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Problems and Perspectives of Debt Negotiations

Papers 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)

Table of Contents

	page
Preface	2
Chapter 1: Current problems of debt negotiations and management for developing countries	3
Chapter 2: Some lessons about the negotiating dynamics in international debt transactions	14
Profile of the Authors	26

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PREFACE

This paper presents a synthesis of 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.

As mentioned above, the chapters in this document are an outcome of the discussions and presentations in this workshop and attempt at addressing practical problems and lessons which may be applicable in the context of international financial negotiations.

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 Ambassador Nguyen Quy Binh and Professor Daniel Bradlow for having contributed to this project by sharing their 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

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Current Problems of Debt Negotiations and Management for Developing Countries

by Nguyen qui Binh

Introduction

The world is embarking on the third millennium. For many developing countries, the vision of development in a new century having a healthy economy and sustainable growth is dampened by the traumatic experience of external debt burden, consorted yet with many negative impacts of globalization and wider disparity in growth rates to their disadvantage. That is not to mention of the chronic depression and crisis or of the fact that in developing countries today more than a billion people representing about one fifth of the world population are living on less then US$ one a day.. Although the main concerns are whether these problems clearly relate to institutional, policy, external or other factors, this note only concentrates on some current issues facing developing countries in their debt negotiations and management. The purpose is to discuss whether or to what extent developing countries can improve their prospect as well as their bargaining power in negotiating or managing their debts.

Current problems

I. Coping with the changes in international policy framework - With the accelerating pace of globalization and interdependence, there is an expectation that new opportunities would be opened, through increased trade liberalization and advancement in technology, for rapid economic growth and development. Nevertheless, the results are quite mixed. Some countries have successfully adapted to the changes and benefited from globalization. Some others, especially the LDCs, have not achieved any significant progress. On the contrary, they are still facing with many serious problems and have been caught in a greater risk of instability and marginalization. While domestic factors have played an important role, it seems clear that the international environment has not always been condusive to their development efforts.

In the area of financial and debt management, developing countries have also been found very often to be victims of the changing international policy framework. In other words, their policies and macroeconomic outcomes are very much driven by the economic force and the policies and actions of the decision-making centers in the rich nations, whether they are major international banks, multilateral financing institutions, investment companies or the governments of those nations[1]. Let us briefly look at such problems through some of the current policy shifts:

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[1] For more information and analysis, see "Financing Development – Key Issue for the South", South Center, 1999.

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a) Shifting to market orientation: During the early years when central economic planning was favoured by many developing countries, and public funds remained to be the primary source to boost the development process, domestic policy-makers as well as their creditors relied on the economic models to determine foreign financing requirements. The economic rational for foreign assistance and loans were however often subordinated, by many donors, to the pursuit of their foreign policy goals in the context of the East-West conflict. Over the years, with the end of the East-West conflict, political consideration is by no means diminishing. The difference is that instead of support being given to countries on account of their position in this conflict, foreign loans are now directed to countries on the basis of their adherence to principles and policies of free markets, trade liberalization and privatization. It is also the case that donors have become openly explicit in linking the provision of foreign assistance with their commercial or financial interests.

Indeed, foreign assistance is being increasingly used by bilateral and multilateral donors to push their reform agenda on developing countries. The proposed reforms may have less to do with the problems faced by the recipient than with the donors' ideology, commercial or strategic interests and domestic politics. Of particular concerns among developing countries have been the broad economic prescriptions they are required to pursue by the multilateral financial institutions in exchange for financial assistance and debt relief. These policies in many cases have done little to enhance their growth and development or their capacity to repay the debts.

For many developing countries, the adoption of undue policies of economic liberalization has increased their exposure to external economic forces over which they really have little control, making their macroeconomic management much more difficult and their economy particularly vulnerable.

There have been other strong pressures on developing countries to open up their economy and integrate more fully into the world economy. These include parallel efforts pursued vigorously in the WTO to engage developing countries in establishing global rules of trade and trade-related issues. This substantial policy shift also brings about profound consequences for developing countries: expanding export has become a central goal of their strategies for raising outputs and accelerating economic growth. Countries have viewed the inflows of FDI and portfolio investment as a reward for their pro-market and privatization policies. Their major concern now is focused on how to retain competitiveness internationally, whether by ways of exchange rate adjustment or productivity increases, so as to capture a share in the intense world market. This has naturally meant a constant fall in the prices of their exports, particularly the primary commodities[2], and a decline in their terms of trade. In fact, they really have little room to maneuver in macroeconomic as well as financing policies, and have been harmed all in different ways - some for lack of adequate international finance, others for too much of it.

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[2] Sharp fall in the real prices of primary commodities began since the early 1980s.

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One important point to emerge for the discussion and future negotiation is the question of conditionality associated with foreign loan assistance: Is it realistic for developing countries to expect or demand that foreign financing be made available only on conditions that certain project performance, accounting or reporting requirements, are satisfactorily agreed to?

b) Moving from fixed exchange rate to freely fluctuating: The shift since 1971 from the original Bretton Woods system of fixed exchange rates to an era of freely fluctuating exchange rates has also drawn damaging effects on the functioning of macroeconomic and financial management of developing countries, particularly to keep the balance of payment viable. The post World War II financial architecture was based on a regime of fixed exchange rates, with the IMF &IBRD (WB) as pillars to ensure a smooth functioning of the world payment system, and crucial to the regime was the gold standard and then the US dollars as a principal medium of exchange and store of value. However, as a consequence of continuing deficits, the US decided in 1971 to abandon the dollar's established parity with gold[3], representing a breakdown of the Bretton Woods system.

As the economic management lost the tether of fixed exchange rates, only the industrial countries were able to pursue macroeconomic policies as though there was no balance of payments constraints. Flexible exchange rates gave rise to higher inflation and hence a general acceleration of inflation since the 1970s. The OPEC action in 1973-1974 to raise oil price simultaneously led to an increase in international liquidity which paved the way for liberalization of capital movements in developed countries. Indeed, the commercial banks of the West became the direct beneficiaries of the rising fortunes of the oil producing countries. Excess liquidity also allowed these commercial banks to become increasingly prominent as suppliers of foreign finance to developing countries.

In the absence of fixed exchange rates, many developing countries resorted to the traditional practice of pegging their exchange rates to the US dollar or a basket of strong currencies to retain stability and anchor inflation. This however has not moved them any closer to financial stability. Their foreign exchange regimes become more susceptible to the fluctuating international market, particularly during the period of sharp depreciations. Serious foreign exchange risks are often associated with misalignments. A country pegging exchange rates to one hard currency may face serious deterioration in its exports and current account balance in relation to other trading partners when the latter depreciate their cornices or otherwise suffer a steep loss of competitiveness vis-a-vis them in case of appreciation. In fact, East Asia 's practice to peg exchange rates loosely to the US dollar, coupled with the Yen's sharp depreciation since mid-1995, contributed to the marked deterioration in their exports and current

[3] Which was fixed at parity of US$36 to one ounce of gold

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account balance in 1996. Pegged exchange rates regimes are also vulnerable to speculative attacks. The question of pegging exchange rates to *"a more balance basket of currencies"* or floating them with or without *"discreet"* control is now a subject of discussion[4]; yet, the issue remains whether developing countries can evade being the loser always in this game under the existing international financial system.

