Document No. 15

Negotiation and Drafting Clauses in Loan Agreements: Events of Default

Paper written following a UNITAR Sub-Regional Workshop on Negotiation Techniques for Senior Officials from Eastern and Southern Africa (Windhoek, Namibia 20 to 22 November 2000)

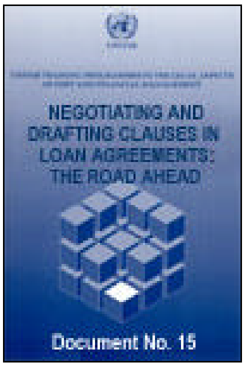

Table of Contents

Published in Geneva
March 2001

INTRODUCTION

This paper follows a joint UNITAR / MEFMI Workshop on Negotiation Techniques (Windhoek, Namibia, 20 to 22 November 2000). The workshop was addressed to 17 senior officials from Angola, Botswana, Malawi, Namibia, Swaziland, Tanzania, Uganda and Zimbabwe. The objectives of the workshop were to discuss various aspects of legal and institutional arrangements necessary for effective loan negotiations including best practices in loan negotiations. Also to discuss the sources of external finance and ways of measuring benefits and risks involved in borrowing, and to share loan negotiation and re-negotiation experiences.

For many countries the management of an external borrowing programme is one of the most important responsibilities of the government. Living standards are at stake and the massive sovereign debt problems of the 1980s and early 1990s are testimony to the terrible price that countries must pay when debt gets out of hand. The ability of a country to effectively negotiate the terms of a loan agreement is an important determinant of the cost at which it will borrow the funds. Therefore through adequate preparation and timely utilisation of the right mix of expertise, developing countries can improve the outcome to a negotiated loan transaction.

This paper, written by one of our speakers, Dr. Vinod K. Agarwal, is the outcome of issues discussed at the workshop. We thank him for his interest and valuable contributions to our training activities.

We hope that this document will be useful as well as challenging to its readers.

Marcel A. Boisard
Executive Director of UNITAR

NEGOTIATING AND DRAFTING CLAUSES IN LOAN AGREEMENTS: EVENTS OF DEFAULT

*by Dr. Vinod K. Agarwal**

An agreement relating to the borrowing of foreign capital contains numerous clauses. The purpose of these clauses is to define various obligations of both the parties to the transaction of loan. The exact nature, kind and content of these clauses varies from agreement to agreement. Nevertheless, there are some standard clauses in every loan agreement. Some of these clauses, namely, General Conditions applicable to Loan Agreement, Conditions Precedent, Covenants, Financial Obligations, etc., were discussed at the time of Hanoi Workshop. It is now proposed to discuss Events of Default clause as contained in the loan agreements.

EVENTS OF DEFAULT

Every lender of money is by nature suspicious. This is true of every lender irrespective of whether he is an individual, an institution, an organisation or a sovereign government. The moment a lender senses any danger or threat to his money, or his perception tells him that the Borrower is in some kind of difficulty or he feels that the Borrower will be unable to pay his money when due or the recovery of his money may be in jeopardy for any reason, he immediately becomes alert and tries to protect his money and ensures its recovery as early as possible. The lender becomes so sensitive that he does not want any change or alteration in the organisational set up or financial status of the Borrower after he has signed the loan agreement and till the payment of all his dues under the loan agreement are over. In money matters, the lenders follow the famous saying that "prevention is better than cure." Some times the perception of the lenders may not be even real. The result is that the lender tries to weave a net of difficult conditions around the Borrower so that the Borrower may not be able to escape from any direction. A slight variation in the status of the Borrower alerts the lender and it results in an event of default. The conditions added for the purpose in a loan agreement are generally called the events of default.

This attitude of the lender creates many problems to a Borrower. A Borrower has to be vigilant at all the time so as to ensure that no situation arises which may result in any kind of suspicion to the lender. Knowingly or unknowingly he may not commit any act which may constitute a default according to the conditions of the loan agreement, for it may have disastrous consequences for him.

