the "Guarantee Agreement" and at many places refers to the Guarantee agreements and provides the obligations of the guarantor. However, it presumes the existence of a Guarantee Agreement. The General Terms and Conditions of the Overseas Economic Cooperation Fund specifically provide that the Fund may require a guarantee for the loan. In other words, a guarantee agreement is not an essential requirement in every case. The execution of the Guarantee agreement depends on the wishes of the Fund. Further, the Guarantor must also be acceptable to the Fund. Article VII is as follows:

> **"Section 7.01 *Guarantee for Loan* – When the Fund requires a guarantee for the Loan, the Borrower shall deliver the Guarantee to the Fund, signed by a Guarantor acceptable to the Fund, immediately after the execution of the Loan Agreement."**

According to the General Terms and Conditions of the Fund, the disbursement of the loan amount is not dependent on the actual expenditure by the Borrower, as in the case of the World Bank. Here, the disbursement is made as per the conditions of the loan agreement. Article 5.01 of the General Terms and Conditions only contains a disbursement procedure. It says that:

> **"Section 5.01. *Disbursement Procedure*. The proceeds of the Loan shall be disbursed by the Fund as the progress of the Project renders it necessary and in accordance with the disbursement procedure."**

The General Conditions of the World Bank do not contain any provision regarding the Applicable Law. Article IX of General Terms and Conditions of the Fund clearly provide that Japanese law shall be the applicable law to the loan and guarantee agreements. It is as follows:

> **"Section 9.01. *Applicable Law*. The validity, interpretation and performance of the Loan Agreement and the Guarantee, if any, shall be governed by the laws and regulations of Japan"**

The other General Conditions will be discussed under the appropriate topics.

The international loan agreements contain a number of Articles. It is not possible to discuss all the Articles. Some of the important articles like Conditions Precedent, Financial Obligations, Covenants, Representations and Warranties, Force Majeure and default Clause are discussed below:

CONDITIONS PRECEDENT

Every loan agreement, irrespective of whether it is with an international financial institution, regional financial institution or a national financial institution, provides for certain conditions precedent. Conditions precedent are those conditions which must be fulfilled before a loan agreement becomes operational. In other words, a Borrower cannot draw any loan amount under a loan agreement until and unless these conditions generally known as "conditions precedent or pre-disbursement conditions" are satisfied. The loan agreement generally contains an Article in respect thereof. The requirement of Conditions Precedent is universal. Every loan agreement will have a clause on conditions precedent. But the requirement and contents of the conditions precedent are not fixed or standardized. They vary from lender to lender.

The "Conditions Precedent" clause in a loan agreement serves multiple purpose. It is added in a loan agreement with a definite object. Through the conditions precedent, a Lender satisfies itself about many things, such as the capacity or power of the borrower to enter into the loan agreement, the necessary authorizations required by the borrower for signing the loan agreement, the fulfillment of the conditions for making the loan agreement legal, valid, binding and enforceable, etc. In other words, through the conditions precedent, the Lenders ensure that all necessary legal and other formalities for coming into force of the Loan Agreement have been complied with by the Borrower in accordance with the laws of the Borrower's country and if the Lender makes a disbursement under the loan agreement, its money is safe and will be legally recoverable from the Borrower.

These Conditions precedent mainly require the production of certain documents by the Borrower to establish certain legal and other facts and/or the performance of certain acts, like payment of commitment charges, management fee, etc. Further, the list of documents which constitute the conditions precedent may be given in the Article in the loan agreement, or it may be specified in the schedule to the loan agreement or in the General Terms and conditions or in any other document. The place or document where of these conditions precedent are mentioned is not material. Wherever they are, the legal effect is the same.

The Article specifying the conditions precedent in a loan agreement may be in any form. There is no fixed or definite language for the purpose. Some illustrative Articles are given below:

> **"Article XII. Section 12.01 – The Loan Agreement … shall not become effective until evidence satisfactory to the Bank shall have been furnished to the Bank:**
>
> **(a) that the execution and delivery of the Loan Agreement … on behalf of the Borrower … have been duly authorised or ratified by all necessary governmental or corporate action.**
> **(b) If the Bank so request, that the condition of the Borrower (other than a member of the Bank) as represented or warranted to the Bank at the date of the Loan Agreement, has undergone no material adverse change after such date; and**
>
> **(c) That all other events specified in the Loan Agreement as conditions to effectiveness have occurred**." (General Conditions, I B R D)
>
> **"Article 5.1 – The Borrower may not, save as the Lender may otherwise agree, deliver any notice of drawdown under the Agreement unless the Lender has confirmed to the Borrower that it has received all the documents listed in the Second Schedule and that each is, in form and substance, satisfactory to the Lender."** (UNITAR)
>
> **"Article 12. The Credit shall only become available to the borrower if KfW shall have received, in form and substance satisfactory to it, and not later than fifteen calendar days after the date of this Credit Agreement, however, at lease five days prior to the first disbursement the following documents."** (Kreditanstalt fur Wiederaufbau, Frankfurt an Main Agreement, hereinafter referred to as KfW).
>
> **"Article X, Section 10.03 – The Loan Agreement shall become effective on the date on which the Fund declares itself satisfied with the evidence of authority and the specimen signatures, legal opinion and the Guarantee, if any.**
>
> **The Fund shall immediately notify the Borrower in writing of the effective date of the Loan Agreement."** (The Fund, Japan.)

These four illustrative articles have been selected from loan agreements of four different international and national lending institutions with a specific object in view. From the third illustration, it may be seen that it provides time limits for the fulfillment of the conditions precedent. No such time limit for compliance with the conditions precedent is fixed in Articles of other financial institutions..

Many a time, it may not be possible to fulfil the conditions precedent within a stipulated period of time. Therefore, this Article must not be accepted in this form when negotiating a loan agreement with a Lender. Article contained in illustration 4 is negatively worded. It provides for a declaration by the Lender that the conditions precedent have been satisfied and for the notification to the Borrower of the effective date. Further, it contains the list of documents the Borrower has to furnish as a condition precedent. Whereas, in illustration 2, the list of documents required to be furnished by the Borrower is contained in a schedule to the loan agreement.

(a) STATUS OF THE BORROWER – Generally, the first document required to be delivered by the Borrower to the Lender as per the Conditions Precedent is the document by which the Borrower has been constituted or by which it has come into existence, such as the statute, Charter, Bye-laws, Memorandum and Articles of Association, etc. This is required by the Lenders to satisfy themselves about the correct legal status and other particulars of the Borrower.