II. Impacts of the current decline in the official and the rise in private capital flows - During the last decade, a major change has occurred in the composition and volume of financial flows to developing countries, which has a serious impact on their financial management and negotiation of loans. Between 1990 and 1997, total net flows of official development loans (ODA) declined from US$ 53 billions to US$ 48.3 billions. At the same time, private capital flows rose from US$ 43.6 billions to US$ 252 billions[5]. The total net of capital flows from multilateral agencies and DAC members increased 2.5 times from US$ 130 billions in 1990 to US$ 325 billions in 1997[6]. This represented an increase of private capital from 33.6% to 77.7% of total net resource flows, while ODA declined from 39% to 15.3%. From 1995 to 1997, private flows amounted to almost 3 times the magnitude of official development finance flows, and over 4 times the magnitude of ODA[7].

While it is important to appreciate the micro and macro impacts of foreign financing - which is in turn dependent on factors such as the level, frequency, types and composition of capital flows - one of the clear implications of foreign capital flows has been their influence over key domestic policies. This is as true for official flows as it is for private flows.

a) Official flows: - The main component of official capital flows is ODA, which is of special interest for developing countries and which merits special attention. It composes grants or loans with low interest, long grace periods and long period for repayment that help developing countries' needs for external financial resources. It also embodies an explicit commitment of the industrial countries to support financially the development process in the developing world. The continued decline in the level of ODA during the last 20 years, especially in the present context of globalization, is a matter of serious concern.

As early as 1958, in order to quantify this commitment, the notion of having a target for donors of ODA was suggested, by an NGO, at 1% GNP of developed countries. Ever since, the measurement, content and implementation of such target have been the major issues in the development dialogue and negotiations.

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[4] See further analysis in "Exchange Rate Regimes" by Holger Wolf in "ASIA Responding to Crisis", ADB Institute 1998, at p45.
[5] Source OECD, Development Co-operation 1998 Report, OECD, Paris, 1999.
[6] Ibid.
[7] Ibidem 1, at p15, "Financial Flows to Developing Countries, An Overview, South Center 1999.

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The target of 0.7% GNP was later on incorporated in the Second Development Decade adopted in 1970. It was expected that the 0.7% target would help to reverse the decline experienced in the level of ODA since 1960; however, the long term trend has continued downwards. The end of the East-West conflict clearly marked the beginning of a steady decline in ODA. The hope for a "peace dividend" that developed countries would reduce their defense expenditures to save resources for development assistance to developing countries did not materialized. To the contrary, developing countries found themselves now competing with other countries in transitions for scarce official loans.

The global figures on ODA provided above have not quite conveyed the true picture of the decline in assistance flows. For one thing, there are more countries competing DAC funds with developing nations which were the original intended recipients. 22 countries in Central-Eastern Europe and the former USSR were also eligible to receive official ODA flows of US$ 6.6 billions in 1993 and US$ 5.5 billions in 1997. The total of ODA flows to these countries and other high income developing countries rose from US$ 1.7 billions in 1993 to US$ 2.3 billions in 1997. If these are deducted, the volume of ODA to developing countries felt from around 0.30% to 0.29% of the donors' GNP. But this is not all. For some time now, the range of purposes for which ODA funds are used has been expanded to include expenditures which do not directly promote higher levels of investment, namely emergency reliefs and administrative costs, food aid, technical co-operations …which amounted to US$ 21.9 billions in 1997. The revision of the OECD data to exclude these items resulted in a decline from US$ 32.4 to just over US$ 10 billions in bilateral ODA flows in 1997; multilateral ODA for that year therefore reduced to US$ 26 billions rather than US$ 48 billions, or only 0.12% of GNP. Further more, in the 1990s about 35% of ODA was channeled through NGOs. The diversified objectives of these NGOs, compounded by their loose accounting mechanism compared to that of the governments, have greatly affected the effective assistance of this funding.

As the overall consequence, many developing countries are experiencing serious difficulties in negotiating their loans as well as in servicing their official bilateral and multilateral debts. Donors have also started to provide debt reliefs in certain extreme cases which covered payment to the international financial institutions or even the cancellation of military debts. The problem is also that when the debt is not actually being serviced there is no net addition to the resources available to the country for economic development.

b) Private capital flows: Since 1990s, an important feature of private capital flows - comprising FDI, commercial lending and portfolio investment - has been the shift from commercial banks to non-bank sources of external finance. The flows of private capital to developing countries was increasing but not evenly distributed. Altogether, 12 countries accounted for over 80% of private capital flows to the developing countries during the 1990s - six countries on the top were Argentina, Brazil, China, Indonesia, Malaysia and Mexico. China accounted for 60% of the flows to the region and 25% to all developing countries.

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The dramatic rise in private capital flows during the 1990s was celebrated by many as evidence of the success of market liberalization and of the private sector's ability to promote economic growth. However, a pertinent question for discussion is whether the great majority of developing countries that have been bypassed by the recent surge of private capital flows are necessarily worse off than some of those recipients of such flows but have ended up with financial collapse and economic disruption. Indeed, with the increase of private capital flows over the last 25 years, developing countries have witnessed a number of major debt or financial crisis, starting from the Pertamina crisis in 1974 to the Mexican debt crisis in the 1980s and the East Asia crisis in late 1997.

A number of observers have explained the East Asia crisis in terms of misguided investments in real estate, crony capitalism in which governments and private enterprises engaged in reciprocal favours, lack of prudential regulation of domestic financial institutions and other failures. Another view contends that it has always been the private flows that have ended in a financial crisis for developing countries, and not a single case of bankruptcy of private lending institutions in industrial countries on account of lending to developing countries. In fact, the movement of private capital in the last decade create problems for developing countries in either direction : The inflows put pressure on the local currencies to appreciate which erode the profitability of the tradable sectors (mainly agriculture and manufacturing) making exports more expensive and causing the trade balances to worsen which in turn increase the dependence on foreign inflows. The outflows on the other hand necessitate domestic demand cuts, which result in a fall of domestic output capital, currency depreciations, and interest rates increases. In some cases, the fast pace of financial liberalization has also significantly delinked finance and investment from international trade and has led to high volatility of capital flows. This has weakened the capacity of some developing countries to manage effectively their integration into the world economy. The effect of the volatility need to be addressed by the international community. Experience have shown that freely functioning markets alone cannot always ensure that foreign private capital will create productive assets and yield income. There is a role here for the government to regulate the inflows of foreign capital and to channel them into areas of national priority.

FDI flows **:** Most developing countries today consider FDI an important channel for obtaining access to resources for development. While the important benefits to be gained from FDI are clear, developing countries should pay sufficient attention to its problematic aspects and the potentially serious implications that FDI may have for the balance of payment, currency markets, management of macroeconomic policies, economic growth, and even the longer run financial viability of the economy.