** This script was prepared for presentation to the participants in the Workshop on "Negotiating and Drafting Clauses in Loan Agreements" organized by the UNITAR at Lagos, Nigeria from 17th to 21st July, 2000. This is not an exhaustive description of "Events of Default" but only an illustrative discussion.*

A Default means the occurrence of a situation when the Borrower is likely to commit default in the discharge of his financial obligation. i.e. the payment of interest or other dues or repayment of the loan amount to the lender as and when due in accordance with the terms and conditions of the loan agreement. Generally, the word "default" is not defined in the loan agreements. According to Oxford Dictionary, "default" means failure to act, failure to pay, not meet money calls, etc. However, a **"default means any Event of Default or any event which with the giving of notice or lapse of time or the satisfaction of any other condition (or any combination thereof) would constitute an Event of Default" (UNITAR Doc.)** An Event of Default is generally defined in most of the loan agreements. It is an actual or likely occurrence of any of those events set out in the "Events of Default" clause in the loan agreement. An event of default may occur in a variety of ways depending on the status of the Borrower and the purpose for which money has been borrowed.

There are two types or kinds of events of default. A breach of any of the provisions of a loan agreement constitutes an event of default. The others are anticipatory events which make it probable that the Borrower will soon commit default.

The consequences of the occurrence of an event of default are serious. It is therefore, necessary that the Borrowers examine these events of default very carefully. It may be ensured that the events of default mentioned in the loan agreement should not give too much discretion to the lenders. The events of default should be properly negotiated with the lenders so as to ensure that they contain sufficient safeguards for the Borrowers. Preferably, grace periods varying from 15 to 60 days can be provided wherever time limits are prescribed or payment obligations are involved. In other appropriate cases test of "materiality" may be added. Further, as far as possible, vague provisions should be avoided in the "Events of Default" clause. These suggestions will be further discussed at the relevant and appropriate places.

The occurrence of an event of default gives a right to the lender to declare that (I) his obligation to pay the loan amount remains to be paid to the Borrower shall cease, (ii) the entire amount paid by the lender and the interest thereon and any other sum payable by the Borrower is due and payable to the lender immediately; and in addition, (iii) the Borrower is liable for the interest for the defaulted period at the enhanced rate called default interest rate.

Some of the relevant Articles in loan agreements highlighting the actions permitted to the lenders on the occurrence of an event of default are as follows:

"On and any time after the occurrence of an Event of Default the lender may by written notice to the Borrower: (a) either (I) declare the Advances to be immediately due and payable, together with all accrued interest thereon and any other sums then owed by the Borrower under this Agreement and, upon that declaration, such sums shall become immediately due and payable without demand or notice of any kind, all of which are expressly waived by the Borrower, or (ii) declare the Advances to be due and payable on demand of the lender; and/or (b) declare that any undrawn portion of the Facility is cancelled, whereupon the same shall be cancelled with immediate effect and the Commitment of the lender shall be reduced to zero with immediate effect." UNITAR Doc. clause 16.2

"If any of the following events shall occur and shall continue for the period specified below (thirty days), if any, then at any subsequent time during the continuance thereof, the Bank, at its option, may, by notice to the Borrower and the Guarantor, declare the principal of the loan then outstanding to be due and payable immediately together with the interest and other charges thereon and upon any such declaration such principal, together with the interest and other charges thereon, shall become due and payable immediately." Gen. Con. IBRD, Article 7 (emphasis added)

"If any of the following events shall have occurred and <u>be continuing</u>, the Bank may by notice to the Borrower suspend in whole or in part the right of the Borrower to make drawings under the loan" NORDISKA Sec. 9.02

A comparison of the above clauses indicates that the second clause is definitely better from the point of view of the Borrowers. The event of default clause will come into operation if such event continues for thirty days. Thus, this clause gives, at least, thirty days grace period to the Borrower. During the period of thirty days the Borrower may take remedial measures or rectify the event. The other feature is that it gives the Bank an option to take or not to take an action. It is not necessary that in every case the Bank must take action. It has discretion. In third clause also, the right of Borrower to make borrowings is not terminated. It only gets suspended, either in whole or in part, only if the event of default "continues".

The following is a list of the Events of Default normally found in a loan agreement:

(a) Non Payment
(b) Misrepresentation
(c) Breach of Obligations
(d) Cross Default
(e) Insolvency
(f) Insolvency Proceedings
(g) Change of Activity
(h) Validity of Agreement
(i) Unlawfulness
(j) Expropriation and Disposal
(k) Moratorium
(l) IMF
(m) Material Adverse Change
(n) Project Authority

The above clauses will now be discussed:

(a) **Non-payment**

If a Borrower fails to pay any sum due under the Agreement, it is an event of default. The following are a few illustrations of the event of default clause:

"If the Borrower shall fail to pay any amount of principal, interest or other sum payable under this Agreement on the date upon which the amount is due and payable" UNITAR Doc. Exercise 3, first version.