(b) CAPACITY OR POWER - The power or capacity of a Borrower to enter into a loan agreement cannot be determined by the law applicable to the loan agreement. The foreign laws cannot determine the power of a person to enter into a contract. The applicable law only helps in the interpretation of articles of the loan agreement. For determining the power and capacity of a Borrower to enter into a contract, the domestic laws of the country to which that Borrower belongs have always to be looked into. The laws of a country lay down the rules regarding the power of the persons of that country to enter into contracts. Thus, the capacity or competence of the Borrower to enter into a loan agreement has always to be determined by the laws of the country to which the borrower belongs. Normally, a Lender is not supposed to be aware of the legal position in respect thereof. Therefore, the Lenders, in order to satisfy themselves that the Borrower has the power and capacity to enter into the Loan Agreement, obtain a declaration from the Borrower that, "it has power to enter into this Agreement". The lenders insist through a condition precedent that a copy of the document providing power to the Borrower to enter into the Loan Agreement is furnished to them. Also, the legal opinion to be furnished by the Borrower's local counsel must also specify that, "the Borrower has power to execute, deliver and perform its obligations under the Agreement." Of course, different Lenders use different language for the purpose. Some of the expressions used are as follows:

> **"The Borrower has power to execute, deliver and perform its obligations under the Agreement and to borrow the Commitments; all necessary action has been taken to authorise the same and no limitation on the powers of the Borrower to borrow will be exceeded as a result of borrowings under this Agreement."** (UNITAR)

> **"Article 12.1 © - Certified copies of all corporate documents required to authorise the borrowing under this Credit Agreement, and conferring power to sign it."** KfW

It may be mentioned that the first illustration seeks assurance from the Borrower that he has a power to borrower and to execute, deliver and perform its obligations. In this Article, the expression "deliver" appears to be misfit. Therefore, unless a particular Lender explains the meaning and purpose of use of the expression "deliver' it should not be accepted in the Article. Further, this Article presupposes the existence of a limit on the power of the Borrower to borrow and therefore, it seeks a clarification that the execution of the loan agreement will not result in exceeding the said limit. In contradistinction, the second illustration only asks the Borrower to give the certified copies of relevant corporate documents only.

(c) AUTHORISATIONS TO BORROW - The Borrower may have the power to enter into a loan agreement, but in some cases, the exercise of that power may require the completion of certain internal procedures. If the Borrower is a body corporate and according to its constitution it cannot exercise the power to borrow unless a Resolution of the Board is passed approving the transaction or an authorization is given by some authority, the power to borrow cannot be exercised by the Borrower without complying the said requirements. Therefore, the Lender has to satisfy itself that such internal procedures have been complied with by the Borrower before the disbursement of the loan amount takes place. For that purpose, as a condition precedent, a Lender requires a declaration from the Borrower that it has obtained necessary authorizations from the appropriate bodies and the documentary evidence in support thereof. Further, the Lenders require that the legal opinion of the Borrower's counsel should also indicate that the Borrower has fulfilled the internal requirements of authorization to borrow the money. Generally these clauses are in the following form:

> **"A copy, certified a true copy by a duly authorised officer of the Borrower, of a Board Resolution of the Borrower approving the execution, delivery and performance of this Agreement and the terms and conditions hereof..."** (UNITAR)
>
> **"Article 12.1(d) - Certified copies of all documents from the competent authorities to the effect that the Borrower is irrevocably authorised to borrow and perform this Credit Agreement."** KfW

The above condition precedent desires that the Borrower should have an irrevocable authority to borrow. The expression "irrevocable" has no meaning. He Borrower must have power and authority to borrow on the date the loan agreement is signed. If his authority is revoked or withdrawn subsequently, it will not make the loan agreement without authority or invalid.

(d) AUTHORISATION TO SIGN - Similarly, the Borrower is required to furnish to the Lender any documentary evidence of the fact that the person signing the loan agreement on behalf of the Borrower has the authority to do so. It is as follows:

> **"A certificate of a duly authorised officer of the Borrower setting out the names and signatures of the persons authorized to sign, on behalf of the Borrower, this Agreement and any document to be delivered by the Borrower pursuant to this Agreement."** (UNITAR)
>
> **"Article 12.1(h) - A certificate from the Borrower setting forth the names and containing the specimen signatures of the persons authorised to sign for and on behalf of the Borrower all statements which may be made under this Credit Agreement."** (KfW)

(e) COMPLIANCE WITH LOCAL LEGAL FORMALITIES – According to the laws of some of the countries before a loan agreement is enforceable and/or binding on the Borrower, it has to undergo certain legal formalities. Such legal formalities vary from country to country. They are not definite or fixed. Such formalities include registration, filing, enrolment, declaration, noting, consent, notarization, etc. The Lenders insist that they should be satisfied with the help of the appropriate documents that the legal formalities required within the Borrower's country for making the loan agreement enforceable have been complied with. Normally, it is as follows:

> **"A copy, certified a true copy by or on behalf of the Borrower, of each such law, decree, consent, licence, approval, registration or declaration as is, in the opinion of local counsel of the Lender, necessary to render this Agreement binding and enforceable."** (UNITAR)

Some time a comprehensive clause covering the above aspects is used in the loan agreements as a condition precedent. The following is the illustration of this kind of clauses:

> **"Article 10B(1) - The Bank shall have received evidence satisfactory to it not less than 7 days before the first disbursement that the execution and delivery of the loan agreement on behalf of the Borrower has been duly authorised or ratified by all necessary corporate and governmental action."**
> Nordiska Investeringsbanken

(f) LEGALITY OF THE AGREEMENT - Lastly, it is necessary to ensure that the loan agreement constitutes a legal, valid, binding and enforceable obligation of the Borrower. The Lenders ask for documentary evidence to the effect that the Loan Agreement constituted a valid, binding and enforceable obligation of the Borrower. It is difficult to provide any documentary evidence in respect thereof. Therefore, a Lender has to content itself with the legal opinion.

(g) LEGAL OPINION - The nature and number of legal opinions required or furnished in a Loan Agreement is not fixed. It varies from case to case In the normal circumstances, two legal opinions are insisted – one by the Borrower's local Counsel and the other by the Lender's Counsel based in the Borrower's country. These legal opinions relate only to the domestic laws of the jurisdiction to which the Borrower belongs. Opinions provide information and analysis and not legal recourse. The schedules or appendices to the Loan Agreement generally provide the format of the legal opinion to be furnished by the Counsel of both the sides. Often, these legal opinions are exhaustive and attempt to cover the entire local law provisions having a bearing on the contractual relationship between a Lender and a Borrower. It is interesting to note that the draft of these legal opinions is finalised by the Lender and the Borrower. The Lawyers who have to give these opinions are generally not present at the time of their finalisation.

The forms of legal opinion are generally very long and complicated. It is practically not possible to discuss its contents at this place.