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The expansion of FDI to developing countries is one indicator of the pace of globalization, as multinational corporations expanded or took over production facilities abroad[8]. This was motivated, as traditional reasons, by factors of low wage costs and closeness to the markets or sources of materials. Also important is the strategic decision concerning specialization and corporate acquisitions and mergers. FDI has also been attracted by the pace of privatization and the increased tendency to allow the private sector to finance infrastructure projects, especially in countries with large and growing markets and macroeconomic stabilities. Multinational corporations in the US, UK and Japan account for the major part of the flows and stocks of FDI in recent years. A noticeable increase in FDI also comes from the developing world[9]- like Korea, Taiwan, Thailand, Brazil and Chile.

From the point of macroeconomic stability, the level and types of FDI have to be managed in the same way as other debt creating flows. FDI will give rise to a permanent stream of profit remittance abroad, assuming that profits are actually made, while in many cases there are actually no new export earnings. If FDI does not normally generate sufficient export surplus to cope with the additional FDI import demands and the repatriation of FDI profits, it will pace a foreign exchange crisis. In many other cases, foreign investors often required the government to provide guarantee to the enterprises or their borrowed loans, so that in the event of failure the government is responsible for serving the debts or compensating the investors. For the maximum benefits to be derived from FDI, there is need for careful negotiations and an appropriate regulatory framework. The necessity to put in place appropriate regulatory frameworks, particularly with the introduction of financial liberation and foreign exchange markets, is essential for developing countries to avoid financial risks and mismanagement. A global regime extending the right of foreign investors to invest as they wish with no attendant responsibilities on their part, and on the other hand limiting the right of developing countries to decide what is appropriate or what types of investments they wish to encourage cannot be acceptable. Deregulation of the financial sector can attract massive capital inflows, yet the risks of imprudent lendings and borrowings - e.g. local investors borrow short term loans with high interest rates for long term projects - can eventually create enormous problems. This has already happened with the East Asia crisis when actual risks were hidden by the pace of rapid development. Another sort of problem comes from the fact that much corruption may occur in deals relating to private investment. FDI can take the form of intra-firm loans, portfolio flows and reinvested earnings, which may be poorly recorded and difficult to tract. FDI activities to borrow funds on the local market in order to liquidate the investments rapidly, to buy foreign exchange and take capital out...may seriously affect the financial stability and economic management of developing countries. Sometimes FDI involves purchasing ownership in case of mergers or privatization which does not lead to an immediate increase in capital accumulation.

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[8] Source: UNCTAD, World Investment Report 1999: Foreign Direct Investment and the Challenge of Development, p1-17.
[9] Ibid, at p20.

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Portfolio investment: Considerable pressures have been exerted on developing countries to develop local capital markets, including the stock markets, and to engage in international financial liberation. In recent years, the *emerging markets* began to attract greater flows of portfolio investment, which are mostly in response to the chance of making a rapid gain. Since portfolio investment is essentially short term, the inflows of such capital may help finance a current account deficit, but there is no assurance that they will contribute to raise fixed investment and physical capital accumulation. In fact, these short term investments can make the currency markets of developing countries become highly unstable, and present problems for maintaining economic stability. The volatility of this form of investment is largely rooted in the herd-like behaviour of investors, and likewise the contagious effect of what they do to a market. Portfolio investment also provides favourable conditions for hedging operation and other speculative currency transactions, giving rise to exchange rates instability and currency depreciation with disastrous economic consequences for developing countries. Further more, portfolio investing in stocks, land, urban properties whose supply is relatively fixed would merely push up their prices. This can cause a spiral of rising investment and market bubbles. Over investment as such would lead to a common information failure which prevents an individual investor to pull out timely from a booming market to avoid bankruptcy. The final outcome of this would be financial crisis.

From this brief discussion of public and private capital flows to developing countries, it can be seen that external finance may have a serious impact on the economic and financial management of developing countries, particularly if the required loan transactions are not carefully negotiated and managed.

III. The burden of external debts - Many developing countries are suffering a major setback in their economic development due to the heavy burden of foreign debts. The external factors referred to above have contributed to the difficulties of speeding up their pace of economic growth and the improvement of their debt service capacity. With a significant portion of public revenues pre-empted for the servicing of foreign debts, investment programs often have to be curtailed, while resources for other socially important sectors such as education, health, nutrition are choked off. Indeed, the debt service burden in some poor countries becomes so onerous that it has led to a sharp deterioration in the health, nutrition and educational standards of their populations, among other things. Difficulty in meeting debt service obligations has also inhibited further inflows of loans, private investment or trade financing.

In the face of a dismal economic future as such, developing countries continue to call for debt restructuring to renegotiate the borrowing terms. This negotiation is usually undertaken under the auspices of the Paris and London Clubs, which may include private rescheduling directly undertaken by a country with its commercial bank creditors. The process is usually accompanied by conditions that require the imposition of severe and austere domestic economic policy measures directed at structural adjustment that may come with serious economic, social and sometimes political consequences for developing countries. The agreement on rescheduling of debts with a commercial bank is itself usually based on adoption of an IMF sponsored economic adjustment program. In essence, this whole process is a grid lock from

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which developing countries can not escape. The 1996 initiative to forgive all the debts for highly indebted poor countries (HIPC) is highly encouraging; yet it has been established on too strict conditionalities which narrows the opportunities to poor countries who may actually benefit.

Indeed, donor delay in providing debt relief to poorest countries contrasts sharply with the speed with which large financial rescue packages have been made available for major developing countries in financial and economic crisis. The same thing can be seen with the substantial debt write-offs provided to certain countries already at high level of economic achievement.

The resolution of debt crisis in which private debt is a substantial component raises important economic and political issues. The market left to them are unlikely to achieve a means of dealing with the debt in a way that limits the economic and social damages, or restore economic confidence. There are also drawbacks to the sort of intervention in which the government takes over the private sector's debt servicing obligations, possibly with financial backing from multilateral financial institutions. If the government intervenes as such, the debt burden is thereby transferred onto the public sector and the general public while private lenders engaged in rash lending bear little or no cost. This does nothing to discourage future irresponsible lending and borrowing. Thus, the issue of bankruptcy resolution is essential to the reform of the international financial system, and a fundamental rethinking on "debt workout" is required. Furthermore, debt crisis are hard to resolve if the debtors' ability to meet their obligations is compromised. There is need to properly reassess the policy conditionalities imposed by the international financial institutions to ensure that they enhance rather than reduce developing countries' capacity for development and debt payment.

IV. Lack of attention and resources for effective debt management and negotiation - With respect to domestic factors, much greater efforts are required on the part of developing countries to overcome domestic problems to achieve efficient debt management and negotiation. Quite aside from liquidity difficulties and the policy constraints facing developing countries in general, many developing countries do not seem to pay much attention to the aspect of regulatory framework or the performance of basic functions of debt management which is one of the contributing factors leading to the debt crisis. There are a variety of examples of the negligence on the part of developing countries to put in place appropriate framework to regulate the whole process of financial borrowing and debt management. Some countries lack basic laws governing the budgetary process and control, including the provisions to specify the conditions and authority to borrow. Very often, the negotiation for loan procurement is done by those officials who have little to do with government financial functions or agencies, and are concerned mainly with the borrowing aspect, not that of repayment. For the long term official loans, they might think that the obligation to repay is of the next generation. It is also the case that the borrowed loan may not necessarily relate to any particular project or program. Some other countries consider their sovereign debt figures and data as highly secret information. This apparently prevents the effective communication and cooperation among all government units. In other instances the governments, in introducing financial liberalization, remove all control over the process of private borrowing and allow the private sector to directly procure loans from abroad. This, as already happened to certain East Asian countries,

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has given rise to many imprudent borrowings and lendings, hence an influx of short term loans for long term projects in a misleading sign of boom, until the moment of burst and crisis.

