How to Improve the Effectiveness of the World Bank's Negative Pledge Clause as a Legal and Policy Instrument.

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<u>Abstracts</u>

Public debt incurred by developing countries has become an ardently debated issue in international relations. The competing interests of creditors and debtors, combined with the increasing necessity of advancing welfare worldwide, make it difficult to establish a workable scheme that provides adequate assistance to needy countries. Foreign aid is evidently part of the solution to development problems. However, conditions imposed by international lenders bring about certain discontents.

The World Bank's negative pledge clause forbids a public borrower from securing external debt that is preferential to that of the Bank. This covenant also includes several exceptions: short-term secured banking transactions and financing, through the transfer of state-owned assets, are allowed. Moreover, only in exceptional circumstances does the Bank waive the clause's application. Thus, in order to secure foreign debt, a borrowing government is usually forced to contract financing that falls within the covenant's exceptions.

This Paper analyzes the World Bank's negative pledge clause and compares it to the provisions used in commercial lending. It also reviews the historical tendencies and current trends with respect to sovereign borrowing, and concludes that the World Bank's negative pledge clause should be amended, in order to bring it closer to commercial practice. It is argued that the amendments proposed in this thesis will enhance the Bank's dual function and role as both a creditor and a development institution.
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En matière de relations internationale, la question de la dette publique est sujette à controverse. Les intérêts opposés des créanciers et débiteurs, de même la nécessité grandissante d'améliorer la qualité de vie à travers le monde, complique l'établissement d'un modèle fonctionnel qui procure une assistance appropriée aux pays dans le besoin. De toute évidence, l'aide étrangère fait partie de la solution aux problèmes de développement. Cependant, les conditions imposées par les prêteurs internationaux engendrent du mécontentement.

La clause *pari passu* de la Banque Mondiale empêche un emprunteur public de garantir sa dette extérieure préférentiellement à celle de la Banque. Cette disposition comporte certaines exceptions : les transactions bancaires garanties à court terme ainsi que la vente d'actifs publics sont permis. Par ailleurs, la Banque ne dispense les emprunteurs de l'application de cette clause qu'en des circonstances exceptionnelles. Conséquemment, pour donner une garantie sur sa dette extérieure, un gouvernement doit emprunteur à l'intérieur des limites prévues par la clause.

Ce mémoire analyse la clause *pari passu* de la Banque Mondiale et la compare aux dispositions utilisées dans les prêts commerciaux. Les courants historiques et actuels de la dette publique sont également examinés. Les conclusions sont à l'effet que la clause devrait être amendée de façon à en rapprocher les termes de la pratique commerciale et renouveler le double rôle de la Banque Mondiale en tant que créancier et institution vouée au développement.

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CONTENTS

CHAPTER ONE

INTRODUCTION

While there exists little controversy surrounding the notion that social and economic development of emerging markets constitutes a major challenge to the world and contributes not only to economic but also to political stability, the same cannot be said about the means of promoting such development. Most developing states forcibly acknowledge the necessity of external funds for the development of infrastructures and the implementation of much needed social and legal reforms. However, the leaders of the capital importing states apprehend that the inflow of foreign investment could adversely affect their sovereignty, and that their national interests will be subjected to those of foreign investors. Capital exporting states and their corporations, for their part, want to shield the assets they have invested in from the arbitrary application of domestic laws, the whole in order to make sure that their investments generate a return.

Although foreign investment represents an important source of development financing, debt constitutes a more common and less stringent manner by which developing countries gain access to external capital.[1] Hence, aside from having the obligation to respect the covenants stipulated in a loan contract, borrowing governments have "direct control of the money, and full rights to distribute or reinvest domestically the profits from successful investment."[2] In contrast, "the protection of personnel as well as

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[1] Trebilcock, Michael J., and Robert Howse. The Regulation of International Trade. London; New York: Routledge, 1999, at 384.
[2] Id.

plant and other equipment is vital to the functioning of foreign investment" and it entails "the continuous presence of the foreign investor and his management in the host state."[3]

The propensity to resort to debt instruments has brought about financial crises and has compelled the international community to work at balancing the competing interests of creditors and borrowing governments. On one hand, the accumulation of foreign debt carries with it the risk of culminating into a sovereign default, which drives creditors to the exit and engenders injurious economic consequences. On the other, injudicious constraints on a country's borrowing power may curtail its development by cutting off necessary financing. Even during stable times, when funds are obtainable, market failures may yield undesirable results.[4] Globally, it is therefore crucial to ensure the timely diagnosis and appropriate treatment of public debt problems.

International economic cooperation is supervised under the auspices of the Bretton Woods organisations, created at the end of the Second World War, one of which is the International Bank for Reconstruction and Development (IBRD, World Bank, or Bank).[5] The World Bank's core mission consists of promoting economic growth and eradicating poverty in the developing world.[6] The World Bank, for its part, plays a role in supplementing capital markets when they run short. Indeed, private flows tend to

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[3] Sornarajah, M. The International Law on Foreign Investment. New York: Cambridge University Press, 1994, at 5.
[4] Stiglitz, Joseph E. "The World Bank at the Millennium." The Economic Journal 109 (1999): 577-597. Rpt. in International Economic Regulation. Ed. Jane Kelsey. Aldershot, England; Burlington, VT: Ashgate/Darmouth, 2002: 157-178, at 578-79.. Stiglitz argues that markets are not Pareto-efficient. Thus, existing resources could be reallocated in such a way as to make some individuals better off without making anyone else worse off. Although a Pareto-efficient allocation of resources is not necessarily equitable, the mere fact that it is feasible to improve the conditions of certain people (for instance developing countries' populations) without worsening those of any other, suggests that there might be some misallocation, let alone waste, of resources.
[5] (1) The General Agreement on Tariffs and Trade (known since 1994 as the WTO); (2) the International Monetary Fund (IMF), and (3) the IBRD. Id. at 577.
[6] Id.

plummet in times of crisis.[7] Moreover, private investment is not always targeted at sectors that most require financing.[8] The IBRD provides loans and guarantees to offset a lack of private funds when and where they are much needed: during times of crisis or economic slowdown, and to sectors, such as health and education, which may be neglected by investors.[9]

Even though the objectives pursued by the IBRD are commendable, the Bank still faces its share of criticism. Along with the WTO and the IMF, the World Bank is often accused of dictating conditions that are issued from a doctrine known as the Washington consensus.[10] The policies that stemmed from this consensus were developed during the eighties by the international financial community and were pushed forward by the American and British governments. They can be summarized roughly under the three following principal pillars: (1) fiscal austerity (the control of governmental expenses); (2) liberalization ("the removal of government interference in financial markets, capital markets, and barriers to trade"[11]), and (3) privatization (the conversion of state-run industries and firms into private ones and the sale of public assets to private interests).[12]

The World Bank's Articles of Agreement forbid it to make arrangements with its borrowers with regard to "political or other non-economic influences or considerations."[13] Therefore, the Bank cannot openly oblige a country to engage in

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[7] Id. at 590.
[8] Id. at 589.
[9] Id.
[10] Ziegler, Jean. "Portrait de groupe à la Banque." Manière de Voir – Le Monde Diplomatique June –July 2004 : 17-21, at 21.
[11] Stiglitz, Joseph E. Globalization and Its Discontents. New York; London: W.W. Norton & Company, 2003, at 59.
[12] Id. at 53-66.
[13] The World Bank. "IBRD's Articles of Agreement, Article III, section 5b)." 17 Feb. 2005 <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,contentMDK:20049557~menuPK:63000601~pagePK:34542~piPK:36600~theSitePK:29708,00.html>.

political reform or adopt policies pertaining to its internal governance. Nonetheless, since the beginning of the 1980s, policy-based lending has allowed the Bank to attach conditions to loans in order to ensure that its aid contributes to the recipient's development objectives and serves the intended purposes.[14]

Besides direct conditionality, the IBRD's general provisions applicable to loan and guarantee agreements contain a negative pledge clause, which is a purely legal covenant with considerable implications. As it will be discussed in more detail hereinafter, in essence, a negative pledge restricts the ability of a borrower or guarantor to grant security interests in order to guarantee of other external indebtedness.[15] The clause requires the borrower to secure the non-guaranteed loan, equally and rateably, with respect to the secured lender. This type of provision is common in international debt instruments, and works at preserving the debtor's assets for the benefit of unsecured creditors. Its presence in the World Bank's loan agreements has a significant impact on the ways in which a country may obtain foreign financing.

The purpose of this thesis is to examine and assess the effects of the World Bank's negative pledge clause on the capacity of the Bank's borrowers and guarantors to incur other foreign debt. The thesis asserts that the IBRD's negative pledge clause does not adequately shield borrower countries' assets from external claimants and precipitates

[14] For example, borrowers have to control inflation, or avoid defaulting on obligations to foreign bondholders. In addition, structural adjustment lending, introduced in 1980, has been specifically designed to encourage the adoption of policies, considered by the Bank as necessary for development. See Salda, Anne C. M. Historical Dictionary of the World Bank. London: The Scarecrow Press, Inc.: 1997, at 56.; see also The World Bank. "Review of World Bank Conditionality: Issues Note, Operations and Country Services." (24 Jan. 2005) 3 Feb. 2005 <http://siteresources.worldbank.org/PROJECTS/Resources/REVIEWOFBANKCONDITIONALITYJan3105.pdf>.

[15] See The World Bank. "General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Article IX, Section 9.03." (30 May 1995, as amended through May 1, 2004)." 16 Feb. 2005 <http://www4.worldbank.org/legal/GConditions.html>.

such borrowers into potentially detrimental financial patterns. Furthermore, this paper proposes amendments to the World Bank's negative pledge clause in order to bring it closer to commercial practice and, by doing so, enhance the Bank's dual function of creditor and development institution.