FINANCIAL OBLIGATIONS

When we talk of financial obligations in the context of a loan agreement, we talk of financial obligations of Borrowers. Generally, we do not talk of financial obligations of lenders. The reason being that where the loan agreement provides for the payment of the loan amount in lump sum or in one instalment, and once the loan amount is paid by the lender to the Borrower, he has fully performed his financial obligation under that loan agreement and no financial obligation of the lender remains to be performed. On the other hand, if the loan agreement provides for the payment of loan amount to the Borrower in instalments, some obligations of the lender remains to be performed on subsequent dates. But it is presumed that a lender would be in a position to discharge his obligations under the loan agreement. Therefore, no provision is ever added in a loan agreement covering the situation of non payment of loan instalment by a lender. Thus, in a loan agreement, we only talk of financial obligations of the Borrowers and not of the lenders.

These financial obligations can be discussed in two stages. The first stage is the taking of loan from the lender and the second stage is repayment of loan amount and the payment of interest and other dues under the loan agreement. So far as the first stage is concerned, a loan agreement normally provides the disbursement date or dates and last date for the drawdown. Therefore, it is a financial obligation of the Borrower to ensure that he complies with all the conditions precedent within the time prescribed in the loan agreement, if any, and draws the money before the expiry of the last date fixed for its withdrawal.

Normally, in a loan agreement a Borrower assumes three kinds of financial obligations. The first financial obligation is the repayment of the loan amount in accordance with the terms and conditions of the loan agreement. The second obligation is the payment of interest amount as and when the same falls due and payable to the Lender. The third obligation is the payment of other sums due to the Lenders under the loan agreement.

So far as the first obligation is concerned, the loan agreements clearly specify the terms for the repayment of the principal amount by the Borrower to the Lender. The principal amount may be repayable in one instalment on specified date after the expiry of the loan period or it may be repayable in a number of instalments. If the Borrower has a choice or the terms of repayment of the principal are negotiable, the repayment of the principal amount in instalments should always be preferred, for in certain cases, the repayment of the entire loan amount in one instalment may be difficult for a Borrower. If the principal amount is repayable in instalments, it may be ensured that the date for the repayment of each instalment and the amount to be repaid is specified in an Article in the loan agreement or in a schedule attached to the loan agreement. The instalments should be spread over a period of time.

Rate of interest - The second financial obligation of the Borrower is the payment of interest amount to the Lender. The first aspect of this obligation is the determination of the rate of interest on the loan amount. There is no fixed or definite rule regarding determination of the rate of interest in a loan agreement. The rate of interest depends on many factors, such as the purpose of loan, the duration of repayment period, the nature of borrower, etc. The rate of interest on loans for the social development in a developing country is normally very low, that is, about 1 or 2 per cent per annum. Such a low rate of interest cannot be really terms as interest. It is in the nature of service charge. Further, the rate of interest on loans advanced by a sovereign to another sovereign is generally moderate. The rate of interest on commercial loans advanced by financial institutions is generally high. The rate of interest on commercial loans is often linked to some international standard like LIBOR. LIBOR is defined as follows:

> **"LIBOR means in relation to a particular period the arithmetic mean of the rate quoted by the Reference Banks as the rate determined by each reference Bank to be that at which deposits in Dollars and in an account comparable with the amount in relation to which LIBOR is to be determined and for a period equal to the relevant period were being offered by prime Banks in the London interbank market at or about 11.00 am on the second banking day before the first day of such period."** (UNITAR)

It is not necessary that in every loan agreement the rate of interest should be linked to LIBOR. The parties are free to determine any method for calculation of the rate of interest or specify any rate of interest in the loan agreement without linking it with LIBOR. Some times, the rate of interest is determined according to formulae prescribed in the Loan agreement or linked to some other institutional rates of interest.

Interest Period - The other issue about the interest is the interest payment period. In some loan agreements it is payable annually. Some Lenders desire the payment of interest semi-annually, that is once in every six months. In such an event, the dates are normally fixed in the agreement. If the draft loan agreement does not specify the dates for the payment of interest, they should be negotiated and specified. They may be 31st March and 30th September or 30th June and 31st December and so on. Monthly or quarterly payment of interest by the Borrowers is neither prevalent in the international borrowing system not it is practically feasible. If a Borrower has a choice, he should insist for the payment of interest annually. The following are some illustrations of this clause:

> **"Section 2.06. Interest and other charges shall be payable semi-annually on May 1 and November 1 in each year."** World Bank Loan Agreement (some loan agreements provide February 15 and August 15)

> **"Interest at the rate specified in the loan agreement shall be payable semi-annually on the principal disbursed and outstanding. Interest shall accrue from the respective dates on which the proceeds of the loan are disbursed."** The Fund, ART. 3.03

> **"Interest shall be payable semi-annually *in arrears* on March 31 and September 30 on each year."** KfW, Art. 3.1

The above clause, unlike the other two clauses, requires the payment of interest "in arrears". These words have significance and financial implications. It means that the interest has to be paid by the Borrower not before the commencement of the interest period but after the expiration of the interest period, that is, in arrears. Hence, at the time of negotiating a loan agreement, efforts should be made to insert the words "in arrears" in this clause.

Interest calculation - The interest is normally calculated from the date on which the amount is disbursed to the Borrower up to the date on which the repayment is actually received by the Lender. The interest calculation clauses in loan agreements also make an interesting study. In some agreement the provision is that the interest shall be calculated on the basis of 360 days year. In other agreements the interest is calculated on the basis of a 365 days year.

> **"Interest and over due charges shall be computed on the basis of a 365 days year."** The Fund, ART. 3.06

> **"Interest determined according to a fixed or a variable interest rate shall be computed on the basis of a 360 days year and actual days elapsed."** NORDISKA, Sec. 3.06

The following Article in a loan agreement adopts both the systems, namely, 365 days year for normal calculation of interest and 360 days year for default calculation of interest.

> **"Interest, commitment fee and commitment premium, if any, shall be calculated on the basis of a year of 365 days and the actual number of days elapsed. Surcharges due to default shall be calculated on the basis of a year of 360 days and the actual number of days elapsed."** KFW, ART. 6.1

There is no definite rule in this respect in the international borrowing system. It depends on the parties to the agreement and their negotiating capacity. If the interest is calculated on the basis of a 360 days a year, the Borrower may have to pay more interest. Therefore, while negotiating a loan agreement effort should be made to ensure that the provision regarding calculation of interest should provide the basis of 365 days a year.