Additional to the problem of inadequate regulatory and legal frameworks for financial and debt management, developing countries also encounter a great deal of impediments in achieving sufficient expertise as well as the necessary technical tool for effective management and administration. Important lessons relating to negotiating loan agreements and the question of human capacity development, particularly for lawyers in loan negotiation, have been discussed in details by the other resource persons, and not just in this UNITAR workshop; I therefore would like to reflect solely on the aspect of technical assistance designated to support effective administration and management of foreign debts.

From the point of general concept, debt management has two dimensions, the macro-economic and the micro-administrative. In the former, debt management must be seen as an integral part of the country's overall macro-economic management. In its micro-administrative dimension, it is part of the broader process of public administration and management. Effective debt management therefore involves both the *executive functions* such as policy, regulatory framework, researching, and *the operational aspects* such as administration, analysis of credit and balance of payment and budget, communications, and other operating functions. In general, there is no universally accepted model for optimizing debt management. The important issue is that all functions are being performed and all government units cooperate and communicate effectively within an integrated and clearly defined institutional framework[10] and environment.

In response to the increasing need of developing countries seeking technical assistance to improve the basic infrastructure and analytical capacity for debt management and negotiation, UNDP decided in 1988 to commission an independent study (by a group of international experts headed by Mr. Lars Kalderen, Director General of the Swedish National Debt Office) to study the experience to date and recommend on how to improve service provision. Consequently, in July 1989 a report called "debt management and the developing countries" was issued with the main conclusion that "the international debt issue cannot be handled in a measured and negotiated way so long as developing debtor countries have not created an administrative structure and capacity to deal effectively with all aspects of managing the country's external debt… some $200 to $300 millions will need to be spent on technical assistance over the next 5 years to bring external debt management in all developing countries up to an acceptable standard"[11]. Acting on the Kalderen report, the UNDP, UNCTAD and the World Bank established a Joint Program to provide technical co-operation in debt management to developing countries. This partnership - which involves not only assistance of UNCTAD and the World Bank but

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[10] UNCTAD has published a document called "Effective Debt Management" to explain this conceptual framework, and the document is available on request.
[11] Source: UNDP, Debt Management and the Devloping Countries, July 1989.

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also of other institutions such as UNITAR, IDLI, IDRC, the Commonwealth Secretariat, the Crown Agents, the regional development banks and some key bilaterals - is designed to draw on the complementary resources and experiences of these institutions in helping developing countries establish appropriate environment for debt management. This Joint Program embraces a range of activities at the global, regional or country level, and entails provision of advice on institutional and regulatory frameworks, developing and furnishing debt management software, assessing training and technical assistance needs in the medium-term, and helping to meet those needs.

UNCTAD in particular has developed a software system called DMFAS which is contemplated to efficiently support the operational debt management functions in the offices of Finance Ministries, Central Banks or other financial agencies. So far, nearly 50 developing countries have benefited from the DMFAS service. Interestingly, the current deployment of DMFAS projects is hampered by a small issue regarding the donors' idea that the beneficiaries should share part of the cost, so that UNCTAD was asked to propose a scheme for partial cost recovery. The attempt of cost recovery is rejected by the beneficiaries on the basis of argument that, in addition to making normal contribution to the UN, they cover the marginal costs of the projects in their countries and pay 13% overhead to UNCTAD for management expenditure, while the development of DMFAS has already been paid by the UNDP and bilateral donors. Some donors have effectively "frozen" their contributions pending the outcome of negotiations on cost recovery. Looking beyond this contentious issue, by improving their debt management, countries may be able to create savings which are far greater than the cost of the technical cooperation project. Yet on the donors' part, there is need also to take a more flexible approach regarding technical assistance, particularly to many poor countries facing difficulties.

Conclusion

Some basic points emerge from the foregoing discussion of the current issues of debt management and negotiation for developing countries:

- The changing international circumstances with regard to foreign financing for development objectives that lead to subsequent changes in the composition, quantity, quality and distribution of financial flows from the developed to developing countries have drawn serious and long-term impacts on the debt servicing capacity as well as on economic and social development of the latter. There are crucial issues that need to be raised in the global policy framework for responsible attention.

- Deregulation of the financial markets and the overly rapid opening up by developing countries of their capital accounts that goes together with the failure to put in place adequate regulations and monitoring mechanisms have made developing countries in particular vulnerable to financial and debt crisis.

- There is an urgent need on the part of developing countries to pay greater attention to enhancing their regulatory capacity and administrative structures for financial and debt management to reduce their vulnerability to crisis.

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Some Lessons About The Negotiating Dynamics in International Debt Transactions

Daniel D. Bradlow

Introduction

Each loan transaction has its unique features. These relate to the purposes for which the borrower is seeking the loan, the identity of the parties, both parties perceived need for the transaction to take place, the alternatives to the transaction that are available to each party, the nature of their relationship, and the dynamics that develop between the negotiators for the borrower and the lender. These factors will determine the balance of bargaining power between the parties and the drafting options that the parties make in the negotiating and structuring of their transaction.

However, these factors will not influence the basic structure of the agreement and the primary categories of clauses that will be included in the agreement. These features of the loan agreement are determined by the nature of the loan transaction itself. In this regard it needs to be recognized that all loan transactions involve the same basic deal. The lender provides credit to the borrower who promises to repay the credit with interest according to the terms and conditions established in the loan agreement. Seen from this perspective, it is to be expected that all loan agreements, regardless of the complexity of the transaction, will have the same structure and the same categories of clauses. Thus, for example, loan agreements from multilateral development banks, bilateral aid agencies and commercial lenders will all have the same structure. They will also all include clauses, however they may be designated, that perform the functions of conditions precedent, representations and warranties, covenants, events of default, and dispute settlement. The credit agreements in bond issues and project financings will also look similar.

Its follows from this that each creditor has its own model agreement, which, at least from their perspective, contains the ideal formulation for each clause in the agreement. At some point, usually early, in the negotiations the creditor will present the borrower with a draft of their "standard" loan agreement. At this point they will suggest that as soon as the borrower signs this "standard" agreement they can have the money. If the borrowers, after reading through this document, suggest to the lenders that some of the terms of this standard agreement are unduly burdensome or are inappropriate for this particular transaction, the lenders are likely to react with feigned horror and say "But these terms are included in all agreements, why will you not accept what all other borrowers are willing to accept." If pushed the lender might add that these terms are part of the market's expectation and that it is unreasonable for the borrower to expect the lenders to deviate from this custom. After all, the creditor might ask, how would they look if they agreed to make an exception for this borrower and something went wrong with the transaction and they were the borrower's only creditor who did not have the protection offered by the clauses that the borrower is challenging. Thus, the creditors will conclude, if its agreement does not contain these provisions, it may find it harder to find other banks willing to participate in the loan to the borrower or might find more difficult to raise the funds it needs to finance its lending operations.