The plan of this paper can be summarized as follows: In chapter 2, the negative pledge clause is defined and the effects of its inclusion in international loan contracts are analyzed. Chapter 3 presents a brief historical assessment of sovereign lending and examines its current trends. Moreover, the impacts of recent developments with regards to debt restructuring on secured financing are considered. In chapter 4, the IBRD's negative pledge clause and waiver procedure are dissected, and three amendments thereto are suggested. Chapter 5 attempts to justify the proposed modifications from a development policy standpoint, and illustrates how such changes may influence the World Bank's tackling of sovereign debt.

CHAPTER TWO

THE NEGATIVE PLEDGE CLAUSE AND ITS LEGAL EFFECTS ON DEBTORS AND THIRD PARTY CREDITORS

Before addressing the negative pledge's impacts on sovereign indebtedness, it is essential to define the negative pledge clause and determine what kind of "security" it provides to lenders, as well as its repercussions on borrowers that must adhere to it as well as third party creditors who, by extending credit on a secured basis, may incite the debtor to infringe on the negative pledgee's rights.[16] For the purpose of this discussion, the negative pledge covenants will be analyzed through the lenses of the doctrine developed in Commonwealth jurisdictions. The reason for this choice is twofold: 1) a significant portion of lending to developing countries is governed by the laws of New York and the United Kingdom[17], and 2) arguably, the law pertaining to the negative pledge is more elaborate and comprehensive in these jurisdictions than anywhere else. The present chapter draws some lessons from the practice of commercial banks and other institutional lenders, which operate under the rules governing the negative pledge covenants. Through the investigation of the characteristics of the negative pledge in the financial sector, which is mostly concerned with the finality and efficiency of lending activities[18], a ground for comparison with the practice and characteristics of the World Bank's negative pledge clause will be established.

The Negative Pledge Clause: What Is It?

Defined broadly, a negative pledge clause is a contractual promise made by a borrower, that "he will not grant any further rights which will give another creditor priority ahead of the lender to its assets, or, depending on the wording of the clause, that the original lender will be granted equal or equivalent rights."[19] In contrast to a security device, the lender, benefiting from such a covenant, does not have a direct recourse against the property of the borrower in order to obtain repayment of the debt. In the

[16] Negative pledgee is a common term used to designate a lender benefiting from a negative pledge clause.
[17] Asiedu-Akrofi, Derek. "Negative Pledge Clauses in International Loan Agreements." Law & Policy in International Business 26 (1995): 407-458, at 408.
[18] It is assumed that debt responds (or at least, should respond) to similar incentives to those influencing foreign investment, therefore that it should be contracted on a selective basis and should benefit the borrower while remunerating the lender for its risk taking.
[19] Hobbs, Tracy. "The Negative Pledge : A Brief Guide." Journal of International Banking 8.7 (1993): 269-274, at 269.

context of international lending, this clause is widely used for a variety of reasons, most notably, the practical difficulties and costs associated with the registration of a security interest over the borrower's assets, and the "good will" between multinational companies trading on a regular basis.[20] However unwarranted it may seem to some commentators, countries have also been obtaining loans without the need to grant formal security. Indeed, "virtually all developing countries are subject to the World Bank's negative pledge clause, or "private jumbo syndicated loans" negative pledge clauses." [21] The custom in loans made to sovereign entities is to confine the breadth of the negative pledge solely to external indebtedness, as opposed to negative pledges found in private commercial lending that apply to all debts.

Since a promise not to grant security may constitute a major impediment in the affairs of a borrower, exceptions to the negative pledge clause are frequently agreed to by lenders and incorporated into the contract. In commercial lending among private actors, these exceptions are quite limited and can be contained in the following categories: a) statutory liens and those arising out of court proceedings; b) guarantees in the form of purchase money security interests created over property acquired after the creation of the negative pledge, and c) secured borrowings replacing previous secured borrowings.[22] In addition to the three exceptions germane to private lending, one can also find two further exceptions in commercial loan agreements with sovereign entities.[23]

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[20] Arkins, Jonathan R.C. ""OK-So You've Promise, Right?" The Negative Pledge and The "Security" It Provides." Journal of International Banking 15.8 (2000): 198-204, at 199.
[21] Id.
[22] Boardmand, Nigel, and John Crosthwait. "Wither The Negative Pledge." Journal of International Banking Law 1.3 (1986): 162-164, at 162.
[23] See Bank Credit Agreement with the Central Bank of the Republic of Turkey, July 13, 1979, cited in Hurlock, Matthew H. "New Approaches to Economic Development: The World Bank, The EBRD, and The Negative Pledge Clause." Harvard International Law Journal 35 (1994): 345-386, note 18.

The first exception concerns short term secured borrowing – which does not usually exceed one year – for the purpose of financing the importation of goods and the current exports.[24] As far as this exception pertains to exportation, it allows "the borrower to gain earlier access to proceeds from the sales of exportable assets" on the specific condition not to use same proceeds for the repayment of other external indebtedness.[25] The second common exception contained in sovereign loans, one that strays from the practice in private lending, relates to project financings. Such an exemption permits the creation of security over new assets within the territory of the borrower, with a view to repaying the loan through the generation of foreign exchange out of the exploitation of these assets.[26]

A negative pledge clause, which essentially aims to protect the assets of the borrower from which the lender expects repayment, constitutes only one aspect of the control exercised by a creditor over its debtor's borrowing power. Cautious lenders, such as syndicates of commercial banks, usually enhance the efficacy of their negative pledges by including other negative covenants in the loan contract, such as a restriction imposed upon the borrower prohibiting him from selling his assets, as well as a limitation on outstanding loans.[27] The significance of such additional undertakings is emphasized when the creditor seeks a remedy palliating to the breach of a negative pledge covenant.

Negative pledge provisions may be divided into two main types. By virtue of the first type of covenant, the borrower is simply prohibited from granting security, in any form, to a subsequent lender.[28] The more elaborate version of the clause, referred to as "affirmative negative pledge" (or affirmative pledge), allows the borrower to charge his

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[24] Id. at 352.
[25] Id.
[26] Id. at 354.
[27] See Boardmand and Crosthwait, supra note 22.
[28] See Arkins, supra note 20.

property, but stipulates that an equal or prior charge has to be given, or is deemed to be given, to the negative pledgee.[29] Although the obligations contracted by the borrower are different under the two types of provisions, it appears that, notwithstanding its form, a negative pledge clause merely establishes a contractual right for the lender rather than an actual security interest.[30] Nevertheless, commercial banks prefer to avail themselves of the affirmative sort of pledges, or sometimes even floating charges, because, as explained below, such instruments present a greater probability of success for a creditor seeking a remedy while, to a certain extent, maintaining the debtor's ability to secure debt and gain access to liquidity.[31]

Why Is It Used?

Lenders resort to these clauses "because most debtors tend to abide by them, whether because of integrity or reputational concerns."[32] Conversely, as a negative pledge clause may be breached by a borrower whose financial situation has deteriorated and for whom only secured financing is obtainable, the lender has to consider a series of factors before lending on an unsecured basis. Among those considerations, are the costs associated with the "setting up" of a security interest and appraising the collateral, the creditor's capacity to monitor the financial condition of the debtor and to foreclose on his property, and the balance of power that exists between the borrower and the lender. These factors are decisive in the creditor's decision to require, or not, an actual

[29] Stone, Jonathan B. "The"Affirmative" Negative Pledge." Journal of International Banking Law 6.9 (1991): 364-370, at 364.
[30] Bjerre, Carl S. "Secured Transactions Inside Out : Negative Pledge Covenants and Perfection." 84 Cornell Law Review (1999): 305-393, at 315.
[31] Schwarcz, Steven L. "The Easy Case for the Priority of Secured Claims in Bankruptcy." Duke Law Journal 47 (1997): 425-489, at 452.
[32] See Bjerre, supra note 30, at 338.

guarantee.[33] Interestingly, a competent and effective lender may use the negative pledge covenant as a timely warning signal, indicative of a borrower in trouble. In such case, the breach of the negative covenant may initiate negotiations between the lender and the borrower as to the rescheduling, or reorganization, of the debt while the debtor is still financially viable.[34]

Breach of a Negative Pledge Covenant by the Borrower

Under United States law, it is generally recognized that the negative pledge clause does not bestow upon the lender any real rights over the borrower's assets.[35] Such a contractual provision would impose only a personal obligation on the borrower. Thus, in case of breach, the lender might sue the debtor for damages and accelerated repayment of the debt if the loan contract provided a right to do so. Usually, this solution will prove to be ineffective because, by violating the negative pledge, a borrower distracts from the lender some of the assets which were initially intended for the reimbursement of the loan.[36] As a general rule, the grant and perfection of a security interest, despite the presence a negative pledge covenant, does not prevent a subsequent secured creditor to be repaid out of the assets used as the collateral in priority to the unsecured lenders.[37] "Hence, when a borrower breaches a negative pledge covenant, the negative pledgee

[33] Id. at 340.
[34] See Schwarcz, supra note 31, at 452.
[35] Knott v. Sheperdstown Manufacturing Co., 5 S.E. 266 (W. Va. 1888) cited in Bjerre, supra note 30, at 315.
[36] See Bjerre, supra note 30, at 312.
[37] See for instance, U.C.C. 9-201 (1999) providing that except as otherwise provided, a security agreement is effective against creditors.

generally has only a cause of action against a party whose assets are, by hypothesis, already encumbered."[38]

A passage in an Australian judgement of the Full Court of the Supreme Court of Victoria encapsulates, in the simplest and most concise way, the protection afforded to the lender by a negative pledge clause, or more precisely the lack thereof:

> The lenders relied on complicated covenants of a kind commonly called "negative pledges" in which lenders have in recent years often placed their faith instead of taking conventional security, sometimes to their regret. For recent experiences have shown lenders that all covenants in the world are no substitute for good old fashioned security.[39]

The Court's statement has drawn criticism because it implied that negative pledges were basically useless instruments in loan agreements.[40] However, certain courts, faced with claims from negative pledge lenders, have in fact, recognized the existence of remedies.[41] Indeed, the case law demonstrates that appropriately drafted clauses may practically reduce the ability of a borrower to encumber its assets and, hence, preserve the interests of the negative pledgee therein.