Penal interest - Penal interest is that interest which is levied by the Lender, over and above the normal rate of interest, as and by way of penalty on the Borrower for the Borrower's failure to comply with certain terms and conditions of the loan agreement. Some loan agreements provide for the payment of penal interest by the Borrower if he delays the repayment of the principal or payment of interest or other charges. There is on fixed or definite rate of penal interest in the international borrowing system. It has to be negotiated and decided by the parties to a loan agreement. It may vary from case to case. The following is an illustration of the penal interest clause in a loan agreement:

> **"Should repayment of principal or payment of interest or any other charges required under the loan agreement be delayed, the interest specified in section 3.03 shall cease to accrue on such overdue amount of principal on and after the due date, and an overdue charge calculated at the rate of three per cent (3%) per annum over and above the interest rate specified in the loan agreement shall be payable on the over due amount of principal, interest or other charges for a period from the due date to the**

> **day immediately preceding the day of actual payment thereof, both inclusive.”** The Fund, ART. 3.05

Other charges – Every loan agreement requires the payment of some other charges by the Borrower to the Lender. Except commitment charges, there is no international convention or practice of making provision for the payment of any other charges in a loan agreement. The parties are free to negotiate and provide for the payment or non-payment of any other charge. Further, they may be called by any name. Some of the illustrations are as follows:

Commitment charges - Most of the loan agreements provide for the payment of commitment charges by the Borrower to the Lender. These commitment charges are levied for the period commencing from the date the loan amount is sanctioned by the Lender and till it is withdrawn by the Borrower. There is no definite or fixed rate of commitment charges. They have to be negotiated and decided by the parties to the loan agreement. They are payable generally at the rate of one half of one percent (0.5%) per annum on the undisbursed amount of loan. However, the World Bank levies the commitment charges at the rate of three-fourths of one percent. Some of the illustrative clauses are as follows;

> **“Section 2.03. The Borrower shall pay to the Bank a commitment charge at the rate of three-fourths of one per cent (3/4 of 1%) per annum on the principal amount of loan not withdrawn from time to time.”** World Bank Loan Agreement

> **“The borrower shall pay to the bank a commitment charge at the rate of one half of one per cent (0.5%) per annum on the amount of each tranche of the loan. such commitment charge shall accrue from and including the date of the borrower’s acceptance of the loan tranche proposal in respect of such tranche to but excluding the date of disbursement of the tranche.”** NORDISKA. Section 3.05.

Management fee - Some loan agreements provide for the payment of management fee by the Borrower. The illustrative clause is as follows:

> **“The borrower shall pay to KfW within fifteen calendar days after the signing of this credit agreement, however at least five days prior to the first disbursement a management fee of us $…..”** KfW, Article 4.1

Legal fee and other expenses - Some Lenders follow the practice of levying legal fee payable by them to the lawyers of the Borrower’s country for obtaining legal opinion and travelling and other expenses incurred or likely to be incurred on the Borrowers. Different terms are used to denote various kinds of expenses. However, there is no standard practice in the international borrowing system about the nature, kind and quantum of such charge on the Borrower. The various fees and expenses have to be negotiated with the Lenders. In order to avoid any future controversy in the matter, it is always better and desirable that the parties should negotiate and agree on a cap or ceiling on such expenses. Once, a ceiling is fixed, the Borrower knows the limit and can calculate the cost of borrowing the money.

Pre-payment - Closely linked with the above obligations is the obligation to pre-payment. It will be a misnomer to call it an obligation. No loan agreement imposes any obligation to pre pay the borrowed amount. The prepayment of the entire loan amount or any instalment thereof is discretionary. A Borrower may decide to pre pay the entire loan amount or any instalment thereof before the date of maturity if he has sufficient money available with him. However, such pre-payment deprives the lenders of interest earnings. Since the Borrower has pre paid the amount, he will not be liable for the interest. The fresh utilisation of funds requires time. In the mean while the funds remain unutilised and the lender looses interest. Therefore, some lenders do not permit pre-payment or they permit the pre payment after levying some penalty or premium. Here are a few illustrative prepayment clauses:

> **"The Borrower may, upon giving not less than thirty (30) days notice in writing to the Fund, prepay in whole or in part the principal of the loan then outstanding together with the interest accrued thereon. Any such prepayment shall be applied to the instalments in inverse order of maturity."** The Fund, Art. 3.01

> **"In the case of any payment prior to scheduled maturity of any principal amount in whole or in part, the borrower shall pay kfw a prepayment compensation in respect of each such prepayment of an amount equal to the present value of the amount by which….."** KFW, ART.5.3

Taxes - The next financial obligation of the Borrower under a loan agreement is towards the payment of taxes. The receipt of loan amount by the Borrower may not attract any tax liability, for it cannot be said to be an income of the Borrower. Similarly, the repayment of the principal amount by the Borrower or receipt of the loan amount back from the Borrower will not constitute income of the Lender. However, the transaction of giving and taking loan and subsequent payment of interest by the Borrower to the Lender on the loan amount may be liable to tax in certain jurisdictions. First, let us see what is meant by tax. The following some definitions appearing in various loan agreements. They are as follows:

> **"Tax shall be construed so as to include all present and future taxes, levies, assessments, imposts, deductions, compulsory loans and withholdings, duties and other charges whatsoever, together with any interest thereon, additions to tax and penalties and fines with respect thereto and any payments made on or in respect thereof."** UNITAR

The World Bank has defined the word "Tax" in a different manner. It is as follows:

> **"Taxes includes imposts, levies, fees and duties of any nature whether in effect at the date of the Loan Agreement or Guarantee Agreement or thereafter imposed."** GEN. COND. I B R D , ART. 2.01(18)

This is a good, nice and precise definition of "tax" and may be adopted by other lenders and Borrowers also. In fact, it has been adopted by some of the financial institutions. This is the definition followed by the Nordiska Investment Bank:

> **"Taxes includes imposts, levies, fees and duties of any nature, whether in effect at the date of the loan agreement or thereafter imposed."** NORDISKA

In a loan agreement, as far as possible a lender wants his entire money back without any deductions of any kind whatsoever. Therefore, all the tax liabilities arising in respect of a loan agreement are passed on to the Borrower. For the purpose, the following clause is added in the loan agreements:

> **"The Borrower shall make each payment due to be made by it to any person under this agreement free and clear of, and without deduction or set off whatsoever, including, without limiting, for or on account of tax, unless the Borrower is required by law to make such a payment subject to the deduction or withholding of tax. If the Borrower is required so to deduct or withhold any tax or amounts in respect of tax, or make any further deductions from any amount to be paid by the Borrower to any person under this Agreement, the Borrower shall pay such additional amounts as may be necessary to ensure that, after the making of such deduction or withholding, such person receives and retains a net sum equal to the sum which it would have so received and so retained had no such deduction or withholding been made."** UNITAR DOC. ART.10, P. 61

The above provision imposes a liability of the Borrower to pay all taxes, including those imposed by the country of Lender. Further, it is not a very happily drafted clause. The clause relating to tax liability used by the World Bank is much smaller, simpler and better to understand. It is a part of the General Conditions. It is as follows:

> **"Taxes – (a) The principal of, and interest and other charges on, the loan shall be paid without deduction for, and free from, any taxes levied by, or in the territory of, the member of the Bank which is the Borrower or the Guarantor."** GEN.COND. I.B.R.D. SEC.8.01

It may be seen that while the first clause uses the expression, "each payment due," this clause specifies all the sums, such as principal, interest and other charges separately. Further, according to this clause, the Borrower is liable for those taxes only which have been levied by or are payable in the territory of the Borrower. In this context, attention may be drawn to one more clause relating to Tax used by the Credit Commercial de France. It is as follows:

> **"All existing and future taxes, levied and duties whatsoever legally payable in France as a consequence of this loan agreement shall be paid by the lenders.**
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> **If any existing or future taxes, levies and duties whatsoever are legally payable in the Borrower's country as a consequence of the loan agreement, the same shall be paid by the Borrower.**

> **If the Borrower elects to make payment to the lender through any other country, the Borrower shall pay taxes, levies and duties, if any, in tht country in respect of such payments.**
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> **In consequence, all payments due by reason of and under this loan agreement will be made to the lenders without any deductions or withholdings. The Borrower agrees expressly that if for any reason full payments of the above amounts is not made, it will immediately pay the lenders the equivalent of sums that have been deducted or withheld outside France."** Credit Com.de France

Before discussion, let us see one more illustration of tax clause. This clause is used by the Fund, Japan. It is as follows:

> **"The Borrower and/or other beneficiaries of the loan shall pay all taxes, charges and other expenses imposed upon the fund within the country of the Borrower in connection with the loan and its implementation."**

All the clauses specified above have imposed the liability for tax on the Borrower. However, the Japanese clause imposes the liability to pay taxes not only on the Borrower but also on other Beneficiary. Further, the Borrower is liable to pay taxes in connection with the loan agreement *and its implementation*. The meaning of this expression is not very clear. This is not a properly drafted provision. In many cases, it may be difficult to ascertain the beneficiary. The Beneficiary is not a party to the loan agreement. How can a liability be imposed on a person who is not party to an agreement?

Therefore, while negotiating the tax clause of a loan agreement, the Borrower should insist on the following aspects. The liability for the payment of all taxes should be only of the Borrower and of no other person, including beneficiary. Such liability should be confined to the taxes imposed by the Borrower's country. The Borrower may not be made liable to pay taxes of any other country. The Borrower should be liable to pay taxes only in respect of the principal, interest and other charges. Normally, these are the only payments involved in a loan agreement but it is better to specify these payments, for the expression "all payments due" is vague. A possibility of the lender incurring some more expenses and then claiming the Borrower to pay taxes in respect thereof cannot be rules out. The tax clause should specifically provide that the liability for taxes imposed by the lender's country shall be that of the lender. It is also desirable to explain the meaning and contents of "taxes". It should preferably be confined to income tax.

CURRENCY PROVISIONS

Some times, currency provisions in a loan agreement also result in imposing financial obligations on the Borrowers. Fluctuations in the rate of currency is one of the major causes of increasing the financial liability of the Borrowers. Most of the international loan transactions are negotiated, disbursed and paid in US dollars. It is an admitted fact that the currencies of the developing countries generally keep down ward trend and very often by the time repayment of a loan commences, the magnitude of the loan amount increases considerably. Further, the conversion of one currency into other currency also causes financial liability and erosion in the value of money. This situation can be guarded or completely avoided by adopting any one currency for the entire loan transaction, that is, for the disbursement and repayment of loan and payment of interest and other charges. If it becomes inevitable, due to peculiar conditions of any particular loan agreement, to have more than one currency of an agreement, effort should be made to minimise the number of currencies and some proper mechanism for the determination of exchange rate is prescribed in the loan agreement. It should not be left for any one of the parties to decide later on. If a lender insists that he will decide the currency exchange rates, in that case some guiding factor for the lender may be provided in the agreement. This is an illustration of an appropriate provision:

> **"Whenever it shall be necessary for the purpose of this agreement to determine the value of one currency in terms of another, such value shall be reasonably determined by the Bank on the basis of quotations or the Bank in interbank market."** NORDISK, Sec. 5.04

Some other provisions as to the disbursement of loan amount in different currencies and its consequences have been discussed earlier.

Another aspect which can be usefully combined with the financial obligations is the restrictions on procurement of goods and services from and out of the loan amount. Normally, once the loan is disbursed, the lender should not be concerned with the way the Borrower spends it. So long as the money is spent on the project for which it is meant should satisfy the lender. The lender should not be concerned as to the source of supply of goods and services. The Borrower should be free to decide the place and the country from where it can get the necessary supply of goods and services. However, that is not the case. The lenders, more particularly the World Bank, exercise strict control on the procurement of goods and supplies required for the project. The World Bank has provided elaborate guidelines for the purpose, including standard bidding documents for use by the Borrowers. Normally, no departure is permitted from the terms and conditions contained therein without the written consent of the World Bank. Here is an illustration of this condition

> **"Section 3.02. Except as the Bank shall otherwise agree, procurement of the goods, works and consultant's and expert's services required for the project and to be financed out of the proceeds of the Loan shall be governed by the provisions of Schedule 4 to this Agreement".** World Bank Loan Agreement

> **"Goods and services (the terms "services" as used in this General Terms and Conditions includes consulting services), to be financed out of the proceeds of the loan shall be procured in accordance with the Guidelines for Procurement and the Guidelines for the Employment of Consultants."** The Fund.

There is another clause contained in the General Conditions which gives power to the lender to review the Borrower's procurement procedures. The lender can also review the decisions taken by the Borrower to make procurement of goods and services for the project. It is as follows:

> **"The Fund may review the Borrower's procurement procedures, documents and decisions. The Loan Agreement will specify the extent to which review procedures will apply in respect of goods and services to be financed out of the proceeds of the loan."** The Fund.

The lenders not only have the power to review the Borrower's procurement procedures and decisions but they also have the power to cancel the loan if the procurement of goods and services is not according to the procedure prescribed by them and is not made from the prohibited sources. . This is an undue restriction on the powers of the Borrowers. The following is the illustration of this kind of clause:

> **"The Fund does not finance expenditures for goods and services which have not been procured in accordance with the agreed procedures and the Fund will cancel that portion of the Loan allocated to goods and services that have been misprocured. The fund may, in addition, exercise other remedies under the loan agreement."** The Fund.

The above condition virtually constitutes a threat to the Borrower that either he should procure the goods and services strictly in accordance with the procedure prescribed by the lender. If a Borrower will fail to do so, the loan may be cancelled and the lender can also take other remedial measures available under the loan agreement.

COVENANTS

Every loan agreement contains certain covenants. They concern both the Borrower and the Lender. On the Borrower they impose certain restrictions and on the Lender they confer certain advantages. It is necessary that every Borrower must examine thoroughly these covenants to ensure that it can comply with them according to their terms and these covenants do not unduly restrict its commercial, financial and operational activities. If any covenant or its language is not acceptable to the Borrower, efforts may be made, during the negotiations, to amend it or delete it.

