CHAPTER 2

Loan Agreements

> *If you repay me not on such a day ... Be nominated for an equal pound of your fair flesh, to be cut off and taken in what part of your body pleaseth me.*
>
> William Shakespeare, *The Merchant of Venice*

Vulture funds are successful because courts enforce their right to collect the full value of a debt as stipulated in the loan agreement. Nearly all the arguments used to justify enforcement of the funds' rights are found in the different clauses of the agreement entered into when the loan is assigned from the primary lender to the vulture fund.

This chapter explains what a loan agreement is and outlines the main types of agreement. It describes their basic structure, and summarises the main concepts and clauses of a typical loan agreement and some of the loopholes which allow vulture funds to operate.

Finally, it stresses the importance of understanding what a loan agreement and its clauses entail, and draws lessons from various cases and experiences.

2.1 What is a loan agreement?

A loan agreement is the written contract between a creditor and a borrower. It sets out the rights and obligations of each party regarding a specified loan. The agreement defines the following:

- the parties to the contract;
- the purpose for which the obligations of both parties are being drafted; and
- the terms and conditions on which the agreement is valid.

In a normal contract between two parties only the intentions of the parties involved in the process are noted down in the agreement. However, in a loan agreement, the concerns of other creditors may have a role in the agreement between one particular creditor and the sovereign debtor.

In the present context, a loan agreement is a legally binding contract which makes a specific value of funds available for disbursement to a borrower by a particular lender. The loan agreement also stipulates in its clauses the amount to be disbursed in accordance with the terms set out in a repayment schedule or a promissory note.

Every loan agreement has unique features which depend on the purpose of the loan. Every agreement contains some basic provisions. Some agreements are used as 'standard' contracts. Regional Development Banks or IFIs such as the IMF, World Bank and African Development Bank (AfDB) use a standard contract. The reason for this is to safeguard the interests of the creditor, since the borrower has no say in terms and conditions already drafted. It also brings a degree of consistency to all lending and ensures that there are not different rules for different borrowers. There will also be a second agreement with other clauses highlighting the terms and conditions under which the project will be fulfilled, known as a project specific agreement or project specific contractual terms.

However, since the standard contract is known to be non-negotiable and is drafted after taking into account the lender's concerns about the risk of non-payment, it is always advisable for the borrower to have a proper understanding of all the terms included in the standard agreement. An example of such a loan agreement can be obtained from the AfDB website.[13]

General advice given by the Legal Debt Clinic is that it is always worth reading through and challenging the precise way the standard clauses are formulated, even though they appear to be non-negotiable.

The nature and form of loan agreement will differ according to the status of the creditor. IFIs will have one type of loan agreement, bilateral creditors another and commercial creditors yet another. Assigned new creditors, in other words vulture funds, usually enter into an agreement known as a settlement agreement which is attached to the initial loan agreement.

This chapter focuses on the structure of a loan agreement where the contract does not have standard non-negotiable terms and conditions. These are the contracts that are the subject of lawsuits and are therefore particularly relevant for vulture funds.

In every loan agreement, the terms and conditions can be classified under three categories of clauses:

A Operational clauses

B Protective clauses

C Change of circumstance clauses

Operational clauses make the loan agreement workable, that is they highlight the amount being disbursed, the purpose of the agreement and how the repayment will be scheduled.

Protective clauses enable the creditor to maximise its security by imposing conditions on the borrower. They limit the future activity and freedom of the borrower and will be analysed below.

Change of circumstance clauses aim to deal with problems which may arise during the course of the loan agreement, as predicted in the operational clauses, or they may cover events which can be envisaged and may happen outside the control of any of the parties to the contract. Such events are known as 'events of default'. There may be many of these, but they have to be specifically provided for under the contract.