"The Borrower does not pay in full any sum due from it under this Agreement at the place, the time, in the currency and in the manner specified in this Agreement." UNITAR Doc. Article 16.1

It may be seen that in the first case, the expression used is, "The Borrower shall fail to pay any amount" while in the second case, the expression is, "The Borrower does not pay **in full** any sum due". Thus, in the second case, if the money due has been paid in part, it may not be an event of default. Further, though the second clause mentions four specific situations for payment, namely, place, time, currency and the manner, in the first case they are implied. However, in none of these clauses any grace period is prescribed.

The following is one more illustrations of the non-payment clause:

"A default shall have occurred on the part of the Borrower on the payment of principal or interest or any other payment required under this loan agreement or any other loan agreement between the Borrower and the Bank". NORDISKA. Sec. 9.01 (emphasis added)

The General Condition of the Overseas Economic Co-operation Fund in this respect is also very much similar to the above clause. It is as follows:

"Default in the repayment of principal and/or payment of interest or any other charges required under the loan agreement and/or any other loan agreement between the Fund and the Borrower." Gen.Cond. O E C F

In the above two cases, not only a failure to pay any sums due under the loan agreement will be an event of default, but a failure to pay sums due under any other loan agreement will also be an event of default, provided that the loan agreement is between the same parties. If, however, the loan agreement is between the different parties, the provisions of this clause will not be attracted. A failure to pay any sums due under any other loan agreement is normally called cross default. The other lenders provide a cross default under any other loan agreement as a default under the instant loan agreement through a separate and independent clause. They use specific clause for the purpose, which will be discussed later on. However, these lenders have preferred to specify that a failure to pay under any other loan Agreement as an event of default under this clause itself. It may further be seen that these clauses cover all kinds of payments, that is, principal, interest and "any other charges/payment' under a loan agreement.

The non-payment clause used by the World Bank is as follows:

"The Borrower shall have failed to make payment (notwithstanding the fact that such payment may have been made by the Guarantor or a third party) of principal or interest or any other amount due to the Bank (I) under the loan

agreement, or (ii) under any other loan agreement or Guarantee Agreement between the Bank and the Borrower, or (iii) in consequence of any Guarantee or other financial obligation of any kind extended by the Bank to any third party with the agreement of the Borrower, or (iv) under any development credit agreement between the Borrower and the Association. I B R D Gen Cond. Sec. 6.02(a)

The way this clause has been drafted by the World Bank shows its over anxiousness in the protection of its money. This is a very exhaustive clause. If the Borrower fails to pay principal, interest or any other sum under this loan agreement or under any other loan agreement, irrespective of the fact that the payment of the sums due has been made by the Guarantor or a third person, it will still be an event of default on the part of the Borrower. Thus, the fact that the
money is not due under the loan agreement is not relevant. The relevant fact is that the Borrower has failed to pay the sums when due. Further, this clause covers not only the loan agreements but guarantees also. It also includes loan agreements between the Borrower and the International Development Association.

A discussion of the non-payment clause will not be complete without a reference to the clause used by the Export Development Corporation of Canada. It is as follows

"The non-payment when due of any sum payable hereunder, whether at maturity, by acceleration or otherwise". EDC, Clause 9.01(a)

This clause lays emphasis on the circumstances when the money is due, that is, whether maturity, acceleration or otherwise. In earlier clauses these events are not specified. They are implied.

(b) **Misrepresentation**

If any statement, representation or warranty made by the Borrower at the time of entering in to a loan agreement is false or turns out to be false at any time during the subsistence of the loan agreement, it gives a right to the lender to treat it as an event of default. A few illustrations of this clause are as follows:

"If any representation or warranty made or deemed to be made by the Borrower in or pursuant to this Agreement or in any notice, certificate or statement referred to herein or delivered under this Agreement is or proves to have been incorrect in any respect." UNITAR P.45

"If any representation or warranty made or deemed to be made by the Borrower in or pursuant to this Agreement or in any notice, certificate or statement referred to herein or delivered under this Agreement is or proves to have been incorrect in any material respect." UNITAR P.46

The above two clauses, the way they have been drafted, include not only the specific statements made by the Borrower but also those statements which are "deemed to have been made". It is very difficult to presume what statements are deemed to have been made. In a deemed statement it is possible that the Borrower might have intended one thing and the lender might have understood it in a different way. Therefore, this is not a correct expression in a loan agreement. Further, these clauses covers not only the loan agreement but also any notice and certificate referred to or delivered under the loan agreement. This makes the clause very wide. Therefore, the Borrowers should not agree for the "deemed to have been made" provision.