Remedies

In addition to the specialized recourse of seeking the appointment of a receiver over the debtor's assets, the principles and criteria of which, fundamentally resemble those related to injunctive relief, the remedies available to the negative pledge creditor may be organized into three principal categories: 1) equitable liens; 2) injunctions, and 3)

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[38] See Bjerre, supra note 30, at 307.
[39] See Bond Brewing Holdings Ltd v National Australia Bank Ltd, (1990) 8 ACLC 330 cited in Allan, David E. "Negative Pledge Lending – Dead or Alive? How to Reinvent the Mortgage." Journal of International Banking 5.8 (1990): 330-339, at 332.
[40] Id. at 333.
[41] See the case law cited in Bjerre supra note 30; Arkins supra note 20 and Stone, supra note 29.

liability of third parties for tortious interference with contract. The following sections do not intend to carry out an exhaustive analysis of the exercise of theses remedies, but rather to point out, in their light, the features of a negative pledge clause "with some teeth", one that may be enforced by the courts, and hence, that serves the protective purpose for which it was devised.[42]

Equitable Liens

An equitable lien is the acknowledgement of the existence of a security interest between two parties that have not accomplished the legal requirements to set up collateral, but that had the intention to do so.[43] If the tribunal admits the creation of an equitable lien, a security interest in favour of the negative pledgee is deemed to have attached on the borrower's assets. Depending on the contractual terms, the beneficiary's adjudicated guarantee ranks equally and rateably, or even prior to the rights of the creditor to whom the borrower granted security in breach of the negative pledge.

The major factor considered by the courts with respect to the formation of an equitable lien, is the intent of the parties.[44] Hence, in the presence of an affirmative pledge obliging the borrower to secure equally and rateably the affirmative pledgee when

[42] The remedies discussed herein apply mainly to private lending and are brought by creditors before national courts. Nonetheless, the assessment of the quality of a negative pledge clause in sovereign loans (and especially the World Bank's clause) can be enlightened through the study of these remedies because, although domestic law of a borrowing country may be referred to as the standard of performance in case of breach of the clause, the developed states have been pushing the developing countries to adopt Western like reforms in respect of bankruptcy laws and regulatory structures encouraging them to " accept templates designed by and for the more developed countries." See Stiglitz, supra note 11, at 251. For municipal law as a standard of performance, see Broches, Aron. "International Legal Aspects of the Operations of the World Bank." Selected Essays: World Bank, ICSID. and Other Subjects of Public and Private International Law. Aron Broches. Dordrecht; Boston; London: Martinus Nijhoff Publishers, 1995. 3-78.at 42-43. Furthermore, conflicts among sovereign lenders are likely to be settled in accordance with common law principles. See Asiedu-Akrofi, supra note 17.

[43] See Bjerre, supra note 30, at 319.

[44] Id.

the former charges his property in consideration of a loan from a third party, judges have typically construed the creation of a security interest concomitantly with the breach of the clause. [45] In spite of the fact that courts accept affirmative negative pledges as embracing the intent to generate a security interest, there remains a debate on the terminology of such a provision. Indeed, certain clauses "provide for automatic attachment of a security interest in favour of a lender if a security interest is given to a third party"[46], while other provisions involve the participation of the borrower who promises to equally and rateably secure the negative pledgee when incurring other secured debt. Some commentators disagree on whether only one terminology, or both, conveys the intention required for the formation of a real guarantee.[47] Nevertheless, courts have generally conceded that affirmative negative pledges, in both forms, may bring about a security interest in the form of an equitable lien. Before judging if a particular clause gives rise to a tangible right of title over the borrower's property, it has to first be decided whether the secured debt incurred by the borrower falls within the ambit of the negative pledge clause, or is rather allowed under its exceptions. From a practical standpoint, broadly drafted exceptions may lead to misunderstandings between the parties and cause interpretation problems. This was the case in the matter of: *Kelly* v *Central Hanover Bank & Trust*

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[45] Id. at 321.

[46] See Stone, supra note 29, at 366.

[47] Bjerre contends that negative pledges, which allow the encumbrance of assets by the borrower if such encumbrance, by its own terms, gives equal and rateable security to the negative pledgee, are essentially undistinguishable from purely negative pledge stipulations and that cases, stating that such clauses give rise to equitable liens, are "quite troubling", see Bjerre supra note 30, at 322. On the other hand, Stone submits "that it is irrelevant whether, on such a contingency, the charging provision provides for an agreement to give a charge or a deemed giving of a charge to come into effect." Stone goes even further and says that, to avoid the problem related with the certainty of intent, "the clause should be worded so as to deem an agreement to give a security, or a security itself to come to life in *scintilla temporis* before the breach." See Stone, supra note 29, at 368-369.

Company[48], where the contract stipulated "exceptions for pledges and mortgages to secure loans contracted in the usual course of business for periods of not more than one year."

Aside from procedural requisites pertaining to the existence of other appropriate remedies, the successful exercise of an equitable lien is subjugated to the requirement of appropriate notice, or knowledge of it, by the subsequent secured creditor who, by taking security from the borrower, provoked the breach of the negative pledge. Although the rules applicable to the issue of knowledge are complex and fall beyond the scope of this paper, it must be said that these rules affect the liability arising from interference with a contract by a third party, to an even greater extent than the remedy in equity.[49] As for the equitable lien, it suffices to affirm that scholars concur in recommending the instauration of a registration system, which would allow perfection of negative pledges, provide notice to third parties, and protect the negative pledge lender against subsequent secured creditors.[50] According to the advocates of this proposition, such a mechanism would, among other things, add to the predictability of contractual relations and lower the costs of due diligence and monitoring for lenders, who often pass them on to their borrowers.[51]

<u>Injunction and Appointment of a Receiver</u>

A creditor may ask the court for an injunction to block the completion of a transaction that would infringe on his rights resulting from the negative pledge

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[48] See Kelly v Central Hanover Bank & Trust Company 11 Supp 497 (SDNY-1935), cited in Stone, supra note 29, at 367, 368.
[49] See Bjerre, supra note 30, at 329.
[50] See Stone, supra note 29, and Bjerre, supra note 30.
[51] Id.

covenant.[52] In the United States, it does not seem that this recourse has ever been used. The negative pledgee usually learns belatedly that the borrower has executed a secured deed and, thus, seldom has the chance to intervene in time to obstruct the creation of a new security interest. Moreover, the prospective lender may be deterred by the costs of litigation and may instead decide not to take security and resort to a different and less litigious measure.[53] Most importantly, since an unsecured lender does not hold any rights in the property of his debtor, the American Federal Courts have typically denied such creditors the right to an injunction, or the appointment of a receiver, until they have exhausted their other legal rights.[54] The situation is different in England and Australia, where such restrictions have not prevented lenders from obtaining equitable relief.[55]

The criteria justifying the award of an injunction have been contemplated in the Australian case referred to above. In that matter, the negative pledge lender, the National Australia Bank Ltd (NAB), brought an action to appoint a receiver to the assets of its borrower, Bond Brewing Holdings Ltd (BBH) and three breweries, to which BBH passed on the funds advanced by the consortium of banks.[56] NAB having granted its loan to BBH on an unsecured basis, its main protection over the assets of BBH and the borrowing breweries consisted of a series of negative pledge covenants. The Court refused to appoint a receiver to the property of BBH and its affiliate breweries. While the appointment of a receiver and the injunction are procedurally exclusive, the substantive principles underlying both recourses are similar.[57] Before appointing a receiver, whose

[52] See Bjerre, supra note 30, at 328.
[53] Id.
[54] See Allan, supra note 39, at 336-337.
[55] Id.
[56] Id. at 332
[57] For similarity in principles, see Bond Brewing v. National Australia Bank, (1990) 1 A.C.S.R. 445, at 461, cited in Arkins, supra note 20, at 203; for procedural exclusivity, see Hobbs, supra note 19, at 273.

function is to conserve sufficient assets to satisfy the claim of the unsecured lender, the Court must consider two the following, overriding conditions:[58]

1) the need to preserve the assets of the debtor for his creditors, and

2) the balance of convenience and justice.

The second criterion of balance of convenience, has to be assessed by the trial judge in accordance with the facts at bar. Consequently, the focus of the present discussion should be placed on the first element: the preservation of the debtor's assets for his creditors. As such, the value of negative covenants and their effectiveness in protecting unsecured lenders who negotiate them may be assessed by exploring the motives used by the Court in order to confer, or in the case at study, not to confer the appointment of a receiver.