2.2 Structure of a loan agreement

The basic structure of a loan agreement is as follows:

- **The preamble** stipulates the broad intentions of the parties; it is advisable to widen it to include several intentions.
- **The definition section** defines fundamental concepts used in the contract; it defines the role of the people who will represent each party and defines terms such as 'floating rate of interest', 'the project' and 'the currency'.
- **The description** describes the project, the parties' obligations and any time limit for the fulfilment of the obligations.
- **Terms of repayment** stipulate the currency, interest rates and period of the loan.
- **Default clauses** describe events which will be considered as a failure to fulfil the obligations under the contract and what the consequences and penalty will be.
- **Legal provisions** set out the governing law of the contract and the means of obtaining redress if one of the parties defaults on their obligations under the contract.
- **Clauses of conditions precedent** make disbursement possible or make the contract effective in terms of grants.

This is the structure of a standard contract that any creditor will try to make a sovereign debtor agree and adhere to.

2.3 Concepts under a loan agreement

We now highlight some important concepts and clauses which throw light on how vulture funds operate. We give an overview of these concepts, rather than a detailed analysis. Most of them will be illustrated by cases and examples in later chapters. The concepts are:

A Operational clauses

Applicable law clause

B Protective clauses

Conditions precedent

Negative pledge clauses (NPCs)

Pari passu clauses

Collective action clauses (CACs)

C Change of circumstance clauses

Events of default clauses

Late payment of amounts due

Breach of obligations

Misrepresentation and warranty

Cross default

Material adverse change default

A Operational clauses

Applicable law clause

The most important and relevant operational clause for the purposes of lawsuits is the applicable law clause.

This provides for the applicable law which will govern the loan agreement in the case of disagreement between the parties or default in their obligations. Usually, both parties determine the applicable law. Parties tend to opt for a sufficiently developed jurisdiction: the UK or New York jurisdictions have been favourites. The borrower should always opt for a jurisdiction where it will be equally protected in its rights. With the development of future legislation regulating the activities of the vulture funds (as in the UK and USA), it is advisable to opt for one of these countries as applicable law. At the time of writing, the UK has passed legislation regulating the activities of vulture funds and the USA has reintroduced a Bill relating to stopping vulture funds' activities. (There is more about this in Chapter 7, Legislation.)

It is a mistake for the sovereign debtor to submit to a jurisdiction not provided for in the loan agreement. Refusing to submit is a powerful legal argument against the creditor which will undoubtedly lead to the withdrawal of the lawsuit.

In the case of *Donegal International Ltd v Republic of Zambia & Anor,*[14] Zambia submitted to the UK jurisdiction, whereas Donegal was unsuccessful in the Cayman Islands and British Virgin Islands. If Zambia had not submitted to the UK jurisdiction, the vulture fund would not have had recourse to court until Zambia expressly waived its right before the UK court during court proceedings.

The Legal Debt Clinic encountered another bilateral agreement which involved an African government as the borrower and a Yugoslavian company as the lender. The applicable law governing the contract was that of Switzerland. The settlement of disputes was to be referred to arbitration by the International Chamber of Commerce, Paris, in accordance with its rules of procedure. Arbitration was to take place in London, UK, or any other place mutually agreed by the parties. This example shows how the borrower exposed itself to an unknown law, Swiss law, and to settlement in a foreign jurisdiction.

B Protective clauses

Conditions precedent

Conditions precedent are preconditions which must be fulfilled before a loan agreement becomes operational. Once funds are lent by a creditor, it becomes proof of the fact that the conditions precedent have been met. Every loan agreement, whether with an international financial institution or any other creditor, has conditions precedent. Such conditions relate either to the validity of the contract or to the disbursement of funds by the creditor. Until the conditions are met there is no exchange of obligations by either party. In some cases, there are time limits to fulfil the conditions precedent and it may be difficult to honour these. It is worth seeing if these time limits can be removed: otherwise it is essential to keep to them.

It is always advisable to obtain a legal opinion about the conditions precedent before signing an agreement. The clause on conditions precedent varies but will usually contain the following words: 'This loan agreement shall not become effective until ...' or 'No disbursement of funds will be made until ... '.