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While the borrower should be able to adequately respond to the lender's argument and even to turn it to its advantage, the argument is a useful reminder to the borrower of four important lessons relating to negotiating loan agreements. The purpose of this paper is to discuss these lessons. The four lessons are: The Underlying Logic and the Structure of a Loan Agreement, The Legal Character of a Loan Agreement, The Document is Standard but Negotiable, and The Market has Customs but is Not Inflexible. Each of these lessons are discussed below. Based on these lessons the paper will offer some suggestions on how a borrower can use these lessons to develop a game plan for its negotiations with its lenders.

Lesson 1: The Underlying Logic and the Structure of a Loan Agreement - In general the timing of the performance required of the two parties to a debt transaction differs from the timing of the performance required in other business transactions. In most transactions, the two parties structure their agreement so that each party has to perform all or part of its obligations at about the same time that the other party has to perform its obligations. For example, in a purchase and sale contract, the buyer will have to pay the seller or make arrangements for it to be paid at more or less the same time that the seller ships the goods to the buyer. Loan transactions, on the other hand, are characterized by performances that are separated by a relatively long period of time. In a debt transaction, after the agreement is signed and becomes binding, the creditor disburses the money to the debtor. At this point the creditor has fully performed its obligations to the borrower. However, the borrower has performed almost none of its obligations. To be sure the borrower may be paying fees and even some interest to the creditor, but the majority of its obligations are still to be performed in the future. In fact, the essence of the transaction is that the borrower gets to keep the lenders funds for the specified term of the loan and is only expected to perform its principal obligation - repayment - at some point in the future. This point can be years in the future.

The separation in time of the performances of the two parties influences both the underlying logic of a loan transaction and the dynamics of the negotiations between the borrower and the lender. First, this separation in time of performance makes the lender very nervous that the borrower, having received the benefits that it expected from the transaction, will refuse to repay the lender. The lender's nervousness is exacerbated by the fact that, in performing its obligations, the lender has exchanged its hard asset - cash - for the borrower's promise that the borrower will be willing and able to perform its obligation to repay according to the terms of the contract. Finally, the lender's nervousness is increased by the fact that the credit that the lender has extended to the borrower is usually not the lender's own money but is funds that it has borrowed from someone else. This means that the lender, in effect, is counting on the borrower performing its obligations in a timely manner so that the lender will be able to repay its own obligations when these fall due.

The lender's nervousness drives the underlying logic of the loan agreement. First, it explains why loan agreements always appear to be heavily biased in favor of the lenders. Most of the clauses in the agreement are designed to deal with the consequences of the lender being nervous because it has exchanged its hard asset, cash, for the borrower's promise of future performance. In other words, a key function of the loan agreement is to give the lender the assurance of that the borrower will perform as promised. It attempts to do this through incorporating clauses that are

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designed to demonstrate to the lenders that the borrower is able and willing to perform its obligations in a timely fashion, and that, in the event that the borrower seeks to avoid performing its obligations, the lender will be able to enforce the agreement against the borrower.

The first set of clauses designed to deal with the lender's anxieties are the conditions precedent to the loan becoming effective and a binding commitment on the creditor. These conditions are designed to demonstrate to the lender that the borrower has the legal capacity to enter into a binding contract, that all the procedures necessary to make this a legally valid, binding and enforceable commitment of the borrower have been followed. The conditions precedent also are intended to satisfy the lender that the borrower has the financial capacity to perform its obligations.

The standard agreement also contains a set of representations and warranties. These are the factual statements that the borrower has made to the lender about its legal and financial situation to satisfy it that the borrower is capable of entering into this transaction and the assurances that the borrower gives to the lender about its financial and legal capacity to enter into this loan transaction. The lender may rely on these representations and warranties as providing an accurate depiction of the borrower's situation at the time that the representations and warranties are made, within the limits of the formulation of the representations and warranties. The borrower must make these representations and warranties to the creditors and must provide it with whatever supporting evidence is required by the agreement as a condition precedent to the loan becoming effective. The supporting evidence is likely to include legal opinion letters, copies of corporate documents, financial statements, and the necessary documentary evidence that the procedures required to make the loan a binding commitment have been followed by the borrower.

Once the borrower has met all the requirements specified in the conditions precedent, the loan becomes a binding commitment on both the borrower and the lender. It is at this point, therefore, that the lender must exchange its cash for the borrower's promise of future repayment. In order to protect itself against the risk that at some later stage the borrower may either become unwilling or unable to perform its repayment obligations, the lenders build into the loan agreement a series of covenants. These covenants are commitments that the borrower is required to make that it will do certain things or refrain from doing certain things during the term of the loan agreement. These commitments may include the borrower's promise:

- to only use the borrowed funds for certain specified purposes,
- to maintain the quality and quantity of its assets and the lender's ability to access these assets if necessary,
- to avoid over borrowing by maintaining certain financial ratios,
- to provide the lenders with certain information, and
- to ensure that this lender or group of creditors is not treated unfairly by the borrower as compared to the treatment it provides other creditors.

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These covenants serve two basic functions, First, they impose certain restrictions on the borrower's future actions. The logic is that these restrictions will limit the borrower's future actions to those which the lender expected the borrower to perform when it entered into this transaction. Thus the lenders are counting on these covenants to prevent the borrower from entering into any risky activities which are outside its usual range of activities. Examples of covenants that perform these functions are the negative pledge, the pari passu clause, restrictions on the purposes for which the borrower can use the borrowed funds, and requirements that the borrower maintain certain financial ratios. Second, the covenants are intended to ensure that the lender obtains certain information on the borrower, its financial condition and its activities over the life of the loan agreement. The information that the lender is seeking is that which will enable it to detect any deterioration in the likelihood of the borrower being able to perform its obligations before the borrower actually is unable to pay. Examples of covenants designed to serve this purpose are requirements that the borrower provide the lenders with financial statements and regular reports, and that the borrower allow the lenders to inspect its records and operating facilities.

To further enhance their confidence that the borrower can be forced to repay the money, the lender include a series of events of default provisions in the loan agreement. These provisions give the lender the right to call the loan in default and accelerate the loan repayment if certain described events occur. These events may include:

- the borrower's failure to repay any portion of the principal amount of the loan or to make interest payments or to pay any of the fees associated with the loan on the agreed date,
- the borrower fails to be in compliance with any of the representations or warranties,
- the borrower fails to act in compliance with any of the covenants,
- the borrower defaults on its other financial commitments, and
- there is a material adverse change in the condition of the borrower.