A primordial issue in the Court's decision was the aim of the order sought by the bank. In the absence of the debtor's consent, the Court was reluctant to appoint a receiver, that would provide for the "orderly governance" of the affairs of the company, because such a decision would equate to "quasi-liquidation" thereof.[59] Some observers have argued that, "if justification for the appointment had been based on the need to preserve the assets of the company and to prevent breaches of covenants designed to prevent the alienation of those assets, the result might have been different."[60] Moreover, when requesting the appointment of a receiver, the lender should be able to identify the property out of which he expects to be repaid and should demonstrate that the terms of the contract confirm such expectation.[61] It follows that in order to offer protection to an

[58] See Allan, supra note 39, at 335.
[59] Id. at 336.
[60] Id.
[61] Id. at 338.

unsecured creditor in respect of the borrower's assets, the loan agreement must contain, in addition to the prohibition to give security to a third party or the obligation to secure equally and rateably the negative pledge lender, provisions limiting the ability of the debtor to transfer his property, even if this results in a loss of flexibility and control for the borrower.[62]

Liability of a third party for interference with contract

Under certain circumstances, the negative pledge lender is able to sue a third party creditor who knowingly enters into a secured credit agreement with the borrower for damages. The keystone of an action in tort brought by the negative pledgee rests in the ability to prove the third party's knowledge of the contract between the borrower and the unsecured lender, who relies on personal covenants to safeguard his rights to repayment.[63] The creditor's awareness may be actual or constructive, meaning that a reasonable business-person, who deals in a particular industry and presumably is aware of the financing customs thereof, may not escape his liability by contending that he didn't have knowledge of a specific contract.[64] In addition, the defendant under such a claim does not need to know the exact terms of a negative pledge covenant in order to be held liable for interference.[65] When knowledge of the contract is established through the regular or constructive way, the third party creditor is deemed to have intended the

[62] Id. at 339. See also Boardman and Crosthwait discussing the lack of provisions restraining the disposal of assets in Eurobond documentation, supra note 22, at 164.
[63] See Arkins, supra note 20, at 203; See also Wing Wo, Lam. "Negative Pledges, and Their Effect on a Third Party." Journal of International Banking Law 14.11 (1999): 360-363, at 360-61; Stone, Jonathan B. "Negative Pledges and The Tort of Interference with Contractual Relations." Journal of International Banking Law 65.8 (1991): 310-319, at 311-12.
[64] See Stone, supra note 63, at 313, and Arkins, supra note 20, at 203.
[65] Id.

breach of the negative pledge clause.[66] By taking a charge from the borrower while having knowledge of the existence of the negative covenant, the defendant is generally considered to have instigated the breach of contract. Nonetheless, it may be advantageous for the claimant to prove a certain degree of procurement on the part of the secured creditor, in order to establish a causal link between the conduct complained of and the damage suffered.[67]

Once awareness of the negative pledge is proven, the defendant will seldom be able to successfully assert that his taking of a security interest from another borrower was justified on any grounds.[68] Finally, the quantum of damages awarded to the negative pledge lender in cases of tortious interference amounts to the difference between the sum he would normally be entitled to, had the security interest not been granted, and the amount he actually perceived from the borrower. In the case of insolvency of the debtor, the moneys that the negative pledgee receives correspond only to his share of the debtor's uncollateralized property divided *pari passu* among other unsecured lenders.[69]

Lessons to be Drawn from the Common Law

The purpose of this chapter is not to present a thorough analysis of the law applicable to negative pledge clauses. Instead, this part sought to extract the essential components for this type of covenant to serve the purpose for which it was intended, namely, for the preservation of the borrower's assets in favour of a lender who, for a variety of reasons, elects not to demand specific security. The study of the common law

[66] See Stone, supra note 63, at 315, and Arkins, supra note 20, at 204.
[67] See Wing Wo, supra note 63, at 363.
[68] See Stone, supra note 63, at 318.
[69] Id. at 319.

governing the rights and remedies of negative pledge lenders illustrates that three features are to be found in a worthy negative pledge covenant:

1) the clause should provide for the automatic creation of a security interest in favour of the negative pledge lender, when secured debt is incurred by the borrower, or should oblige the latter to secure the negative pledgee equally and rateably;
2) the clause should be combined with provisions restraining the transfer of assets by the borrower;
3) The exceptions to the negative pledge clause should be drafted narrowly and precisely, in order to avoid ambiguity as to its scope.

The following chapter turns to the dynamics of sovereign lending and the role played by negative pledges in that respect.

CHAPTER THREE

SOVEREIGN BORROWING AND THE NEGATIVE PLEDGE CLAUSE

To appreciate the role of the negative pledge clause in external financing of sovereign entities, it is crucial to explore some of the historic aspects and the current trends of international lending operations. This review is intended to reveal the motivations of foreign lenders that insist on negative pledge covenants and, in certain cases, demand actual security from borrower countries. As the concerns encountered by creditors of every category are entangled, the following sections deal with the issues common to sovereign lending from private and official sources.[70]

Sovereign Borrowing and Default: Historical Perspectives

States have failed to honour their obligations for as long as they have contracted loans. Throughout history, there have been instances of countries defaulting on foreign debt.[71] Enforcement of the creditor's rights has traditionally been done through negotiations and when these fell short, through commercial and political sanctions.[72] In fact, "creditors have often demonstrated some flexibility in dealing with defaults, in part because repayment could rarely be enforced through the seizure of assets (except for the use of gunboat diplomacy) due to a broad interpretation of sovereign immunity."[73] In that respect, the elimination of sovereign immunity in the United States and United Kingdom, the laws of which usually govern loan contracts to state entities, has not lessened the frequency of sovereign defaults, nor induced creditors to abandon negotiation in favour of litigation.[74] In most cases, sovereign debt payment defaults are cured through voluntary action. The absence of an international bankruptcy regime and the unavoidability of settling defaults through negotiation have traditionally obliged

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[70] Auerback, R.M. "Sovereign Debt – Default and Restructuring of Debts Owed to Private Creditors." Journal of International Banking Law and Regulation 18.11 (2003): 440-452, at 440.
There are three sources from which countries borrow: private creditors, such as banks and bondholders, which represent the prevalent share of sovereign financing; other states, known as official bilateral lenders; and international development institutions, such as the International Monetary Fund, the World Bank and regional development banks.
[71] See The World Bank. "Global Development Finance, 2003, Striving for Stability in Development Finance." 15 Feb. 2005 <http://web.worldbank.org/external/default/main?theSitePK=544497&contentMDK=20274650&menuPK=544505&pagePK=64167689&piPK=64167673>, at 57, stating the default of the Attic Maritime Association on loans form the Delos temple in the fourth century B.C., England's default towards Italian bankers in 1357 and France periodically ceasing payments on its debt from the 1500s to the 1800s.
[72] Id.
[73] Id. at 58.
[74] See Auerback, supra note 70, at 440.

creditors of sovereign debtors to agree to a restructuring of debt instead of seeking acceleration and repayment at any cost. States consent to restructuring agreements and resume debt repayments in order to either, preserve their reputations with creditors, or to avoid direct economic and even military sanctions.[75]

The first waive of contemporary sovereign default occurred during the 1980s. The main creditors then consisted primarily of banks, which "accounted for about 90 percent of developing countries' public external debt to private creditors."[76] One of the critical factors of the worldwide crisis, starting with Mexico's default in 1982 and culminating with the issue of Brady bonds in 1990, was the stocking of massive oil-income reserves in Western banks, which lent huge amounts at floating interest rates to developing countries.[77] As the prices for oil and many other commodities were then on the rise, borrowers did not bother about the threat of interest rates escalating. However, a combination of the political disorder following the overthrow of the Shah of Iran and the tightening of the U.S. monetary policy triggered a global recession characterized by a hike of interest rates and a collapse of commodity prices.[78] The depression was exacerbated by an outburst of short-term bank loans, due to the mistaken perception that liquidity was the key problem exhausting the borrower states.[79] Moreover, the principals owed on existing debts were, in some cases, rescheduled by the banks for periods not exceeding one year.[80] As maturities clustered, the debtors defaulted on their loans and it

[75] Id. at 441-442.
[76] See the World Bank, supra note 71, at 58.
[77] Id. See also Auerback, supra note 70, at 442.
[78] See the World Bank, supra note 71, at 59, and Auerback, supra note 70, at 442.
[79] Auerback, supra note 70, at 442.
[80] See the World Bank, supra note 71, at 59, agreements with Argentina and Brazil, two of the world's biggest debtors at the time, covered only 12 months.

became obvious that the soaring indebtedness levels commanded salient adjustments in respect of debt management in developing countries.

Debt Restructuring

The first attempt to ease the debt burden of less developed countries was performed in the realm of the Baker Plan in 1985, named after the US Secretary of State who proposed it. The suggested scheme called for increased lending from official and private sources in return for the implementation of IMF structural adjustment programs by governments of the debtor countries.[81] However, apprehending a greater exposure to default in an already tenuous international market, the commercial banks did not provide as many loans as was required by James Baker in his proposal:

> Expectations that voluntary bank lending would resume to the debtors who rescheduled debt service payments and undertook structural reforms (key elements of the Baker initiative-a U.S. government-led plan to allow countries to grow their way out of debt difficulties along with net new lending) were frustrated.[82]

The Plan failed and the financial community, along with the World Bank, focused on debt reduction rather than on rescheduling of existing debts and additional lending.[83] Because the defaulted commercial loans were unsecured,[84] creditors had to accept a cutback of virtually 20 percent of the $191 billion commercial bank debt in 13 countries.[85] The reduction of debt, performed according to a plan introduced by U.S.

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[81] See Auerback, supra note 70, at 443.
[82] The World Bank, supra note 71, at 59. In fact, net bank loans to the 17 countries caught up by the Baker Plan amounted to less than $3 billion per year from 1985 to 1988.
[83] See Auerback, supra note 70, at 443.
[84] Id. Auerback presents two reasons for that fact: 1) the difficulty of pledging public assets to foreign banks, and 2) the belief that lending to sovereign bodies entailed low credit risks since nations were reluctant to evade contractual obligations.
[85] The World Bank, supra note 71, at 60.

Treasury Secretary Nicholas F. Brady in March 1989, comprised debt buybacks, debt-for-equity-swaps, and the creation of new collateralised bonds that were substituted to the existing unsecured debt.[86]. The exchange operation involved the creation of security on developing countries' assets, and the consequent World Bank and commercial banks' negative pledge clause waivers, the study of which is addressed in the final section of this chapter.