The conditions precedent may vary from one creditor to another. Debtors should always pay attention to them as they may have an important impact if the matter goes to court and they had an obligation to fulfil under the contract. This is particularly relevant when the conditions precedent concern such legal issues as requirements which will make the contract valid and enforceable, warranty issues or who

has the power to enter the agreement and bind the government. It must be stressed that the conditions precedent have important implications regarding the validity of loan agreements and so are most carefully drafted and presented by the creditor.

Borrowers need to be cautious, as legal implications and liability will follow once the conditions are met. It is advisable to make a list of documents required under the conditions precedent and to include the list in the contract so as not to fall into default. Usually the vulture fund will also include certain conditions precedent after stepping into the rights of the original creditor in the settlement agreement.

Negative pledge clauses

Negative pledge clauses are standard provisions in loan instruments which regulate the granting of security interests in a sovereign debtor's assets. They are categorised as protective clauses in the loan agreement.

NPCs may prohibit borrowers from encumbering their assets through the creation of liens, mortgages or other encumbrances, or they may require borrowers who do encumber their assets to secure a creditor's claim equally and rateably in order not to subordinate the present creditor's claim to those of prior creditors. The purpose of such an NPC is to preserve the assets and future revenues of borrowers by preventing the assets from being used to secure other loans which would jeopardise their current priority claim on the sovereign's assets. It is also referred to as a 'covenant of equal coverage'.

An NPC gives the creditor security. The borrower should negotiate this clause as a reason to borrow money at a lower interest rate or to obtain other financial advantages.

An example from the African Development Bank's agreement

It is the policy of the Bank, in making loans to, or with the guarantee of, its Member States not to seek, in normal circumstances, special security from the Member State concerned. However, the Borrower or the Guarantor shall ensure that no other External Debt shall have priority over its loan or guarantee obligation in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such Member State.

Pari passu *clauses*

A *pari passu* clause is included in every sovereign debt agreement. There has been much debate about this principle and its meaning, especially after the pronouncement by the Belgian courts, when it was raised by Elliott Associates.[15] The traditional meaning of *pari passu* clauses is that all creditors should treated equally in

repayment terms in the event of bankruptcy or insolvency. The Belgian judgment introduced a new interpretation: that one creditor cannot receive any repayment until all other outstanding creditors receive a *pro rata* repayment. This clause prevented the sovereign debtor, Peru, pursuing its debt restructuring by withholding payment from Elliott Associates. This clause therefore stops debtor countries from agreeing to a settlement agreement or restructuring their debt with some creditors who are agreeable, and not take into account payment to the creditors who disagree. The power of this clause will be illustrated in Chapter 3, Lawsuits, by the case of *Elliott Associates, LP v Banco de la Nacion and The Republic of Peru*.

From the perspective of threats by vulture funds and their activities, the *pari passu* clause has become an effective means of seeking repayment if the creditor is unwilling to agree to a restructuring process. This was the strongest argument made in the case of Elliott Associates against Peru, which the Belgian court accepted. In law, Elliott Associates was right to object to the restructuring process and demand repayment of its debt on the basis of the *pari passu* clause.

For reference we provide an example of a *pari passu* clause in a loan agreement between Republic of Cameroon and Midland Bank PLC, where the latter subsequently sold the debt to Rumbold, a vulture fund. Such a clause can stand on its own as a paragraph or is inserted as part of a clause:

> Under paragraph 9 'Undertakings'
>
> 9.1 The Borrower undertakes with each of the Bank and the Agent that, from the date of this Agreement and so long as any moneys are owing under this Agreement, it will:
>
> (d) ensure that its obligations under this Agreement shall at all times rank at least *pari passu* with all its other present and future unsecured and unsubordinated obligations of the Issuer, present and future.