In all other respects the above two clauses are very much similar except that in the second case the word "material" has been use. The use of the word "material" makes a material difference in the obligations of the Borrower. In the first case, a slightly wrong or misstatement on the part of the Borrower would constitute an event of default. In the other case, the wrong or false statement should be material, that is, it should be of such a nature that it would have effected the decision of the lender to advance money to the Borrower. Then alone, it would be treated as a wrong statement and an event of default.

The following are two more illustrations of "misrepresentation" clause deserve attention:

"Any representation, warranty or statement made by the Borrower in this Agreement or in any notice or other document, certificate or statement delivered by it pursuant to this Agreement or in connection with this Agreement is or proves to have been incorrect or misleading when made or deemed to be repeated." UNITAR, clause 16.1(b)

In this illustration, the last portion deserves attention. It covers not only the incorrect statements but those statements also which prove to be misleading when made or *deemed to be repeate*d. As we shall see later on, the loan agreements contain a provision that the statements, representations and warranties mentioned in the Agreement shall be deemed to have been repeated every time an instalment of loan is released by the lender. Therefore, all such statements should be correct at that time also.

"A representation made by the Borrower in or pursuant to the loan Agreement, or any statement furnished in connection therewith, and intended to be relied upon by the Bank in making the loan, shall have been incorrect in any material respect." Gen. Cond. I B R D, ART. 6.02(I)

The above clause is used by the World Bank. It contains two safeguards for the Borrowers. The first is that the statement which is incorrect is intended to be relied by the Bank in making the loan. If it was not relied by the Bank in making the loan, it will not be an event of default even if it proves to be incorrect. Secondly, it should be incorrect in material respect. Thus, it should be emphasised during the negotiations of a loan agreement that if this clause can be used by the World Bank, it could be used by the other lender as well. It is a properly drafted clause and deserves to be adopted in all loan agreements by the lenders.

(c) **Breach of Obligations**

The clauses relating to breach of obligations are as follows:
"The Borrower does not duly perform or comply with any of the obligations expressed to be assumed by it under the Agreement". UNITAR, clause 16.1©

"The Borrower fails to perform or observe any of its obligations hereunder or the Guarantor fails to perform or observe any of its obligations under the Guarantee and such failure is not remedied within five days (which shall be banking days in Frankfurt am Main) of notice from KfW requesting such remedy." Kreditanstalt fur Wiederaufbau, p. 18

In a loan agreement a Borrower assumes, apart from payment obligations, a number of other obligations. If the Borrower does not fulfil or perform any such obligation, it has assumed under the loan agreement, it constitutes an event of default. However, justice demands that it should not be treated immediately as an event of default. The Borrower should be given an opportunity to remedy any such fault within a reasonable period of time. If the Borrower fails to remedy such defect within a reasonable time, then alone it should constitute an event of default. The reasonable time is a question of fact and may vary from case to case. The second clause gives 5 days time to the Borrower. This is a better draft. Therefore, it may be adopted.

(d) **Cross Default**

As has been discussed above, cross default means a default in respect of any of the payment obligations by the borrower under any loan agreement other than the loan agreement in question. The following are some of the illustrations of this clause:

"Any indebtedness of the Borrower is not paid when due, any indebtedness of the Borrower is declared to be or otherwise becomes due and payable before its specified maturity, or any creditor or creditors of the Borrower becomes entitled to declare any indebtedness of the Borrower due and payable before its specified maturity." UNITAR DOC, Art. 16.1(d)

"Any part of the principal amount of any loan in a currency other than the currency of the Borrower having an original maturity of more than one year shall, in accordance with its term, have become due and payable in advance of maturity because of event of default as provided in relative Contractual instruments, or any security for any such loan shall have become enforceable." NORDISKA p. 13,

"if the Borrower (I) fails to pay any amount due, under any loan, guarantee or security agreement, on the due date or within any applicable grace period; or (ii) defaults under any other term of any loan, guarantee or security agreement to which it is a party which would allow (assuming the giving of appropriate notice if required) the holder or holders of such loan, guarantee or security to accelerate such obligation;" E D C, clause 9.01(g)
This is one of the most undesirable clause. Under the cross default clause a lender could declare a Borrower who has defaulted, or who is anticipated to default, on an

otherwise unrelated agreement to be in default on its agreement as well. If a Borrower commits a default as per the events of default clause in any other agreement, it will constitute and event of default under this agreement also. It is not necessary that the other agreement should be with the same lender. It could be with any other lender, institutional or otherwise.