The Brady Plan and The Establishment of a Bond Market for Developing Countries

To persuade the private creditors to consent to debt reduction, the IMF and the World Bank provided important support, either in the form of collaterals to secure the reduced amount of debt, or direct loans, which allowed the debtor states to repurchase their debt for cash.[87] The first type of assistance, in the from of structural adjustment loans granted by the IMF and the IBRD, was designed for countries that did not have sufficient reserves to purchase U.S. Treasury obligations, which guaranteed the repayment of the Brady bonds for the whole term thereof. The defaulting countries' old debt was swapped into new discounted indebtedness.[88] In addition to the U.S. treasury obligations guaranteeing the principal, the payment of interest was secured by cash that was deposited with the New York Federal Reserve.[89]

The Brady plan has contributed to the improvement of debt ratios in most of the borrower countries participating in it. As a result of the plan, the average debt to gross

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[86] See Sachs, Jeffrey. "Making the Brady Plan Work." Foreign Affairs Summer 1989. See also, The World Bank, supra note 71, at 60, and Auerback, supra note 70, at 443.
[87] "The international institutions have agreed to provide up to $25 billion over three years, and Japan has committed $4.5 billion." See Sachs, id.
[88] See Auerback, supra note 70, at 443.
[89] Id. at 444.

national income ratios of several major debtors fell by 14 percents from 1988 to 1994.[90] However, the plan has brought certain discontents as well. Indeed, as the Brady bonds are tradable on the secondary debt market, they have attracted hedge funds and other potentially undesirable market participants.[91] Moreover, the requirement to provide collateral has obliged debtors to allocate their public assets for the purchase of foreign reserves, which may not be the best investment a country could make.[92] Nevertheless, although the form of the security may be questioned, the guarantees granted to debt holders under the Brady plan facilitated the restructuring process, since it is doubtful whether creditors would have accepted to delay reimbursement and trim down their debts without collateralization.

Since the beginning of the 1990s, the sovereign debt market has been increasingly occupied by bondholders. While there are recent indications that bank lending to sovereign entities has picked up, notably to allow certain countries to redeem their Brady bonds,[93] bondholders possess an important share of sovereign indebtedness.[94] A lot of countries have reduced the amount of their outstanding Brady bonds,[95] and replaced them by a range of complex instruments issued in bond markets.[96] Due to the proliferation of debt holders, the official lenders have put forward numerous efforts to harmonize the resolution of sovereign debt crises – in so doing, they have ran into as many obstacles.

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[90] See the World Bank, supra note 71, at 60: figure 3.16.

[91] See Auerback, supra note 70, at 441, and at 444. "Hedge funds" designate entities which speculate on public debt by purchasing discounted sovereign obligations in the hope of making a profit.

[92] Id. at 445.

[93] The World Bank. "Global Development Finance, 2004, Harnessing Cyclical Gains for Development. 15 Feb. 2005 <http://web.worldbank.org/WBSITE/EXTERNAL/RESEARCH/EXTPROSPECTS/GDFEXT/GDFEXT2004/0,,contentMDK:20177059~menuPK:335441~pagePK:64097019~piPK:64096667~theSitePK:335432,00.html>, at 52.For instance, Mexico has borrowed $2 billion for that purpose.

[94] Financing through issuance of bonds has risen from 6 percent of private debt flows in 1990 to 46 percent in 1997. Id. Box 2.4, at 49-50: Evolution of markets for developing country international bonds.

[95] Id

[96] See Auerback, supra note 70, at 446.

The Crooked Path to Concerted Action in Sovereign Debt Restructuring

The intervention of the official sector, composed of creditor countries and multilateral organizations, has become a key constituent of less developed countries' debt management. International financial institutions, and, to a lesser extent, bilateral lenders are able to supply large bailout packages accompanied by policy conditions imposed on debtor countries.[97] Nearly half of the official aid funds to developing countries in 2002 were dedicated to debt relief.[98] Several political and practical concerns explain such an important official participation in debt restructuring.[99] As for the present study, the most relevant aspect of the escalating official support relates to the lack of a sovereign debt restructuring system binding the external unsecured creditors.[100]

When a country defaults on its loans and foreign lenders huddle to claim reimbursement, no formal and compulsory legal priority rules govern their relations with the sovereign debtor. Instead, the borrower's conduct is directed by a handful of tacit conventions. In the first instance, the international financial institutions (IFIs) are granted *de facto* priority over other external creditors.[101] Only countries covered by the Heavily

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[97] See the World Bank, supra note 71, at 60, figure 3.17 at 61, reflecting the increase in IMF's rescue packages over the last decade. These funds are primarily aimed at solving debt servicing problems.
[98] See the World Bank, supra note 93, at 107.
[99] For example, danger of spreads from one debt market to another, the difficulty to coordinate a great number of bondholders, and the strengthening of political and economic ties between the debtors and creditors are among the reasons accounting for the wider intervention of official sources during debt crises. See the World Bank, supra note 71, at 60-61.
[100] Since this paper aims to contemplate the World Bank's negative pledge clause, which is exclusively concerned with external indebtedness, it does not address extensively the issue of domestic debt, but recognizes that it has an important part in a restructuring.
[101] See Roubini, Nouriel and Brad Setser. "Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform." Conference on "Improving the Sovereign Debt Restructuring Process" co-hosted by the Institute for International Economics and Institut Français des Relations Internationales, Paris, March 9, 2003 1 Sept. 2005 <http://www.iie.com/publications/papers/roubini-setser03003.pdf>, at 5; see also The Paris Club.

Indebted Poor Countries Initiative (HIPC) Initiative[102] are exempted from this tenet. The rationale for the favourable treatment conferred to the IFIs stems partly from the fact that, as lenders of last resort, these institutions provide loans when no other lender would and, by doing so, they maximize other creditors' recovery. The second obligation assumed by a defaulting debtor is to treat its external creditors equitably.[103] Given the lack of an authoritative international statute establishing a priority regime among different types of external creditors, contractual provisions and, in some cases, the threats of acceleration incite the debtor to deal fairly with its creditors. In this respect, the Paris Club, comprised of several official bilateral creditors, has included in its Agreed Minutes, a clause of "comparability of treatment":

> The Paris Club creditors do not expect that the debtor's agreements with its other creditors will exactly match the terms of the Paris Club's own agreement. Instead, considering the diversity of other possible creditors (non-Paris Club official bilateral creditors, banks, suppliers, bondholders, etc.), the Paris Club creditors require that the debtor seek terms that are "comparable" to the Paris Club's own agreement. The Paris Club creditors require the debtor to share with them the results of its negotiations with other creditors.[104]

Consequently, sovereign debt restructuring does not abide by strict rules, but is rather submitted to a quasi-political process, where the players involved rely mostly on negotiations. Furthermore, debt rearrangements made by foreign creditors may impact on domestic holders and, broadly, on the debtor country's citizens through the policy

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"Presentation: Comparability of treatment." 15 Feb. 2005 <http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B01WP06>.

[102] The HIPC Initiative is a program launched in 1996 by the World Bank and the IMF jointly, in order to alleviate the debt burden of the world's poorest countries. Currently, the Initiative applies to 27 heavily indebted countries to which the informal priority rule does not apply. See The World Bank, supra note 93, at 119.

[103] See Roubini and Setser, supra note 101, at 5.

[104] See The Paris Club, supra note 101.

conditionality imposed by the IMF and the World Bank.[105] This sort of imperfect system brings about an intricate set of problems. For instance, creditors are tempted to call in their loans and "rush to the exit" when the sovereign borrower is on the verge of default.[106] Likewise, in the wake of a failure to pay by their country's government, domestic depositors may try to shield their assets by substituting local for foreign currency savings.[107] The risk of a disorderly creditor race may be amplified if the debtor has contracted a large stock of short-term obligations, and servicing becomes impossible as a bulk of payments fall due. Moreover, it may be enticing for certain creditors to sit on the fence during a debt restructuring and to bring separate suits against the defaulting state.[108] Perhaps most importantly, minor creditors are inclined to refuse to go along with others in a concerted action when they find reward in seeking judicial relief. This phenomenon occurred in a recent series of cases amid the implementation of the Brady plan in Peru.

Peru's Cases

During the time when Peru conducted negotiations with its main creditors under the Brady Plan, two important cases were resolved before U.S. courts. In contrast to the prevalent practice prior to the 1980s crisis, the Brady guidelines urged foreign banks not only to provide new loans to distressed countries, but also to reduce and restructure their existing debts. Hence, judicial proceedings intended to claim unpaid debt appeared to

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105 Gelpern, Anna. "Sovereign Debt Crisis : Creditor's Rights vs. Development." ASIL Proceedings (2003): 221-229. 16 Feb. 2005 <http://www.iie.com/publications/papers/gelpern0804-3.pdf>, at 222.
. See also Roubini and Setser, supra note 101, at 6, with respect to policy conditionality.
106 See Roubini and Setser, supra note 101, at 4.
107 Id. at 6.
108 Id. at 4-5.

disregard the policy endorsed by the United States with respect to foreign indebtedness. Nevertheless, two private corporations, having acquired Peru's debt on the secondary market, obtained favourable judgments in this context. The outcome of these cases accentuates the voluntary nature of debt restructuring, and unveils the barriers to executing a judgement on property belonging to sovereign entities.

Pravin Banker Associates[109]

This case was brought against a Peruvian state-owned bank, Banco Popular, by Pravin, who purchased a portion of Peru's foreign debt comprised of loans originally granted by a Pittsburgh bank. The funds borrowed by Banco Popular were used to extend credit to corporations and citizens of Peru.

In 1983, Peru's authorities announced that the country was unable to service its foreign debt. As a result, the short-term debt, which Pravin would eventually acquire, were rescheduled for 360 days and guaranteed by the government. From 1984 onwards, Peru engaged in a series of negotiations with its creditors in the hope of achieving long term debt relief. Since negotiations failed, many of them filed law suits in 1989, so to avoid the legal expiration of their claims. Following President Fujimori's compliance with IMF prescriptions and at the advent of the Brady Plan, a number of creditors, including the Pittsburgh bank, which would later assign its debt to Pravin, agreed to stay their proceedings against Peru's sovereign entities. In 1990, Pravin purchased Banco Popular's discounted debt on the secondary market. When the debtor defaulted again in 1992, the new creditor filed a suit against the Peruvian bank and the guarantor

[109] See *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru,* 109 F.3d 850, 1997 U.S. App. (2d Cir. N.Y. 1997)

government in the district of New York.[110] After several stays granted to the debtors, mostly to allow the completion of Banco Popular's liquidation in Peru, a summary judgment was rendered in favour of Pravin, who was permitted to enforce the debt.[111] This decision was affirmed by the U.S. Court of Appeals for the Second Circuit. The appellate Court's ruling is contemplated here.