Collective action clauses

In order to reduce protracted sovereign debt restructuring it was necessary to find a clause in the contract which would allow swift and binding debt restructuring. CACs are clauses in bond agreements that allow the restructuring of a country's debt, as long as a majority of creditors approve. CACs weaken the power of vulture funds by eliminating the legal basis on which one vulture fund creditor can hold out and stop a debt restructuring process. CACs force all creditors to accept a restructuring decision approved by a sufficient majority. For example, in the Peru case, if there had been a CAC, Elliott Associates would have been forced to accept the debt restructuring agreement, as the majority of creditors were willing to restructure the

debt. Elliott Associates would have had no legal basis for bringing the lawsuit as a hold-out creditor, or would not even have been allowed to hold out.

CACs provide a way of discouraging vulture funds, but they are used in bonds and not loan agreements. The G10 endorsed the use of CACs in 1996 and other states followed suit in 1998. IMF communiqués also call for increased use of CACs. After the success of the Elliott Associates lawsuit, one measure against the *pari passu* clause has been the CACs.

It is argued that although CACs can only be utilised in bonds, the principles and conditions provided for under CACs can be inserted as clauses in a loan agreement. However, the drawback is that such clauses are unattractive to many creditors and can effectively raise the costs of borrowing. The Legal Debt Clinic advises more prudent borrowing with safer clauses, even at the expense of high costs of borrowing. If all sovereign debtors insist on including such clauses, creditors will readily accept them.

C Change of circumstance clauses

Note: This section uses the terms 'defaulting' and 'non-defaulting' party as well as 'borrower' and 'lender'.

Change of circumstance clauses are needed as protection by the non-defaulting party if the defaulting party fails to fulfil part of its obligation under a loan agreement. As the lender has already given money to the borrower under the agreement, change of circumstance clauses are often for the benefit of the lender, as it believes that the borrower is more likely to be in difficulty and be unable to repay on time. The lender therefore includes a set of circumstances which would make the borrower unable to escape its obligation. These changing sets of circumstances can be circumstances arising from those already defined in the loan agreement or new circumstances beyond the control of the parties. They are known as the events of default.

Events of default clauses

Events of default clauses allow the non-defaulting party to stop performing its obligations if such events occur on the part of the other party. They are critical clauses in a loan agreement. The events of default provisions are drafted taking into account the commercial realities of the transaction.

Events of default are those material circumstances which can substantially prejudice the position of the non-defaulting party. The agreement will set out the circumstances to be explicitly as considered events of default, which may even enable the non-defaulting party to terminate the agreement. The defaulting party will have to examine the background to see if the default clauses really will prejudice the non-defaulting party. Otherwise, the defaulting party may find itself in difficulties.

Clause of default in the settlement agreement entered between Zambia and Donegal International Ltd

Under the default sections, clauses 2.1, 2.2 and 2.3, it was provided that Zambia should make 36 monthly payments to Donegal in the total sum of US$14,781,498.96, together with interest on the unpaid balance calculated at the rate of 6 per cent per annum. It also provided that *only 21 days* after Zambia defaulted upon *any payment*, Donegal could elect to terminate the settlement agreement by a notice in writing.

'Upon service of the Notice, *this Agreement will be null and void* and of no effect and Donegal will be entitled to judgment in respect of the Debt in full with interest at 8 per cent per annum compounding quarterly having given credit for any amounts already received pursuant to Clause 2.1 above.

'Upon service of the Notice, the Republic of Zambia *hereby consents to the award of a judgment* by the High Court in England for the full amount of the Debt together with interest both before and after judgment at a rate of 8 per cent per annum compounding quarterly but after having given credit for any amounts already received pursuant to Clause 2.1 above.'[16]

There are two categories of default clauses:

- non-performance by a party of a particular provision under the agreement;
- occurrence of an event which has been specifically defined as amounting to an event of default.

The Legal Debt Clinic's workshops recommend that a borrowing country should always include natural calamities as an event of default. The borrowing country should be able to enlarge the scope of the events of default.