The Covenants are generally in the nature of undertakings given by a borrower for its future conduct till the repayment of loan is over in accordance with the conditions of the loan agreement. The Borrower undertakes, through the covenants, that it will not act in a manner prejudicial to the interest of the Lender during the subsistence of the loan agreement. In other words, they are the restrictions imposed on certain activities of the Borrower during the subsistence of the loan agreement. The Borrower is required to periodically submit to the Lender various details like information of major transactions likely to have impact on the financial capacity of the Borrower, debt equity ratio, encumbrances created by him on his assets, etc in order to satisfy the Lender about the safety of his loan. The covenants have to remain valid and in force from the date of the loan agreement for so long as any amount is or may be outstanding under it.

Through these covenants, the lending institutions also monitor the business activities of the Borrower and the progress made by him in the implementation of the project for which the loan was taken from the beginning to the end till the loan is repaid. . They impose an obligation on the Borrower to regularly and punctually submit progress report of the Project to the Lender. The covenants also help the lender in assessing the financial health of the Borrower and his capacity for the repayment of loan instalments as and when they fall due.

There is no fixed list of the covenants that may be included in a loan agreement. Similarly, the language and contents of the covenants also vary from agreement to agreement. The restrictive nature of the covenants also varies depending on the status of the Borrower. The selection of covenants in a loan agreement depends upon the business or nature of the borrower, the purpose of the loan, and the Borrower's financial condition, etc. In the case of a sovereign Borrower, the covenants are much less restrictive.

The covenants can be divided into two categories, namely Positive covenants and Negative covenants. Under the Positive covenants the Borrower is required to furnish such information to the Lender as may be specified in the covenant. Negative covenants prohibit the Borrower from doing certain acts, such as transferring properties and assets, granting or issuing security and incurring indebtedness, etc. which are considered prejudicial to the interest of the Lenders.

Some of the covenants may now be discussed. The following is an illustrative list of covenants:

(a) Authorizations
(b) Accounts
(c) Other Financial Information
(d) Defaults
(e) Pari Passu ranking
(f) Purpose
(g) No Encumbrance
(h) Restrictions on lending
(i) Disposals

(a) Authorizations - This covenant provides as follows:

> **"The Borrower shall obtain, maintain in full force and effect and comply with the terms of all authorisations, approvals, licences, exemptions, notarisations and consents required in or by the laws and regulations of the Republic to enable it lawfully to enter into and perform its obligations under this agreement or to ensure the legality, validity, enforceability or admissibility in evidence of this agreement in the Republic".**

A some what similar provision also exists in the Conditions precedent. There is a difference between the object, purpose and applicability of the two provisions. The Conditions Precedent depict the past conduct whereas the Covenants regulate the future conduct of the Borrower. In the Conditions Precedent, the authorization is only for entering into the loan agreement. Such an authorization relates to the internal working procedures of the Borrower. The Authorization required under the Covenants provides that the Borrower will not only have the authority to enter in to the loan agreement but he will maintain such authorization in full force and will comply with any document or instrument of authorization according to its terms. Further, in the covenants, the term authorization has been used in the wider sense. It means all the authorizations of all the competent authorities, by whatever name called, acccording to the laws and regulations of the Borrower's country. Thus, it includes approvals, exemptions, permissions, consents licences, etc. of the appropriate authorities. In other words, in covenants, "authorization" means the authorizations of all the government and public authorities required by the laws and regulations of the Borrower's country for assuming valid and binding obligations under the loan agreement.

(b) **Accounts –** The illustrations of this covenant are as follows:

> **"The Borrower shell send to the Lender within 180 days after the end of each financial year, its balance sheet and profit and loss account for that year, prepared in accordance with generally accepted accounting principles adopted in the country and complying with the auditor's report relating thereto."** UNITAR

> **"The Borrower shall furnish to the Bank, *as soon as available* but in any case *not later than four months* after the end of each year, certified copies of its financial statements for each year as so audited and the report of such audit by said auditors."** Nordiska

> **"The Borrower undertakes to furnish KfW as soon as practicable – and in any event not later than 30 calendar days after presentation to the Parliament – with its annual report, audited balance sheet and profit and loss account; a provisional balance sheet and a provisional profit and loss account shall be furnished to KfW not later than 180 days after the close of each fiscal year."** KfW

This covenant requires the Borrower to furnish to the lender financial statements periodically. These statements help the Lender to assess the financial status of the Borrower annually. If the Borrower is becoming financially weak or if its capital base is eroding or it is taking too many loans or selling or transferring many properties during the pendency of the loan agreement, it will be reflected in his annual financial statements. These financial statements help the Lender in reasonably assessing whether the Borrower will be able to repay the loan amount on due dates.

The financial statements generally comprise three documents. The first is the Profit and Loss account. The other is the Balance Sheet and the third is the auditor's report. Generally, these documents are required to be furnished to the Lender in the language specified in the covenant. Normally, it is the English language that is specified. However, by negotiations, the parties may decide the documents that will be furnished and the language in which they will be furnished by the Borrower to the Lender.

In the first instance it may be stated that as per the above covenant, the statements of account are required to be submitted after the end of the financial year. Here the reference is to the financial year of the Borrower and not the financial year of the lender. Some Borrowers follow the financial year from 1st January to 31st December, that is calendar year. Some Borrowers follow the financial year from 1st April till 31st March of the following year. Some follow from 1st July to 30th June of the next year. Different Borrowers follow different financial years. There is no fixed practice in this respect. Thus, whenever the financial year of the Borrower is over, within the prescribed period of time in the covenant, he must submit the financial statements to the Lender.

In this Covenant, two points require negotiations with the Lenders. The first point is the period during which the Borrower shall submit the financial statements to the Lender. In the first illustration, the Borrower is required to submit the financial statements to the Lenders within 180 days or six months from the end of each financial year of the Borrower. In the second illustration, the period provided to the Borrower for submission of the financial statements is four months from the end of each year. Though the covenant does not specify "financial year" and only says "year", it can be presumed that the reference is to the financial year. Many a time it is difficult for a Borrower to get its accounts audited immediately after the financial year is over. Auditing of accounts is a time consuming process. In the case of some countries, the financial statement has to be presented or submitted to some authority or body. Before such submission, they cannot be disclosed to any body. Therefore, it is desirable that maximum time is available to the Borrower for submission of financial statements to the Lenders. Hence, the Borrowers must insist for a minimum of one year's time or as soon as possible for submission of financial statements to the lenders. If you will start with one year, it is expected that a compromise will reach some where on nine months or so. In case of urgency, as has been done in third illustration, provisional balance sheet and provisional profit and loss statement can be submitted to the lender.

The second point is the documents comprising the financial statement. As has been stated earlier, generally, the financial statement means balance sheet, profit and loss account and auditor's report. It is always better to specify the documents required to be furnished to the Lender so as to avoid any confusion and consequential breach of the terms of agreement later on. Further, it may be seen that in the second illustration, certified copies of the financial statements are required to be submitted to the Lender, which is not so in the first and third illustrations. Thus, it should be made clear in the covenant that the copies of the financial statements will be certified by the Borrower or a notary public or any other competent authority of the Borrower.