Peru alleged that the negotiations with its creditors were being disrupted by Pravin's suit. The tribunal relied upon the interpretation of the principle of international comity to determine whether the restructuring process's jeopardy justified the denial of the creditor's claim. "International comity is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation."[112] The Court acknowledged that Peru's debt reorganisation efforts had an extraterritorial effect in the United States. However, this did not automatically accord deference to Peru's foreign acts – the court asserted that the dismissal of the remedy sought by the plaintiff must be consistent with U.S. national policy. The American approach to sovereign debt restructurings embraces two competing elements: 1) "the United States encourages participation in, and advocates the success of, IMF foreign debt resolution procedures under the Brady Plan," and 2) "the United States has a strong interest in ensuring the enforceability of valid debts under the principles of contract law, and in particular, the continuing enforceability of foreign debts owed to United States lenders."[113] Highlighting the "strictly voluntary basis" of a private creditor's partaking in multilateral

[110] See *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*, 165 Bankr. 379 (S.D.N.Y. 1994)
[111] See *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*, 912 F. Supp. 77, 1996 U.S. Dist. (S.D.N.Y. 1996)
[112] See Judge Calabresi citing *Hilton v. Guyot*, 159 U.S. 113, 164, 40 L. Ed. 95, 16 S. Ct. 139 (1895), supra note 110, at 854.
[113] Id. at 855.

debt talks, the Court enounced that, in spite of the bank advisory committee's recommendation to stay all legal proceedings, debts would remain enforceable throughout the negotiations. Therefore, the judge found that the second facet of the U.S. policy binds its intention to "encourage participation in" and "advocate the success of" orderly debt restructurings.[114] Deciding otherwise would imply that the Brady Plan corresponds to a judicially-enforced bankruptcy process, as opposed to a self-commanding mechanism. For these motives, the court affirmed the District Court judgment and conferred upon Pravin the right to enforce Banco Popular's debt.

It appears from the reasoning of this case that, when holdout creditors exercise their rights to repayment against a sovereign body and U.S. law governs the loan contract, the orderly debt restructuring is subdued by U.S. domestic policy considerations.

Another remarkable aspect of Pravin's case pertains to the execution of the judgment awarded to the creditor. Subsequently to being granted the right to enforce Banco Popular's debt, Pravin undertook to execute his judgment on the proceeds of the privatization of a Peruvian state-owned enterprise.[115] The creditor filed a motion to attach the sums deriving from the sale of a Peruvian telephone service company, about 30 percent of which was held by Conade, a public corporation. The transfer of Conade's shares was performed through underwriters that were supposed to deliver stocks of the state-owned enterprise to the U.S. market. Pravin attempted to execute his judgement upon the underwriters' obligation to pay Conade. The claimant contended that "Peru and Conade should be treated as if they were one single entity, thereby permitting Peru's debt

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[114] Id.

[115] *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*, 9 F. Supp. 2d 300, 1998 U.S. Dist. (S.D.N.Y. 1998)

to be collected from Conade's assets."[116] The Court rejected this argument on the ground of the governmental instrumentality's independence. If the assets of the government were assimilated to those of its state agencies, "the efforts of sovereign nations to structure their governmental activities in a manner deemed necessary to promote economic development and efficient administration would surely be frustrated."[117] No proof was offered to establish that Peru had used Conade to distract the telephone company's stock from its creditors, and Pravin did not possess a security interest on Conade's property. Thus, the Court applied the presumption of separation and distinctiveness between state owned corporations and the government. Revealingly, a major obstacle in the creditor's pursuit of repayment was the lack of guarantee.

Elliott Associates[118]

Akin to the facts of the preceding case, Elliott purchased a fraction of Peru's non-performing debt on the secondary market. The principal amount acquired by Elliot from two private banks neared $21 million of two Peruvian state-owned banks' (Banco Popular del Peru and Banco de la Nacion) working capital debt guaranteed by the government of Peru.[119] Due to the precedent set in Pravin, the debtors could not invoke the doctrine of international comity in U.S. courts. Alternatively, they relied on Section 489 of the New York Judiciary Law, which prohibits the purchase of claims "with the intent and purpose of bringing an action or proceeding thereon." After a first favourable

[116] Id. at 304.
[117] Id. Judge Robert W. Sweet quoting a passage from the Supreme Court in *First National City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 77 L. Ed. 2d 46, 103 S.Ct. 2591 (1983). According to Judge Sweet, the Supreme Court's reasoning "hypothecated facts striking similar to the instant case."
[118] *Elliott Assocs., L.P. v. Republic of Peru*, 194 F. 3d 363, 1999 U.S. App. (2d Cir. N.Y. 1999)
[119] Working capital debt, as opposed to syndicated bank debt, "consists of direct loans between single lenders and borrowers", instead of using an agent bank as intermediary. Id. at 366-367.

judgment, the Appellate Court turned Peru's argument down and expressed a difference between a debt acquisition for the purpose of enforcing it, which was not illegal, and the purchase solely intended to litigate against the debtor in order to collect legal fees. According to the judge, Elliot's move to acquire debt and to sue the debtors fit in the first category of behaviour, and did not transgress the provisions the Judiciary Law. As to the consequences of Elliot's claim on Peru's debt sort-out, Circuit Judge Michel made the following remarks when reversing the district court's ruling:

> Second, Peru's Brady Plan was not binding on all creditors, such as Elliott, that were not members of the Bank Advisory Committee. Thus, given that the Brady system purposefully does not create such a binding obligation, there was no settlement and, consequently, unlike the district court, we do not condemn Elliott merely because "its purpose was to stand apart from the lenders who had agreed to the Brady restructuring, and to use judicial process to compel full payment."[120]

Reiterating the U.S. policy in respect of sovereign debt restructurings and underlining New York State's analogous concerns, the Court opined that the prohibition to collect sovereign debt in domestic courts would compromise opportunities for holders of indebtedness to sell their instruments. By adding to the risk, such a deterrent effect would harm the secondary market for defaulted sovereign debt. As per the Court's view, the failure to require the sovereign entities to honour their obligations would result in higher borrowing costs, and potentially in the impossibility to obtain loans in New York. "A well-developed market of secondary purchasers of defaulted sovereign debt would thereby be disrupted and perhaps destroyed even though its existence provides incentives for primary lenders to continue to lend to high-risk countries."[121] Hence, in the context of sovereign debt workouts, U.S. courts prefer to preserve private creditors' rights to

[120] Id. at 376. Judge Michel cited and rationalized the reversal of *Elliott Assocs., L.P. v. Republic of Peru.* 12 F. Supp. 2d 328, 1998 U.S. Dist.
[121] Id. at 380.

enforce a country's debt, rather than to constrain their participation in collective debt reorganizations.

Elliot's case also pertains to the immunity enjoyed by sovereign states and instrumentalities as to the execution of judgments upon their assets. Once the decision in favour of Elliott was been delivered, the creditor filed a motion to attach certain property of Banco de la Nacion, since the other debtor, Banco Popular, had been liquidated. Pursuant to the Foreign Sovereign Immunities Act (FSIA), 28 U.S.C. § 1610, the order of execution limited the attachable assets to "property that is used for a commercial activity in the United States."[122] Elliott had this order amended to strike out the limiting language therein.[123]

On the one hand, Section 1610(a) of the FSIA "limits recovery against a foreign state to property in the United States(…) used for a commercial activity in the United States."[124] On the other hand, "section § 1610(b) provides that any property in the United States of an agency or instrumentality of a foreign state engaged in commercial activity in the United States shall not be immune from attachment."[125] Therefore, the plain language of the FSIA, accompanied by its historical review, supported an interpretation that allowed the creditor to attach any category of assets used by Banco de la Nacion, to the extent that the latter was carrying out commercial activity in the U.S. In addition, an extract from the Restatement of the U.S. Foreign Relations Law uncovers the underlying reason of this interpretation:

> These distinctions reflect the premise that state instrumentalities engaged in commercial activities are akin to commercial enterprises, so that immunity

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[122] *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.R.D. 116; 2000 U.S. Dist.
[123] *Elliott Assocs., L.P. v. Banco de la Nacion*, 96 Civ. 7916;
[124] Id. at 11.
[125] Id.

> is exceptional and limited, whereas the primary function of states is government and, absent waiver, their liability should be limited to particular claims and their amenability to post-judgment attachment should be limited to particular property.[126]

Some specific methods allow creditors to recover debts, especially from state agencies. However, it appears that under U.S. law, the most reliable manner by which lenders can set apart sovereign assets for the repayment of their debt, is to obtain a waiver of sovereign immunity. This may surely be achieved by requiring security from the borrower country.

The creditors' success in suing Peru and, at least for Elliot, recovering amounts owed by a sovereign entity, demonstrates the shortcomings of sovereign debt reorganizations. Even though holdout creditors have not provoked the collapse of multilateral negotiations, their actions have drawn the attention of the private and official sectors. In recent years, a range of reforms have been examined in order to endow the international system with a more orderly debt restructuring process.