The object of this clause is to protect the lenders from likely failure of the Borrowers to pay the principal, interest and other sums due to the lenders. If a Borrower has not been able to pay a debt under any other agreement, it is presumed by the lender that he will not be able to pay the principal, interest and other dues under his agreement as well. Further, as the clause of cross default has been drafted in some of the existing agreements, it is very wide. It may include indebtedness even under non-loan agreements, such as procurement agreements or service agreements. The cross default event as in the first case applies to indebtedness. Indebtedness is defined as follows:

"Indebtedness" means all obligations of any person from time to time (present or future, actual or contingent, as principal or surety or otherwise) for the payment or repayment of money". UNITAR Doc. Article 1

This definition is very wide. It covers all obligations for payment or repayment of money. This clause, as at present, does not make any distinction between internal indebtedness and external indebtedness. An obligation to pay money to any person within the country and in the domestic currency is also covered by it. In fact, this clause requires proper drafting. A domestic indebtedness can be settled by a sovereign Borrower, if he feels that it can cause cross default, by printing extra domestic currency and paying off the lenders. Hence, indebtedness in this clause should be confined to external indebtedness and not to simply indebtedness. Of course, the meaning and extend of external indebtedness itself is a subject of discussion.

The second illustration specifically says, "any loan in a currency other than the currency of the Borrower". Therefore, this clause does not cover domestic indebtedness. It generally covers external indebtedness. Further, every external indebtedness is also not covered by it. It covers only such external indebtedness which has original maturity of more than one year. Therefore, those loans which have been taken by a Borrower for a period of less than one year and if he commits a default in the repayment, it will not be a cross default. However, the second clause contains one more stipulation, that is, "security for any loan shall have become enforceable."

In loan agreements generally the expression "external indebtedness" is defined. One such definition is as follows:

"External Indebtedness means any indebtedness which is: (a) dominated, payable or optionally payable otherwise than in the currency of the borrower's country; or (b) payable to a person incorporated, domiciled, resident or with its head office or principal place of business outside the borrower's country." UNITAR Doc. Article 1

The language of the third clause is still wider. It covers not only the loan agreements but guarantee and security agreements also. The loan agreement does not define the expression "security agreements". In the absence of a definition of this expression, it is difficult to comprehend the meaning and scope of "security agreement". Such vague and wide clauses should, as far as possible, be avoided in a loan agreement. In view of the aforesaid, it is necessary that the Borrower should be very careful. The contents of this clause should be properly and carefully negotiated with the lenders after thoroughly understanding of implications thereof. A little mistake at this stage can prove fatal subsequently.

(e) **Insolvency**

The provisions regarding insolvency generally contained in a loan agreement are in the following words:

"The Borrower is, or for the purpose of any law is deemed to be, unable to pay its debt as they fall due, admits inability to pay its debt as they fall due, commences negotiations with any one or more of the creditors with a view to the general adjustment or rescheduling of its indebtedness, or makes a general assignment for the benefit of, or a composition with, its creditors." UNITAR Doc, Article 16.1 (e).

"If the Borrower (I) makes an assignment for the benefit of its creditors; or (ii) petitions or applies to any tribunal for the appointment of a receiver or trustee for itself or any substantial part of its assets; or (iii) starts any proceeding relating to itself under any present or future organization, amalgamation, arrangement, adjustment of debt, dissolution or liquidation law of any jurisdiction; or (iv) in any way consents to, approves or acquiesces in any bankruptcy, reorganization or insolvency proceeding started by any other person, or any proceeding by any other person for the appointment of a receiver or trustee for the Borrower or any substantial part of its assets; or (v) allows any receivership or trusteeship to remain undischarged for a period of 30 days; or (vi) becomes or is declared by any competent authority to be bankrupt or insolvent;" EDC, section 9.01(d).