It is interesting to note that this list of events of defaults suggest that the lender wants the right to call the loan in default not only when the borrower fails to perform its primary obligations -- payment of interest and principal -- but also when it breaches any of those other obligations that have been included to prevent the borrower allowing its condition to deteriorate to the point where it is in danger of being unable to meet a payment obligation. Thus, in a sense the lender can be understood as having placed a protective barrier around the borrower's repayment obligation. It seeks to treat any breach of this protective barrier as an event justifying calling the borrower in default. The lender's, driven by their nervousness, want to make sure that in the loan agreement they have dealt with every possible situation that they can think of that may cause the borrower to escape its promise to repay. The lender recognizes that one possibility is that the borrower may dispute its interpretation of the loan agreement and may argue that it is not required by the agreement to make the payment claimed by the lender. To address this situation, loan agreements will contain provisions to deal with the consequences of a dispute arising between the lender and the borrower. These provisions will include a choice of governing law and a choice of governing forum so that it is clear where disputes between the parties will be resolved and according to what law the dispute will be resolved. The lenders will also seek to

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include in the agreement provisions designed to ensure that there are a minimal number of obstacles to having the governing forum decide the merits of their claim. This means that it will require the borrower to waive any immunity it may have, to take whatever steps are needed to ensure that it is subject to the jurisdiction of the forum and that it waive its rights to raise most objections to the forum's jurisdiction over it.

The second major consideration influencing the structure of the loan agreement is the interest of both parties in having a transaction that functions efficiently. This means that the parties need to spell out in their agreement exactly how the money will be disbursed to the borrower and how it will be repaid to the lenders. They also need to agree on such matters as how they will communicate with each other and how the borrower will indicate to the lenders that it is meeting all of its commitments under the loan agreement.

While these two considerations explain many of the clauses of the loan agreement, they are not a complete explanation of the contents of a loan contract. Even if these two factors are comprehensively dealt with in the loan contract, the agreement is not complete unless it deals with the possibility that the assumptions that the parties have made about the transaction could turn out to be incorrect. They could be incorrect because of developments that the parties may or may not be able to control. Thus the contract needs to contain clauses that deal with changes in the circumstances of the contract and that assign the risk for these change in circumstances to one or other of the parties. As may be expected, the usual situation is that the risks are assigned to the borrower.

Based on the above explanation of the contents of the loan agreement, it can be seen that the clauses of any loan agreement can be categorized into the following 3 types of clauses[1]:

Operational Clauses: these clauses are designed to make the financial agreement operational. They include the amount of the loan, the repayment schedule , the interest rate, the interest period, definitions, the disbursement schedule, notice requirements, the purpose of the loan, the role of the agent bank, tax issues and the fees associated with the loan.

Protective Clauses: these clauses are designed to protect the lender and restrict the borrower's future actions in order to enhance the likelihood that the borrower will repay the loan according to the agreed schedule. These clauses include the conditions precedent, the representations and warranties and the covenants.

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[1] See K. Ventakachari, The Eurocurrency Loan: Role and Content of the Contract in L. Kalderen and Q. Siddiqi, Sovereign Borrowers: Guidelines on Legal Negotiations with Commercial Creditors (1984) for more detailed description of these three categories of clauses.

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Change of Circumstances Clauses: these clauses are designed to deal with problems that may arise during the course of a loan transaction. In particular the purpose of these clauses is to define possible events that may occur in the future and establish their consequences. These clauses include the events of default, the change of circumstances clauses and the clauses dealing with dispute resolution.

Lesson 2: International Loan Agreements are influenced by the Common Law - International loan contracts, such as Euroloan agreements and agreements with multilateral development banks, are heavily influenced by common law particularly the US common law and the common law approach to contracts. This approach is premised on the autonomy of the parties to determine their own contractual arrangement. This means that the law will allow the parties the freedom to structure their relationship to suit their own needs. As long as the parties act lawfully and have described their arrangement comprehensively so that any reader of the contract can understand how they want the transaction to proceed, the law will defer to their wishes. The law will not defer to the parties in two situations. The first is when the parties are seeking to engage in activity that is not in conformity with the laws and policies of the relevant jurisdiction. The second is when the parties' agreement is not comprehensive, in the sense that it does not clearly and unambiguously deal with the issue that has arisen between the parties or is silent on the issue.

There are two conclusions that can be drawn from the common law character of international loan agreements. The first is that in drafting such agreements, the parties seek to maximize their autonomy by drafting agreements that are as comprehensive as possible. Their hope is that if they can be comprehensive in their drafting, they will make the agreement as predictable and as consistent with their interests as possible. They also hope that this will minimize the risk that one party will resort to a court of law to intervene and interpret their contract for them. One consequence of this is that every time a loan provision is shown to provide an inadequate solution to an issue that has arisen between the parties, the lenders will attempt to redraft that clause in their future agreements. Their goal is to ensure that in the future that issue will clearly produce their desired outcome. One necessary consequence of this approach to contract drafting is that loan agreements have become longer and more detailed over time.

The second result is that in order to ensure that they can achieve the predictability and autonomy that they are seeking, lenders include in their agreements a choice of what law they want to govern their agreements. They want a law that will do two things. First it must respect the principal of party autonomy. Second it must have a sufficiently well developed body of law on debtor-creditor relations that they can have a good idea about how it is likely to resolve any issues on which the contract may be less than clear. This means that in Euro-loan agreements the lenders are more likely than not going to want to select the law of England or New York as the governing law.

At first a borrower may find the lender's insistence on New York or English law as the governing law disconcerting. However, borrowers should think carefully about whether this choice works to their disadvantage and, if so, to what extent. In this regard, it is useful to remember that the key service that the governing law must

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provide to the parties is predictability. This means that the law should be sufficiently well developed that it can provide answers to any questions that may arise out of the parties loan transaction. This means that the law should be well developed and have a substantial body of case law that is likely to address whatever issues may arise between the parties. New York and English law, because of the importance of London and New York as international financial centers, satisfies this criteria.

One other point of interest for borrowers to contemplate is that jurisdictions with well developed legal systems are also likely to have a well developed system of defenses and protections for borrowers. This means that these legal systems, in fact, may offer a particular borrower better legal protection than it is able to obtain under its own law.

Lesson 3: The Document is Standard but Negotiable - As was discussed above, from the lender's perspective all loan transactions are essentially the same: they involve lending money that must be repaid according to the agreed schedule. Lenders argue that it follows from this observation that all loan agreements will have to deal with the same issues and so should contain the same clauses. As a result, each lender tends to develop a model loan agreement that it believes best addresses its concerns about the risk of non-payment and establishes the most efficient procedures for executing the transaction. The lender then seeks to have each of its borrowers accept this "standard" agreement.

The existence of this "standard" agreement enables the lender, when providing the borrower with the draft of this agreement, to say "this is our standard agreement and if you will sign it we will provide you with the money". This gives the lender a significant advantage in its negotiations with the borrower. The reason is that it seems to place the borrower in the position, when requesting any changes in the terms of the agreement, of having to frame its request in such a way as to justify a deviation from the "standard document". This appears to increase the negotiating burden on the borrower. It may also induce some borrowers to be hesitant about proposing any amendments to a term of the document.