Opposing Interests among Creditors

As demonstrated above, sovereign debt workouts are not administered according to authoritative rules. A convention recognizing precedence to funds loaned by IFIs and contractual provisions govern the relations between lenders and the borrower state. For certain categories of creditors, it is less problematic to conclude restructuring agreements than for others. The official sector, including IFIs and lender countries, has been reputed to promote orderly restructurings and even to provide funds when no private creditor

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[126] Restatement (Third) of the Foreign Relations Law of the United States § 460, cited in the opinion by Judge Sweet, Id at 12-13.

would.[127] Loans granted by banks acting in syndicates are governed by terms that anticipate glitches handled through voting procedures.[128] Complications arise when the debtor needs to delay and/or reduce debts owed to bilateral private creditors and bondholders. For instance, individual lenders detaining working capital debt as in the cases involving Peru, may refuse to join in negotiations along with other creditors and will instead claim reimbursement in courts. Concerted actions of bondholders often prove to be complex, as bonds are usually held by a disparate group, and as their issues may be subjected to miscellaneous jurisdictions.

In order to assess the corollaries of the attempts made to reform the existing system, the following sections abridge the principal options aimed at enriching the debt restructuring process.

Collective action clauses (CACs)

CACs "limit the ability of minority bondholders to disrupt or slow down debt restructuring proceedings by enforcing their claims through litigation."[129] Two major demeanours may be managed by such clauses. Firstly, such provisions may empower "a qualified super majority of bondholders to bind all bondholders within the same issue to the financial terms of a restructuring agreement, either before or after a default."(*restructuring provisions*)[130] Secondly, *enforcement provisions* require that a certain percentage of holders (usually 25 %) vote in favour of acceleration of claims after

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[127] See Auerback, supra note 70, at 451.
[128] Asiedu-Akrofi, Derek. "Sustaining Lender Commitment to Sovereign Debtors." Columbia Journal of Transnational Law Association 30 (1992): 1-56, at 11-12.
[129] See the World Bank, supra note 93, at 58.
[130] Id. Box 2.7, *Collective actions clauses*, at 59.

a default, while a simple or qualified majority may reverse such acceleration.[131] In addition, clauses referred to as "exit consents", tend to dissuade rogue creditors. Thus, a majority of holders may vote to amend or waive the non-payment covenants of the originally issued bonds, such as the negative pledge clause, before an exchange for new bonds with revised payment provisions is completed.[132] Under English law, sovereign bonds enclosing restructuring provisions are regularly issued.[133] Until recently, a significant portion of sovereign loans governed by New York law utilized enforcement provisions and enabled exit consents, in accordance with the principles set forth by the American securities legislation, which allows the alteration of the financial terms of publicly-issued corporate bonds with the unanimous consent of bondholders.[134] However, in February 2003, Mexico, followed by other countries, issued bonds on the New York market using CACs in line with the model suggested by the G-10.[135]

The G-10's draft adopts the English-style restructuring provisions and a trustee structure, which eases communications between the borrower and the bondholders, and makes possible collective decision making.[136]

Although progress has been made with respect to the acceptance of CACs, the time needed to incorporate such clauses in the outstanding sovereign bonds is far-reaching. Moreover, since these provisions operate exclusively among one class of bonds issued by a country and do not cover other types of debts, the espousal of CACs will not solve all restructuring problems.

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[131] Id.
[132] See Auerback, supra note 70, at 448.
[133] Buchheit, Lee C. and G. Mitu Gulati. "Sovereign Bonds and The Collective Will." Emory Law Journal 51 (2002): 1317-1363, at 1325.
[134] Id. at 1328, See also the World Bank, supra note 93, at 58, and Roubini and Setser, supra note 101, at 8.
[135] See the World Bank, supra note 93, at 59.
[136] See Roubini and Setser, supra note 101, at 8.

Code of Conduct

Discussions in the international community have been initiated with respect to the formulation of "a code of conduct to be voluntarily followed by private and official creditors, as well as sovereign borrowers, in situations in which debt sustainability is in question, thus enhancing the stability of the international financing environment."[137] The guidelines springing from such a code might assist in coordinating the course of action among holders of different sorts of sovereign debt.[138] By no means would a code of conduct represent an absolute tool of debt restructuring and it would have to be tied in with other legally binding measures.

The IMF's Binding Approach

The most drastic and resisted reform proposal has been the IMF's initiative of Sovereign Debt Restructuring Mechanism (SDRM). Conceptually comparable to national bankruptcy laws, the SDRM was projected to allow the debtor country to be shielded from litigation by external creditors, while negotiating restructuring terms. Furthermore, the proposed mechanism would have obliged a minority of creditors to comply with the new terms, once a majority of creditors have agreed to them.[139] Another important feature of the SDRM was the super-priority profiting to financing granted during the insolvency process, as in the debtor-in-possession provisions under Chapter 11 of U.S. Bankruptcy Law. The IMF's project was opposed and abandoned, in part

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137 See the World Bank, supra note 93, at 60.
138 See Roubini and Setser, supra note 101, at 9.
139 See the World Bank, supra note 71, at 64.

because of the absence of political consensus.[140] In addition, several disadvantages have been identified with the SDRM. Among the downsides, are the possibility of solvent debtors' strategic defaults, the increase of investors' uncertainties as to their legal rights and as to the outcome of negotiations, and the difficulty to define the debts covered by the mechanism.[141]

Prospective Consequences of Sovereign Debt Reforms

Any alteration to the present rights and obligations of lenders and borrowers should take into account the essential balance between the necessity to conserve the sanctity of contracts and enforceability of debts, on one side, and the availability of a predictable and reliable restructuring system for insolvent countries, on the other. Thus, the cost of defaulting should be elevated enough to avoid an abusive use of the restructuring mechanism by the debtor, while the capital market and economic growth should not be closed to countries experiencing debt sustainability problems.[142]

A shift towards a globally binding system of sovereign debt resolution may be achieved by the general endorsement of CACs already underway, the respect by lenders and borrowers of a code of conduct and perhaps the adoption of a statutory framework. The Argentinean debt restructuring will hopefully provide insights as to the future developments of international debt resolutions. Although the investors' reliance on precedents may yield similar arrangements to the ones concluded in previous situations, the uncompromising stance of Néstor Kirchner, Argentina's President, towards debt-

[140] See Roubini and Setser, supra note 101, at 16, and Auerback, supra note 70, at 451.
[141] See the World Bank, supra note 71, at 64-67.
[142] See Portes, Richard. "Resolution of Sovereign Debt Crises: The New Old Framework." Center for the Study of Globalisation and Regionalisation, 6th Annual Conference (May 2003) 17 Feb. 2005 <http://wbln0018.worldbank.org/eurup/web.nsf/pages/paper+by+portes/$file/PORTES.pdf>, at 4-6.

holders and the IMF reveals a defaulting country's power to unilaterally impose restructuring conditions.[143] Hence, a debate remains as to the type of intervention that would best coordinate and protect creditors' rights, and still allow the debtor state to achieve debt relief and to access fresh financing. It is suggested that a rule-based approach, rather than a strictly market-based tactic, has a greater potential to attain an organized restructuring debt system, while maintaining the needed balance between creditors and debtors.[144]

As for the focus of this paper, the evolution towards an international regime of debt reorganization will plausibly provide incentives for certain creditors to demand tangible guarantees from borrower countries. With respect to the consequences of the SDRM, the World Bank has declared that "one might expect greater reliance on securitized debt, where the collateral is outside the control of the government (for example, future flow receivables where receipts are paid into an escrow account)."[145] It is submitted herein, that any effort to curb the eagerness of holdout creditors, such as Pravin and Elliott, to litigate against a borrower country, may increase their motivation to seek security from it. On the whole, collateral is treated as a factor that mitigates credit

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[143] Despite an unexpectedly good economic performance, investors are apprehensive due to the Argentinean government's hard stance with respect to its demand that debt holders accept a 75% "haircut". Regarding the bondholders, they wish to "achieve a better deal thanks to political pressure, the potential reputation cost for the Argentina government, and the existence of precedent solutions that establish a relative minimum set of acceptable conditions." See Deutsche Bank. "Argentina Debt Outlook: Light at the End of the Restructuring Tunnel?" (8 Apr.2004) 15 Feb. 2005 <http://www.emta.org/keyper/keyviewarg.htm>.
In addition, the same patterns appear in Argentina as in prior restructurings. For instance, a U.S. Court has recently ordered the Argentinean government to pay defaulted sovereign debt to an American creditor. See Economic and Legal Developments in Argentina, Newsletter, 7th Issue, April-August 2004, on file with the author. President Kirchner announced the suspension of Argentina's agreement with the IMF aiming to force through a unilateral debt swap, see "Argentina's economy, Heading for a carve up." The Economist 11 Sept. 2004: 33.

[144] For discussions of both methods, see : Portes, supra note 142, Roubini and Setser, supra note 101, and Anna Gelpern, supra note 105.

[145] See the World Bank, supra note 71, at 68.

risk.[146] Far from being marginal, such a consideration may be influential, since the risk of lending to state entities has increased for most sovereign borrowers.[147]

In the final sections of this chapter, the negative pledge clause is assessed as a risk management tool for lenders who avail themselves of such covenant and, in some circumstances, waive its application.

The Negative Pledge and the Control It Provides over Sovereign Assets

The major problem faced by external creditors, who wish to secure loans made to countries, is the control exercised by states on their own assets, and the immunity from attachment enjoyed by sovereign entities. As the domestic assets are unattainable for foreign creditors, the repayment of their loans usually depends on the good will of the borrower and, in the rare cases where loans are secured, collateral in the forms of gold and foreign exchange reserves held in overseas banks. In addition to the ardent competition among creditors, the lenders' dissuasion to seek actual security often comes from the good credit ranking, as well as the commendable status and reputation of the borrower state.[148] Hence, unsecured lenders require from the borrower that they be treated no less favourably than its other creditors. By negating the debtor's right to confer security, or requiring that it rateably guarantees the unsecured loan, a negative pledge clause "ensures that a borrower's assets would be available to discharge outstanding financial obligations to general unsecured creditors."[149] As mentioned

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[146] The Basel Committee on Banking Supervision, a group of central banks and supervisory authorities in the G-10 countries, has set new standards for establishing minimum capital requirements for banking organizations. See the World Bank, supra note 93, at 61, where it is affirmed that the new Basel Capital Accord (Basel II) recognizes collateral as a "credit risk mitigant".
[147] Id. at 62.
[148] See Asiedu-Akrofi, supra note 17, at 408 - 409.
[149] Id. at 412.

before, negative pledge clauses contained in sovereign loans apply solely to external indebtedness, since "foreign assets of the borrower are those sought in the event of default on foreign debts."[150]

Aside from the negative pledge, cautious lenders resort to provisions prohibiting disposal of property in order to prevent asset stripping.[151] The sale of sovereign property shrivels the pool of assets from which the creditor expects reimbursement. Broadly drafted clauses may restrain the borrower country's ability to use privatization proceeds for servicing external debt.[152] However, depending on the treatment of the revenues and the nature of the disposed asset, a creditor relying on a "bare" negative pledge may be adversely affected by the alienation of sovereign property.