The above clauses cannot apply to sovereign Borrowers or corporate Borrowers. A sovereign Borrower can never be declared insolvent. Similarly, a corporate Borrower is generally not declared insolvent. He may be declared bankrupt. In any case, a declaration of insolvency or bankruptcy is not an essential requirement under these clauses. A simple negotiation or rescheduling of indebtedness under a loan agreement alone is sufficient to invoke the provisions of this clause by a lender.

The first clause has four parts. The first part provides for the situation when the Borrower is deemed by any law to be unable to pay its debts as they fall due. The second situation is where the Borrower admits inability to pay its debts as they fall due. In the third case, the Borrower commences negotiations with his creditors with a view to the general adjustment or rescheduling its indebtedness. The last situation is where a Borrower makes a general assignment for the benefit of or a composition with its creditors. If any such event takes place, the Borrower shall be deemed to be insolvent. This is a much wider provision as compared to the event of insolvency contained in the domestic laws of a country. A Borrower cannot be considered to be an insolvent till he is so declared by a competent court of a country. Under domestic laws, mere inability to pay debt or the commencement of negotiations or even rescheduling of debt does not amount to insolvency. It is possible that after negotiations or rescheduling of indebtedness, a Borrower may be in a position to satisfy his debt obligations. Thus, this clause needs proper negotiations with the lenders.

The advantage of the second clause is that it provides a time limit of 30 days for the Borrower to discharge receivership or trusteeship. A Borrower can, if so possible, avoid the rigors of this clause within the aforesaid grace period.

(f) **Insolvency Proceedings**

The loan agreements generally contain, in addition to an insolvency clause, an "insolvency proceedings" clause also. Mentioned below are a few illustrations of this clause:

"The Borrower takes any corporate action or other steps are taken or legal proceedings are started for its winding up, dissolution or reorganisation or for the appointment of a receiver, administrator, administrative receiver, trustee or similar officer of it or of any or all of its revenues and assets." UNITAR Doc. Article 16.1(f).

"The Guarantor or any other authority having jurisdiction shall have taken any action for the liquidation of the Borrower, save for the purpose of reconstruction or amalgamation such as does not prejudice the interest of the Bank, or for the suspension of the Borrower's operations." NORDISKA, Sec. 9.03 (h).

"The Guarantor or any other authority having jurisdiction shall have taken any action for the dissolution or disestablishment of the Borrower (other than a member of the Bank) or for the suspension of its operations." Gen. Cond. I B R D, Art. VII.

"Any of the following occurs to the Borrower: the appointment of a receiver, the declaration of a moratorium in respect of any of its indebtedness, bankruptcy, discontinuance of business, liquidation, inability to honour debts, compulsory or voluntary winding up, the sale of a major portion of assets or any event similar to any of the foregoing." KREDITANSTALT FUR WIEDERAUFBAU, p.18.

The insolvency proceedings clause envisages a stage before the actual declaration of insolvency. In the insolvency, as an event of default clause, as has been discussed above, the actions envisaged are taken by the Borrower voluntary on the basis of assessment of his own financial position without involvement of the court or any other governmental authority. The insolvency proceedings clause envisages a definite action by the Borrower through a court or other instrumentality of appropriate governmental agency. However, winding up or dissolution can be considered to be the commencement of an insolvency proceeding but reorganisation of business activities or management cannot be considered to be in the nature of insolvency proceedings. A Borrower may have to reorganise its business activities or management structure for better conduct of its business or for various other reasons. Reorganisation of business activities by a Borrower is a matter of daily occurrence in the corporate world of both the developed and the developing countries. Hence, the expression "reorganisation" deserves to be deleted from this clause. The second clause makes an exception in favour of reconstruction and amalgamation. According to this clause, reconstruction and amalgamation do not constitute insolvency proceedings and hence, they are not events of default. Legally, this is the correct position. However, the appointment of a receiver, administrator, trustee or similar officer in respect of the revenues or assets of the Borrower is a definite indication of bad health of the Borrower. Further, "suspension of its operation" cannot be an indication of bad health unless it is done due to financial reasons. Suspension of its operation by a Borrower can be for various reasons. Of course, prolonged suspension of operations can be a genuine ground for worry by the lenders.

In this respect, attention is invited to the clause used by the World Bank and quoted above. It is a very nicely drafted clause and with the addition of the word "prolonged" before the expression "suspension of its operation" can be adopted in other loan agreements.