Before the borrower succumbs to this hesitancy there are some issues that it should take into account. The first is that, while it is true that the core elements of all loan transactions are similar and the fundamental risk associated with all transactions are identical, it is not true that there is such a thing as a "standard" loan agreement. What is standard about loan agreements is that all loan agreements are likely to contain representations and warranties, conditions precedent, covenants, events of default and dispute settlement clauses. However, there is diversity in the way in which these clauses are drafted. Consequently, while borrowers may have to accept the presence of each of these categories of clauses in their loan agreements, they do not have to accept the lenders proposed way of drafting each of these clauses. In fact, all lenders will agree to deviations from their "standard" clause if they become convinced that the deviations are necessary in order to structure a successful business agreement. Lenders can be persuaded of this either by the specific facts of the transaction or by the borrower's argument about why the change is needed.

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It follows from this point, that while the "standard" nature of loan agreements may place constraints on the borrower's negotiating room, a proper understanding of the "standard" nature of the agreement also helps the borrower identify the space for negotiation that is open to it. This space is focused primarily on the precise formulation of each of the terms of the loan agreement and the inter-relationship between them rather than on the broad structure of the loan agreement.

This general point about "standard" loan agreements, is applicable to all lenders, including such lenders as the World Bank and the other multilateral development banks. The World Bank's agreements consist of two parts - the general terms and conditions applicable to all IBRD loans or IDA credits and the contract applicable to each individual transaction. The multilateral development banks, like any lender, seeks to convince its borrowers that all terms of these agreements are standard. In fact this is only partially correct. The general terms and conditions are standard while the project specific agreement is subject to variation. Consequently, it is extremely difficult to persuade the World Bank to amend the general terms and conditions because this requires the Bank to make the same change for all borrowers. However, it is easier in appropriate projects to get the World Bank to agree to modify the effect of the general terms and conditions through the provisions contained in the project specific contract. In fact, the first article of the general terms and conditions states that in the event of a conflict between the general terms and conditions and the specific contract the specific contract governs.

It is also useful to keep in mind in connection with the World Bank that all its loan agreements become public documents. Consequently, even though a change in a specific document is only applicable to the specific borrower, the terms of the contract do establish a public precedent that other borrowers can refer to in their negotiations with the Bank. The same is not true of contracts with commercial lenders. Their agreements are not made public. However there is some leakage of these documents and it may be possible for borrowers to obtain copies of the loan agreements that other borrowers have entered into with the same lender.

Lesson 4: The Market has Customs but is Not Inflexible - An objection that a lender may raise to a borrower's proposed changes to a draft of a specific clause is that they are inconsistent with the "custom" of the particular market in which the borrower is seeking to obtain funds. Through this argument, the lender is seeking to suggest that all lenders in the market use the draft proposed by the lender, and that the borrower, by objecting, is either uneducated in the ways of the particular market or is being unreasonable in even making its proposal.

It is often difficult for the borrower to respond to this argument. In order for markets to function efficiently there must be some market conventions. These conventions, if appropriate will operate in the interest of all participants in the market. Thus, it is in the borrowers interest that there be certain conventions governing how particular financial market operate. These convention enable the borrower to accurately and efficiently assess the terms of the offers it receives from the banks. Examples of the types of issues that are beneficially dealt with through market conventions are the rules for calculating interest payments and for counting days, so that both parties know when notices to withdraw funds should be given or when they are required to

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make certain payments. It is also useful for there to be market conventions in cases where the parties to the transaction might be negotiating the terms of an agreement that will be applicable to actors other than themselves. For example, where a lead bank is negotiating the terms of a syndicated loan which other banks will be expected to accept if they wish to participate in the syndicate. Another example is loan transactions in which the lender intends to sell off the loan as soon as it can find a willing buyer. In these cases it is useful for potential third parties to know that certain issues of critical importance to them will be dealt with in the customary manner. In these cases, certain market conventions will promote the liquidity of the loan which may beneficially affect its price to the borrower.

Never the less, the lender's claim of "custom" must be viewed critically. While the claim has validity in regard to the inclusion of a particular of clause in the agreement, it may not have the same validity in regard to the drafting of the clause. The reason is that, in fact, there is such great variety in the drafting of all the clauses in loan agreements that it is hard to identify the "customary" draft of any particular clause. This is to be expected since lenders and their lawyers do not agree on what is the optimal draft of each clause. Moreover, in individual transactions the borrower and lenders draft of compromise on the drafting of the clauses of their loan agreement. Thus the precise formulation of each clause in each loan agreement will depend on the facts of each case and the dynamics of the negotiations in each case.

Borrowers are therefore, well advised to treat any claim of market custom with skepticism. They should carefully analyze the claim to see if it truly serves the goal of promoting market efficiency and they should test the claim empirically by reviewing a number of different loan agreements to see if they all treat the issue in the same "customary" way. If the lender's claim of "custom" fails on either of these counts, the borrower can assume that, at least in principle, it is possible to negotiate over the drafting of the clause at issue.

The question of market custom raises another issue for borrowers. This issue is how to address the lender's implied admonition that the borrower in challenging the "custom" is displaying its ignorance of international finance. Left unstated is the lender's perception that the borrower, by showing its ignorance, may be indicating that it is a greater credit risk than the lender originally thought. While there is obviously no necessary connection between the borrowers' knowledge of market customs and its ability and willingness to pay, it is clear that its ignorance of market custom does not cast it in the most favorable light. To avoid this problem, borrowers need to educate themselves about market customs and they need to take these into account in developing their negotiating proposals and strategy. While this knowledge might inhibit them from making some creative but unusual proposals, it is more likely to empower them: The more knowledge that they have about market customs, the better they will be able to assess the reasonableness of the lender's proposals, and the validity of its arguments against the borrower's proposals. This knowledge will also enable them to make a more informed judgement about their own negotiating strength and to determine how best to allocate their negotiating capital.

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A Proposal for the Borrower's Game Plan - Based on The Above Four Lessons
Based on the lessons described above, the borrower can draw a number of conclusions that can help it shape its approach in its negotiations with a potential lender. First is a general conclusion that follows from all four lessons. This is that all borrowers, regardless of how weak their negotiating position might seem to be, do have some negotiating power. Consequently, they are not forced to accept the lender's standard agreement without amendment. This point necessarily follows from the fact that while there are structural features common to all loan agreements, there is great variety in the precise formulation of each contractual provision. This means that the parties, in principle, will always have options available to them in deciding how to formulate of any particular provision to utilize in their agreement. This means that the possibility exists for each borrower to argue for its own favored formulation. In this regard it is important to remember that even the most hardline lender recognizes that its standard agreement may not be appropriate without change in all circumstances and that it may be in its own best interest to listen to the borrower's proposals for amending the agreement.