(c) Other financial information - The illustrations of this covenant are as follow:

> **"The Borrower shall forthwith upon receiving a request to that effect, provide the Bank with such information relevant to this Agreement or relating to the Borrower or the financial condition of the Borrower as the Bank may from time to time reasonably require…"** UNITAR
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> **"The Borrower undertakes for as long as it is indebted by reason of this Credit Agreement to provide such additional financial or other information concerning itself as KfW may from time to time reasonably request."** KfW

This covenant imposes an obligation on the Borrower to furnish such information to the Lender as may be desired by him from time to time. The information desired by the Lender may relate to the Borrower or the financial condition of the Borrower. In the first illustration, the information asked for must be relevant to the Credit Agreement. There is no such requirement in the second illustration. In this respect, the first illustration is better drafted.

(d) Default – Default is another important covenant. It is as follows:

"The Borrower shall promptly inform the lender of the occurrence of any event which, with the giving of notice, lapse of time, determination of materiality or the fulfilment of any other applicable condition or any combination of the foregoing would constitute a Default and, upon receipt of a written request to that effect from the lender confirm to the lender that, save as previously notified to the lender or as notified in that confirmation, no such event has occurred." UNITAR

It requires the Borrower to inform the Lender immediately if any event of default circumstances come into existence. Even though the default has not occurred, but if the circumstances similar to default or a situation which may likely to result in default has taken place, the Lender expects that he should be informed immediately of such situation by the Borrower. The purpose of this information is to forewarn the Lender of the coming events. If a Lender feels that the situation is serious and the recovery of his money may be in jeopardy, he may like to take preventive measures. This covenant is not very happily drafted. An effort may be made to simplify it during negotiations with the lenders.

(e) Pari Passu Ranking - The illustrations of this covenant are as follows:

> **"The Borrower shall ensure that at all times the claims of the banks against the Borrower under this Agreement will at all times rank at least pari passu with all the present and future claims of all its other unsecured creditors except those whose claims are mandatorily preferred by any bankruptcy or other similar laws of general application".** UNITAR
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> **"The Borrower shall ensure that at all times its obligations hereunder will constitute direct, unconditional and general obligations of the Borrower and shall ensure that the obligations of the Borrower hereunder will rank at least pari passu in priority or payment and in all other respects with all other unsecured indebtedness of the Borrower, present or future, save for such obligations as are from time to time mandatorily preferred under the laws of the Republic."** NIPPON Bank, cl.6.03
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> **"The Borrower shall ensure that at all times the claim of the lenders against the Borrower under this Agreement rank at least pari passu with the claims of all other unsecured creditors in respect of external debt except for statutory preferences." "**Fuji Int. Finance, cl. 13.03 (vi)
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> **"Regarding repayment of principal and payment of interest or any other charges required under the loan agreement, the Borrower shall undertake not to treat debts to the Fund less favourably than any other debts other than short term debts."** The Fund, Art. 6, sec. 6.05

When a Borrower borrows money, he may borrow it after giving some security for the money to the Lender or otherwise. If he borrows by giving some assets or property as security, the Lender is called a secured Lender. If the borrowing is without security, the lender is knows as unsecured Lender. Thus, a Borrower has to kinds of creditors – secured and unsecured. A secured Lender is the one who has given money on the basis of some security. For his money, he creates a charge or lien on some specific assets of the Borrower though they continue to be in the possession of the Borrower. The charge or lien may be fixed or it may be floating. In the case of a fixed charge the Borrower looses the right to sell or dispose of such assets without the prior permission of the lender. Further, if the Borrower fails to pay the money due to the lender, the lender has a legal right to sell those assets and recover his money. An unsecured lender has no such right available to him.

According to leading law Dictionaries, pari passu means all unsecured indebtedness is treated equally. In other words, it means equal participation of all the unsecured creditors in the assets of the Borrower for recovering their money. This covenant requires that the Borrower shall treat all the unsecured lenders equally. He will not give preference to any particular lender in the matter of recovery of loan amount.. In other words, the lender shall not be discriminated in the matter of availability of assets. It may be noted that the last illustration insists for the right of pari passu only with respect to the external debt.

Negative Covenants - The following covenants are called negative covenants because they prohibit a Borrower from doing certain acts.

(d) Encumbrances - An encumbrance may be explained as follows:

> **"a reference to a mortgage, charge, pledge, lien or other encumbrance securing any obligation of any person or any other type of preferential arrangement having a similar effect."** UNITAR

The covenant imposing an obligation on the Borrower not to create encumbrances on his assets is as follows:

> **"The Borrower shall not create, or permit to subsist, any encumbrance over all or any of its present or future revenues or assets, other than an encumbrance which has been disclosed in writing to the Lender before the execution of this Agreement and which secures only indebtedness outstanding at the date of this Agreement."** UNITAR

The object of this covenant is to prevent the borrower from creating any encumbrances on his assets and revenue so long as the loan amount has not been paid in full to the lender. He must not offer his assets or revenue as a security for borrowing money. For the purpose of discussion, this covenant can be divided into two parts. The first part deals with the present and future conduct of the Borrower. The second part deals with the past actions of the Borrower. Taking the second part first, it permits the Borrower to continue with such encumbrances which were disclosed to the lender, in writing, on the date of the agreement. Thus, the Borrower must disclose to the lender, in writing, all the encumbrances on his assets and revenue existing on the date of the agreement. He must prepare a list of all such encumbrances, irrespective of the amount involved, and submit the same to the lender at the time of signing the loan agreement.. Further, the nature of the encumbrance must be such that it secures the indebtedness outstanding on the date of the agreement.

The first part of the covenant prohibits the creation of any fresh or new encumbrance on all or any of the present or future revenues and assets of the Borrower. There is an absolute prohibition. The Borrower cannot create new encumbrance even with the permission of the lender. This covenant covers even insignificant encumbrances also. No Borrower should accept or agree to such a covenant. A Borrower, which is generally a business organization, may have to create many encumbrances on its assets for day to day working. Without creating encumbrances it cannot function smoothly. There is a need for a savings provision in this covenant which has been suggested at the end of discussion of this covenant.

It uses an expression - "permit to subsist". It means that the Borrower will not allow any encumbrance to continue on his assets and revenue after the date of the loan agreement. Though it is not specified clearly, the intention appears to be that the Borrower shall allow to continue only such encumbrances about which the lender has been informed in writing. If there is any encumbrance about which the lender has not been informed in writing, such encumbrances must be redeemed.

This covenant covers both assets and revenue. No doubt, in commercial principles, there is a clear distinction between the assets and revenue. Further, it covers present as well as future assets and revenue.