(g) **Change of Activity**

The following is an illustration of this clause:

"The Borrower ceases to carry on the operations it carries on at the date hereof or enters into any unrelated operations. UNITAR, Art. 16.1

The purpose and object of this clause appears to be only to ensure that the Borrower may not, by changing its business activities or operations, endanger the money of the lender. However, an absolute ban on the change of activities of the Borrower may cause hardship. This clause should permit a borrower to change his activities or operations which should not materially adversely affect the paying capacity of the Borrower or, alternatively, with the prior written consent of the lender. If a lender feels, after considering the proposed activities, that they may not jeopardise his interest or may not have the material adverse effect, he may grant permission to the Borrower to
change his activities.

(h) **Validity of Agreement**

This clause is as follows:

"At any time any act, condition or thing required to be done, fulfilled or performed in order (I) to enable the Borrower lawfully to enter into, exercise its rights under and perform the obligations expressed to be assumed by it in this Agreement, (ii) to ensure that the obligations expressed to be assumed by the Borrower in this Agreement are legal, valid and binding or (iii) to make this Agreement admissible in evidence in the country is not done, fulfilled or performed." UNITAR Doc. Article (I)

"if any court makes any judgement or order, or any law, ordinance, decree or regulation is enacted, the effect of which is to make this Agreement or the Guarantee or any material provision hereof or thereof, invalid or unenforceable, and the Borrower fails to provide acceptable replacement documents to EDC evidencing and, where applicable, securing its indebtedness under this Agreement within 30 days of such event." EDC, Article 9.01(I)

The first clause deals with those actions which the Borrower is required to take in pursuance of the Article of the loan agreement relating to Conditions Precedent and Covenants. If a Borrower fails to take any of those actions, it amounts to an event of default.

The scope and extent of the second clause is entirely different. Whereas the first clause deals with the voluntary actions of the Borrower, second clause deals with the actions of certain governmental and other authorities affecting the validity of the loan agreement. In particular, this clause comprehends those actions which affect the validity of the loan agreement and are, under the normal circumstances, beyond the control of the Borrower. This clause provides some relief to the Borrower in the sense that if the Borrower provides replacement document (for the loan agreement or other documents whose validity has been in question) within 30 days to the lender, it will not be an event of default.

Thus, the Borrowers can prepare, with the help of the aforesaid two validity clauses, an appropriate and suitably worded "validity clause" for use in their loan agreements.

(i) **Unlawfulness**

This clause is as follows:

"At any time it is or becomes unlawful for the Borrower to perform or comply with any or all of its obligations under this Agreement or any of the obligations of the Borrower under this Agreement are not, or cease to be legal, valid and binding." UNITAR Doc. Article 16.1(j).

If any event takes place, after the loan agreement is made, due to which the loan agreement becomes unenforceable or unlawful or if the Borrower cannot perform its obligations thereunder, it is an event of default. When such event makes the obligations of the Borrower illegal or not binding on the Borrower, the loan agreement becomes unenforceable. The obligations of the Borrower when made were legal valid and binding. They cease to be legal, valid and binding by any subsequent legislative action or for any other reason. The object of this clause is apparent. On the happening of such an event, obviously, the lender would not be able to enforce the agreement and recover his money.

(j) **Expropriation and Disposal**

Some loan agreements declare expropriation of the Borrower or its assets by the host government or disposal of assets an event of default. The clauses relating to expropriation and disposal are as follows:

"All or a substantial part of the Borrower's assets shall be expropriated by any governmental or other authority or the Borrower shall transfer or dispose of all or substantial part of its assets." UNITAR Doc. Article 16.1(k)

"If the borrower sells or otherwise disposes of all or a substantial part of its assets by one or more transactions without the prior consent of EDC" EDC, Article 9.01(e)

The first clause can be divided into two parts. The first part deals with the take over or nationalisation or expropriation of assets of the Borrower. Normally, expropriation or nationalisation of an organisation is a governmental activity carried out in its sovereign capacity. The Borrower has no control or say in the matter. Nevertheless, expropriation or nationalisation of the Borrower's assets is an event of default. The reason being that after expropriation, the Borrower may not have sufficient funds to repay the loan amount or pay the interest due to the lender.

The second aspect is the transfer or disposal of the assets by the Borrower. It is a voluntary act of the Borrower. The clause contains sufficient safeguard to the Borrowers by providing that the transfer or disposal should be of "all or substantial part of the assets". Hence, this clause will not be attracted if the disposal of assets is in the normal course of business activities. In the second clause, the consent of the lender for the disposal of substantial part of the assets of the Borrower is necessary. It provides an opportunity to the lender to examine whether after the disposal of substantial part of the assets, the Borrower will have sufficient means or capacity to repay the principal amount of loan and pay the interest and other sums due under the loan agreement.