The above four lessons, however, also suggest that the borrower's negotiating room is constrained by the nature of international loan transactions. These constraints arise from the logic of the loan agreement and the need for the borrower to convince the lender to surrender its cash in return for the borrower's promise of future performance. They also arise from the basic similarities between all loan transactions that give all loan contracts a certain uniformity and the limited number of market customs that are necessary to ensure the efficient functioning of financial markets. However, within these constraints it is possible for borrowers to negotiate the specific terms of any particular transaction. This means that it is open to borrowers to challenge the drafting of almost any clause of the loan agreement. It also means that it is possible for borrowers to suggest tradeoffs between the clauses so that a clause that is viewed as more favorable to the lenders can be offset by another clause that is drafted in a way that is more acceptable to the borrowers. Similarly the borrowers can propose tradeoffs between the legal terms of the agreement and the financial terms. For example the borrower could propose that it be compensated by a reduction in the cost of the loan in return for accepting more restrictive clauses in the agreement. Alternatively it can offer to pay slightly more in order to obtain less restrictive clauses.

In addition to the above general conclusion, a number of specific conclusions can be drawn from the lessons described above. The first is that the underlying logic of the loan agreement helps explain the lender's fundamental objective in any negotiations over a loan transaction. In any loan negotiation it is seeking to ensure that the borrower will not undertake any unduly or unexpected risky activity that may increase the possibility of it being unable to perform its obligations as promised. In fact, the lender's instinct is to so restrict the borrower's ability to engage in risky activity that the only possible use the borrower can make of the funds is to place them in a fixed deposit with the lender, with the maturity of the deposit timed to match the maturity of its repayment obligations. Obviously the lender cannot achieve and does not expect to achieve this objective. This exaggeration of the lender's perspective however is a useful reminder that what the lender is seeking in the negotiations is to make each covenant and each representation and warranty as expansive in scope as possible.

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The borrower, on the other hand, is seeking to achieve the greatest possible freedom in how it conducts its business and uses the money that it receives from the lender. Its instincts lead it to want to convince the lender to give it the money and leave it alone until the day for repayment comes. Clearly, the borrower recognizes that this objective is unrealistic. This exaggeration, however, highlights that the borrower's basic objective in the negotiations is to maximize its freedom of action during the course of the loan transaction by limiting the scope of each restrictive covenant and representation and warranty as much as possible.

The negotiating dynamic between the lender and borrower is, therefore, to find the mutually acceptable balance between restricting the borrower's ability to engage in risky activity and giving the borrower the necessary flexibility to profitably conduct its affairs and to meet whatever situations may arise in the future. This dynamic should guide borrowers in framing the arguments they make to lenders and in deciding how to allocate their negotiating resources. It should also guide a lender in deciding when to accept the borrower's proposals for changes in its proposed clauses and on the tradeoffs it will demand for doing so.

The efficacy with which the borrower can advocate for its position will be enhanced if it understands how each clause in the loan agreement serves the lender's basic purpose of allaying its nervousness about entering into a loan transaction. If the borrower has this understanding it will be better able to develop arguments that the lender may find persuasive in advocating for its proposed draft of a specific clause of the agreement. This knowledge will also help the borrower gauge how flexible the lender is likely to be on any particular negotiating point. The knowledge should also assist the borrower in assessing how to allocate its negotiating capital.

The common law nature of international loan agreements also offers a relevant insight in this regard. It is in the interest of both the lender and the borrower that each clause in the loan agreement be drafted in such a way as to maximize their autonomy over their transaction. This means that it should address all foreseeable issues relevant to each provision and that it do so in clear and unambiguous language. Failure to do so increases the risk that the courts will be required to intervene and decide some issues for the parties. This situation suggests a way for the borrower to maximize its negotiating space. To the extent that the borrower can point out to the lender that its formulation of a particular clause deals more effectively with all foreseeable events than what the lender is proposing, it will have a reasonable chance of persuading the lender to accept its proposed draft of the clause.

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The lender's claims that all loan agreements are standard and are based on market custom offer the borrower two important insights. First, they highlight the need for the borrower to carefully prepare for loan negotiations. A well prepared borrower must understand the market customs in the particular market in which it is seeking to borrow. This knowledge must include information on the structure and content of the loan agreements used in the market. As we have seen above, while there is not one standard formulation for each clause in all loan agreements, the basic structure of loan agreements are standard. This means that the more loan contracts that the borrower can obtain and review in preparation for the loan negotiations the better. The knowledge to be gained from this exercise will not only educate the borrower on how different lenders in the same market approach the same problem but will also educate it on what are the most desirable drafting options.

Conclusion

The underlying logic of loan agreements contains some important lessons for borrowers. These lessons help highlight the constraints on the borrower's negotiating room and the areas within which the borrower does have the capacity to conduct negotiations with its potential creditors. While each borrower's negotiating capacity is dependent on the facts of its particular situation, it is clear that every borrower has the ability to negotiate the drafting of each clause of the agreement. However, in order for each borrower to be able to effectively exploit its negotiating potential it needs to be knowledgeable about the basic logic underlying all loan agreements and how this affects the structure of the legal and the financial relationship between the borrower and the lender. It also needs to be familiar with the diversity in formulations used in the clauses of loan agreements and how these have been interpreted by the relevant courts that have been called upon to interpret these clauses. In addition, while the borrower must be respectful of and knowledgeable about the customs of the market and the standard practices of the lenders, it should review claims of market custom and standard provisions with care and with an understanding that not all such claims are necessarily completely valid.

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PROFILE OF THE AUTHORS

Ambassador Nguyen Quy BINH is currently the Ambassador and Permanent Representative of the Socialist Republic of Vietnam to the United Nations and other International Organizations in Geneva. He holds an LL.M degree (1990-1991) from Harvard Law School, MA, USA as well as an LL.B Diploma (1980-1981) from the Institute of Social Studies, the Hague. His fields of specialization include Law and Multilateral Diplomacy, Development Planning and Debt Management as well as specific issues involving loan agreements and the role of the lawyer in the borrowing process. From 1994-1997, Ambassador Binh was Director, International Law and Treaty Department of the Ministry of Foreign Affairs as well as Chief Negotiator in Legal Affairs for the Ministry in Hanoi, Vietnam. From 1992-1994, he was Deputy Director, for the same department. Earlier, he has also been a Legal Officer at the Vietnam Permanent Mission to the United Nations in New York and in Hanoi.

Daniel D. BRADLOW is Professor of Law and Director of the International Legal Studies Programme at the Washington College of Law, American University, Washington, D.C. where he specializes in international economic law. His current scholarship focuses on the international financial institutions, the international legal aspects of sustainable and equitable development, and the legal aspects of debt and financial management. He has been a Senior Special Fellow of the United Nations Institute for Training and Research (UNITAR) and serves as an advisor to the Rethinking Bretton Woods Project. In 1996 he was a Visiting Professor at The Community Law Centre at the University of Western Cape, South Africa. He has lectured in many countries in Africa, Asia and Latin America on international financial law and international business law issues. Prior to joining WCL, Professor Bradlow was a Research Associate at the International Law Institute and a consultant to the United Nations Centre on Transnational Corporations, as well as an attorney in private practice. He has edited books and published articles on international financial law, the international financial institutions, foreign investment, the World Bank Inspection Panel, and the changing responsibilities of the World Bank and the IMF in the management of the global economy. Professor Bradlow holds degrees from the University of Witwatersrand, Northeastern University and Georgetown University and is a member of the New York and District of Columbia Bars.

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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 Chatelaine
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

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