To safeguard the interest of the Borrowers, in this covenant it is necessary to provide that it will apply only in those cases where the encumbrance proposed to be created subsequent to the loan agreement or existing on the date of this agreement do not jeopardise the interest of the lender or it will not have material effect on the financial capacity of the Borrower. If this provision is added to the covenant, the result would be that small or insignificant encumbrances will be out side this clause and the Borrower would be able to carry on his business freely and without any apprehension of committing a breach of the agreement.

(g) Disposals – The following are a few illustrations of this covenant:

> **"The Borrower shall not sell, lease, transfer or otherwise dispose of, by one or more transactions or series of transactions (whether related or not) the whole or any part of its revenues or its assets."** UNITAR
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> **"The Borrower undertakes that so long any moneys are owing under this Agreement, it shall not (whether by single transaction or a number of related or unrelated transactions and whether at the same time or over a period of time) sell, transfer, lease out, lend or otherwise dispose of the whole of its assets not any part which is substantial in relation to its assets, or the disposal of which could have a material effect on it, nor materially change the scope or nature of its business, whether by disposal, acquisition or otherwise."** UNITAR
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> **"The Borrower represents that at the date of this Agreement no lien exists on any of its assets as security for its debts.**
>
> **The Borrower undertakes that after the date hereof if any lien shall be created on any assets of the Borrower, the Borrower shall be obligated to provide the lender with equivalent security for the performance of its obligations hereunder; Provided, however, the foregoing provision shall not apply to any lien arising in the ordinary course of financial transactions and securing a debt maturing not more than one year after the date on which it is originally incurred."** NORDISKA

As has been mentioned earlier, this is also called a negative covenant. It imposes a restriction on the Borrower that he will not sell, lease or otherwise dispose off any of his assets during the period the agreement is in existence. In other words, this covenant prohibits the Borrower from parting with the possession of any of his assets. In the first covenant there is an absolute prohibition on the powers of the Borrower to sell or dispose of his assets. . Even if the Borrower will sell or dispose off the scrape or worthless material, it will amount to a violation of this covenant. Therefore, this kind of covenant should not be accepted by the Borrowers. The second covenant contains certain exceptions. It says that it will not apply to those cases where the assets proposed to be transferred are not substantial or which could not have a material adverse effect on the Borrower. Thus, this covenant contains sufficient safeguards for the Borrowers and can be accepted with minor modifications.

(h) Restrictions on Lending – This covenant is as follows:

> **"The Borrower shall not make any loan, grant any credit (save in the ordinary course of business), or give any guarantee or indemnity to, or for the benefit of, any person, or otherwise voluntarily assume any liability, whether actual or contingent, in respect of any obligation of any other person."** UNITAR

> **"The Borrower shall not incur any debt if, after the incurring of such debt, the consolidated debt of the Borrower then incurred and outstanding would be greater than twelve times the consolidated capital and surplus of the Borrower."** NORDISKA

This covenant prevents the Borrower from giving any loans or incurring any debt. The object of this covenant is to ensure financial soundness of the Borrower. He should not give loans or incur debts so as to weaken his financial position. The first covenant contains an exception in favour of transactions in the ordinary course of business. This exception is vague. Borrowers have to give numerous loans and grant credits in the course of their business activities. Thus, this covenant should also provide that the Borrower shall not give loans and grant credits which may have material adverse effect on the financial capacity of the Borrower. The second illustration provides a limit in the form of "twelve times the capital and surplus of the Borrower". Even this kind of limits are not good for a sound working system of the Borrowers.

PROFILE OF THE AUTHOR

Dr. Vinod K. AGARWAL has LL.M and Ph.D (Law) degrees from the University of Bombay, India. He obtained a Certificate in Comparative Law from the Institute of European Studies, University of Brussels and has attended the External Session of the Hague Academy of International Law. He has been a Visiting Fellow at the Institute of Advanced Legal Studies, University of London. Presently, he is the Secretary General of the International Centre for Alternative Dispute Resolution in New Delhi after retiring from the Government of India as Additional Secretary, Ministry of Law, Justice and Company Affairs. He has held various positions in the Government of India. He has been a member of many delegations sponsored by the Government of India for negotiation, both in India and abroad, of loan agreements entered into by public sector undertakings such as Industrial Development Bank of India, Industrial Finance Corporation of India, Railway Finance Corporation, Shipping Credit and Investment Corporation of India, Oil and Natural Gas Commission, Air India, Indian Airlines, etc. with the international financial and other institutions like Export-Import Bank of Japan, Export-Import Bank of Korea, Export-Import Bank of America, Caisse Nationale de Credit Agricole S.A. Paris, Bank Paribas, Kreditanstalt für Wiederaufbau, Chase Manhattan Asia. As part his work with the Government of India, Dr. Agarwal was responsible for examination, vetting and negotiation of international loan agreements entered into by the Indian borrowers with lenders and other international financial institutions. He was also responsible for attending negotiations on behalf of the Government of India as well as advising the government on various legal issues and the conduct of litigation and arbitration.

He was a leader of the Indian delegation to the United Nations Commission for International Trade Laws. He has been a Resource Person for many workshops organised by the UNITAR in various parts of the World.

About UNITAR

UNITAR is an autonomous body within the United Nations which was established in 1965 to enhance the effectiveness of the UN through appropriate training and research. UNITAR's programmes in the legal aspects of debt, financial management and negotiation are among a wide range of training activities in the field of social and economic development and international affairs carried out, generally, at the request of governments, multilateral organizations, and development cooperation agencies. UNITAR also carries out results-oriented research, in particular research on and for training, and develops pedagogical materials including distance learning training packages.

UNITAR's **Training and Capacity Building Programmes in the Legal Aspects of Debt, Financial Management and Negotiation** are conducted for the benefit of over 35 partner countries mainly from sub-Saharan Africa and Vietnam. These programmes aim at meeting the priority training needs of senior and middle-level government officials through a wide range of seminars, workshops, and training of trainers workshops. In parallel to training activities, the programme also assists in strengthening local capacities of governmental and academic institutions through distance learning training packages, up-to-date publications as well as networking activities.

During 2001, the programme will focus on:

- Training government officials through short-duration regional seminars and workshops on various aspects of debt, financial management and negotiation;
- Developing On-line Training Courses (in parallel with its traditional regional training) with a view to tapping a wider audience and reducing cost of training per participant;
- Strengthening existing ties with regional training centres and offering joint courses with partners in the field;
- Creating awareness among senior government officials of the importance of the legal aspects in the borrowing process and of putting together a multidisciplinary team for loan management and public administration;
- Providing in-depth training and skills development for accountants, economists, financial experts and lawyers coming from government ministries and departments involved in negotiation, financial management and public administration; and
- Developing and disseminating training packages and 'best practice' materials directly related to the practicalities of legal aspects of debt and financial management, with a view to strengthening existing human resources and institutional capacities at the national level.

A description of UNITAR's latest activities and training programmes in the area of debt and financial management is available on its website at: www.unitar.org/dfm.

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