(k) **Moratorium –** The clause regarding moratorium is as follows:

"A general moratorium is declared of the payment of any external indebtedness for borrowed money of the Borrower or the country or the Borrower or the country is unable to pay such external indebtedness as it falls due or commences proceedings with a view to the general adjustment of its indebtedness." UNITAR Doc. Article 16.1(l)

This is a very wide clause. It deals with the declaration of moratorium of external indebtedness. It does not apply to the moratorium of domestic indebtedness. Moratorium means suspension of financial or payment obligations by a Borrower under a loan agreement. It is generally for a certain period of time. Generally, every loan agreement defines external indebtedness. If a Borrower declares moratorium on its external indebtedness, it is an event of default. Similarly, if the country of the Borrower declares moratorium of its external indebtedness, it will also be an event of default. Apart from the declaration of moratorium an inability to pay, external indebtedness is also sufficient to constitute an event of default.

(l) **IMF**

The two illustrations of this clause are as follows:

"The member of the Bank which is the Borrower or the Guarantor: (I) shall have been suspended from membership in or ceased to be a member of the Bank, or (ii) shall have ceased to be a member of the International Monetary Fund." IBRD, Sec. 6.02

"The Country ceases to be a member in good standing of the International Monetary Fund or ceases to be fully eligible to utilise the resources of the International Monetary Fund". UNITAR Doc. Article 16.1(m)

The first clause is used by the World Bank. According to this clause, if a member of the Bank is suspended from the membership of the bank, or he ceases to be a member of the Bank or ceases to be a member of the International Monetary Fund, it is an event of default. The rationale of this clause is apparent. The Borrower is a member of an institution. He ceases to be a member of that institution. The institution is justified in asking him to repay all its money immediately.

The other clause is used by the other lenders. This also has two parts. The first part uses the expression, "ceases to be a member in good standing". The meaning of this expression is not clear. What is meant by "good standing". This is a very vague expression. Further, whether a Borrower is entitled to utilise the resources of theInternational Monetary Fund is not the concern of the other lenders. Hence, this clause should not be agreed to.

(m) **Material Adverse Change**

This clause is as follows:

"Any material adverse change in the conditions of the Borrower as represented by the Borrower, shall have occurred prior to the effective date." IBRD, Gen. Con., Sec. 6.02

"if any other event or circumstance occurs which, in the opinion of the EDC, is likely to materially or adversely affect the ability of the Borrower or the Guarantor to perform all or any of its obligations under this Agreement or the Guarantee as the case may be." EDC, Article 9.01(k)

The first clause deals with a situation that has occurred prior to the effective date. Prior to the effective date, the loan agreement was not in existence. It comes into existence only on the effective date. Thus, if the lender has come to know that any material adverse change in the conditions of the Borrower has taken place, he may not let the agreement come into force. There is no question of an event of default. In such a situation, this clause looses its relevance. The intention of this clause appears to be that though the material adverse change has taken place before the effective date, but the lender was not aware of the same. The moment he came to know of the fact that before the effective date a material adverse change in the conditions of the Borrower has taken place, he declares it as an event of default.

(n) **Project Authority**

Certain international lending institutions like the World Bank, Asian Development Bank and African Development Bank, etc. follow a system of entering into a separate contract with the project authority of the project which is financed by them. It is normally called a "Project Agreement". These institutions generally provide that a failure of the Project Authority to perform its obligations under the Project Agreement shall be an event of default.

The clause provided by them is as follows:

"The Project Executing Agency shall have failed to perform any of its obligations under the Project Agreement, if any." ADB Gen. Cond. Sec.8.01(d)

This clause is wide enough to include any obligation under the Project agreement. If the Project Executing Authority fails to perform its obligations under the Project Agreement, it will be an event of default.

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 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.

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.

Street Address:
Chemin des Anemones 11 -13
CH-1219 Châtelaine
GENEVA
SWITZERLAND

Postal Address:
UNITAR
Palais des Nations
CH-1211 GENEVA 10
SWITZERLAND

Tel: +41 22 917 1234
Fax: +41 22 917 8047
E-mail: DFMinfo@unitar.org
WebSite:http//:www.unitar.org/dfm