Usually, the events of default provisions allow a grace period (the minimum is 15 days and the maximum can be three months) after a default occurs to allow the defaulting party to take action to remedy the default. The non-defaulting party can be required to grant the defaulting party more time to remedy the default before the non-defaulting party can terminate the agreement. So, when asking for a grace period, the longer it is, the better.

Before terminating the contract, the non-defaulting party must:

- Declare that the occurrence constitutes an event of default;
- Ask for immediate performance under the contract by the defaulting party;

- Ask for interest for the defaulted period at a higher rate, known as the default interest rate.

It is important to remember that if an event of default occurs, the consequences for the defaulting party will be very serious.

Types of events of default

The following are the most common events of default:

- **Late payment of amounts due**

Failure to pay when the repayment is due is considered an event of default in all loan agreements. This is important where parties to the agreement are highly sensitive about punctual payment. The exact definition of the default event is also important. Does it mean no payment at all or failure to pay the full amount? In the former case, part payment will not amount to a default payment. This shows that it is essential to read the wording of the event of default clause carefully.

- **Breach of obligations**

If a party fails to perform a particular obligation, it can be assumed as a default. However, before considering that this failure gives a right of termination by the non-defaulting party, reasonable time to remedy the fault should be given.

- **Misrepresentation and warranty**

If one party makes a statement, representation or warranty when the loan agreement is signed which in time appears to be false, it enables the other party to treat the change in the circumstances as a default.

- **Cross default**

A cross default is when a default occurs by one party in one particular agreement and the non-defaulting party can construe that there will be a default in another agreement which is not related to the present agreement. The non-defaulting party anticipates that defaults committed in the present agreement will result in the commission of default in other contracts.

- **Material adverse change default**

If there is a material change in the position of a party to a loan agreement, the non-defaulting party can as of right call for a default by the defaulting party. It is safer for the borrower to include a comprehensive set of covenants and warranties in the agreement, where the special circumstances creating the material adverse change are well-defined.

An example from the AfDB loan agreement

Cross-suspension (instead of the term cross default)

- **The Fund, the Bank or any Bank Managed Fund has suspended in whole or in part the right of the Borrower or the Guarantor to request for and receive disbursements under any agreement with the Bank, the Fund or any Bank Managed Fund because of a failure by the Borrower or the Guarantor to perform any of its obligations under such agreement or any guarantee agreement with the Bank, the Fund or the said Bank Managed Fund.**

Conclusion

This chapter explains what a loan agreement is and has outlined the main types of agreement. It describes its basic structure and gives an overview of the concepts and clauses in a loan agreement that are relevant to the way vulture funds operate. These concepts will appear again in the discussion of cases and examples in later chapters.

The chapter provides several lessons for borrowers about ways to avoid lawsuits. These are lessons which have emerged from the experiences of the Legal Debt Clinic.

To recap the main tips:

- A loan agreement is a legally binding document between the borrower and the lender entailing respective obligations to be fulfilled by each party.
- As regards standard terms and conditions in a loan agreement, it is always worth reading them through and challenging their validity, especially when there is a volatile financial market, even though they appear to be non-negotiable.
- For conditions precedent, it is always advisable to obtain a legal opinion before signing an agreement. Once the conditions precedent are fulfilled, legal implications will follow.
- As regards default, it is important to remember that if an event of default occurs, the consequences for the defaulting party will be very serious. When asking for a grace period, the longer the better.
- Inserting clauses such as CACs protects a borrower's interest.
- Knowledge and understanding of the clauses and terms outlined in this chapter are helpful when negotiating a loan agreement.
- The terms and conditions of a loan agreement can have detrimental effects.

Further reading

- AfDB, 'General Conditions Applicable to the African Development Bank Loan Agreements and Guarantee Agreements (Sovereign Entities)', http://www.afdb.org/fileadmin/uploads/afdb/Documents/Legal-Documents/30774810-EN-NEW-GENERAL-CONDITIONS-ADB-SOVEREIGN.PDF, accessed on 12 March 2010.