The Negative Pledge's Preventive Function

When used effectively, the negative pledge can perform two complementary tasks. Firstly, it is used as a standard of performance by the lender enabling him to monitor the encumbrance of the borrower's assets. If security is created in breach of the negative pledge, the lender may declare a default and seek the appropriate remedy in accordance with the contract. Secondly, a borrower that is subject to such a clause has to administer its finances properly, in order to avoid the creation of charges on its property and a consequent default. In fact, the negative pledge clause in international lending can best serve as a trigger leading to negotiations between an illiquid borrower and its

[150] Id. at 413.
[151] See Boardman and Crosthwait, supra note 22, at 164.
[152] See the negative pledge clause in the 1984 Zambian Commercial Refinancing Agreement and the 1985 Morocco Refinancing Agreement, cited in Asiedu-Akrofi, supra note 17, at 417-418.

creditors before a payment default occurs.[153] This role, which the negative pledge has not yet fulfilled, would be amplified at the outset of a debt crisis, as illustrated by the pattern of the 1980s experience.

Indeed, the excessive indebtedness of developing countries in the early 1980s caused liquidity difficulties and pressured the borrower states to ask for bridge loans, which were not disbursed without collateral.[154] Due to the negative pledge's prohibitions contracted by the debtors, these financings could not be set up without theoretically violating the clause. Therefore, creditor banks utilized a right to setoff against foreign accounts belonging to the debtors. This setoff was permitted under New York law, and thus, allowed the banks to attach sovereign property without contravening the negative pledge clauses.[155] The accrual of short-term loans eventually exacerbated the debt crisis and prompted the conception by the World Bank of debt and debt-service reduction (DDSR) operations, which supported the developing countries as to their obligations towards commercial banks. For selected countries, such operations involved the waivers of the negative pledge clause by commercial banks and official lenders.[156] The waivers, necessary to exchange the existing debts for guaranteed Brady bonds, revealed a certain motivation on the part of *bona fide* creditors to participate in orderly debt workouts.[157] It remains that, only after the crisis was aggravated by the misguided short-term loans treatment, an effective restructuring was finally established. Had there been a warning

[153] See Palzer, Keith A. "Relational Contract Theory and Sovereign Debt." 8 Northwestern School of Law Journal of International Law and Business 8 (1988): 727-758, at 754.
[154] See Asiedu-Akrofi, supra note 17, at 415.
[155] Id., at 416.
[156] See Asiedu-Akrofi, supra note 128, at 45.
[157] See Raffer, Kunibert. "Sovereign Debt Workout Arrangements." Alternatives to Neoliberalism Conference sponsored by the New Rules for Global Finance Coalition (May 23-24, 2002) 16 Feb. 2005 <http://www.new-rules.org/docs/afterneolib/raffer.pdf>, at 5.

signal of financial trouble sooner, the effects of the crisis might have been softened, since the debt problems would have been dealt with differently and at an earlier stage.

It is submitted that an amended negative pledge clause in the World Bank's agreements may contribute to the timely detection of debt sustainability problems in developing countries. Moreover, further developments towards a rule-based regime of sovereign debt reorganization may increase the recourse to collateral in international lending, and hence, create difficulties with the application of the World Bank's current negative pledge provisions. In the next chapter, the IBRD's usage of the negative pledge clause is examined and a series of amendments are proposed. These suggestions are aimed at the enhancement of the Bank's responsiveness to sovereign debt crisis, and the improvement of developing countries' access to external financing.

CHAPTER FOUR

THE WORLD BANK'S NEGATIVE PLEDGE CLAUSE

This part presents the attributes of the World Bank's negative pledge clause and reviews several cases where the Bank applied, or waived, the prescriptions provided for by this covenant. Against this backdrop and given the preceding chapter's findings with respect to the enticement for collateralization of sovereign loans, three amendments to the clause are submitted in order to increase its legal effectiveness, and to allow the Bank to use it as a sound developmental policy tool. The provisions discussed herein concern exclusively the IBRD and not the International Development Institution (IDA), a World

Bank Group's party that provides concessional aid to the neediest countries, and that does not include a negative pledge in its contracts.

IBRD's Negative Pledge Clause: The Language

Section 9.03 Negative Pledge

(a) It is the policy of the Bank, in making loans to, or with the guarantee of, its members not to seek, in normal circumstances, special security from the member concerned but to ensure that no other external debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such member.[158]

Except for situations where the project is co-financed by the Bank and a secured creditor, or when the borrower has an unworthy credit, the Bank does not require specific security over assets of governments and their instrumentalities.[159] As for loans made to private borrowers, the Bank may require a priority depending on each case's circumstances. Also, a charge may be created on the debtor's assets through the operation of the negative pledge clause. In fact, an IBRD funds' recipient, willing to pledge its assets in guarantee of external debt, is obliged to provide the Bank with an equivalent security interest:

(i) To that end, if any lien shall be created on any public assets (as hereinafter defined), as security for any external debt, which will or might result in a priority for the benefit of

[158] See the World Bank, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Section 9.03(a), supra note 15; "External Debt" is defined as any debt which is or may become payable other than in the currency of the country which is the Borrower or the Guarantor.

[159] See The World Bank. "Operational Manual, Security Arrangements, OP 7.20." (February 2001) 16 Feb. 2005 <http://wbln0018.worldbank.org/Institutional/Manuals/OpManual.nsf/0/EAE166B934F4F462852569EC006E6238?OpenDocument>.

the creditor of such external debt in the allocation, realization or distribution of foreign exchange, such lien shall, unless the Bank shall otherwise agree, ipso facto and at no cost to the Bank, equally and rateably secure the principal of, and interest and commitment charges on, the Loan, and the member of the Bank which is the Borrower and the Guarantor, in creating or permitting the creation of such lien, shall make express provision to that effect; provided, however, that if any constitutional or other legal reason such provision cannot be made with respect to any lien created on assets of any of its political or administrative subdivisions, such member shall promptly and at no cost to the Bank secure the principal of, and interest and commitment charges on, the Loan by an equivalent lien on other public assets satisfactory to the Bank.[160]

This provision constitutes an affirmative type of negative pledge, as discussed in the second chapter. Hence, a lien is deemed to be created in favour of the World Bank when the borrower secures other external debt. The term "Lien" includes mortgages, pledges, charges, privileges and priorities of any kind"[161] and is intended to cover "any arrangement that provides a preference for a creditor with respect to property."[162] Obligations that are or may become payable, "other than in the currency of the country which is the Borrower or the Guarantor"[163], are exclusively covered by the negative pledge. As a result, the borrower country may secure domestic debt without infringing the clause. While recognising the necessity for countries to have access to secured financing from national banks, this exception also uncovers the World Bank's

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[160] See the World Bank, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Section 9.03(a) (i), supra note 15.
[161] Id. Section 2.01(17)
[162] See The World Bank. "IBRD'S NEGATIVE PLEDGE POLICY WITH RESPECT TO DEBT AND DEBT SERVICE REDUCTION OPERATIONS" (19 July 1990) On file with the author, par. 11, at 5.
[163] See the World Bank, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Section 2.01(10), supra note 15.

expectation to obtain repayment out of foreign assets rather than domestic ones.[164] The following subparagraph defines "public assets":

(ii) As used in this paragraph, the term "public assets" means assets of such member, of any political or administrative subdivision thereof and of any entity owned or controlled by, or operating for the account or benefit of, such member or any such subdivision, including gold and foreign exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions, for such member.[165]

This extensive definition encompasses any property belonging to, or managed by, the state or its agencies. Gold and foreign reserves, normally serving as collateral in secured sovereign loans granted by external lenders, are specifically enumerated in the clause. Besides these explicit references, exportable assets, such as tradable natural resources, are also caught by the negative pledge.[166] Such a broad description of "public assets" reduces the financing options of countries where the preponderance of the income-producing assets are state-owned, as was the case in Central and Eastern Europe and the former Soviet Union transiting from communism to an open market.

Paragraph (b) of Section 9.03 expresses the parallel negative pledge rule applicable to a borrower that is not the government of an IBRD's member nation. The lien created by such borrower "on any of its assets for any debt," must secure equally and rateably the payment of the Bank's loan. Noticeably, any debts, not only the external obligations, of a para-public agency are covered by this provision. Therefore, it may be

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[164] See Hurlock, supra note 23, at 358.
[165] See the World Bank, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Section 9.03(a) (ii), supra note 15.
[166] See The World Bank, supra note 162, par. 10, at 4-5.

detrimental for a state-owned entity to borrow funds directly from the World Bank, and to have the loan guaranteed by the government, since secured credit would not be available to such entity until the Bank's loan is fully repaid. The last paragraph of the Section pertains to the exceptions to the negative pledge rule:

(c) The foregoing provisions of this Section shall not apply to: (i) any lien created on property, at the time of purchase thereof, solely as security for the repayment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; or (ii) any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.[167]

<u>The Exceptions</u>

The first exception, akin to "purchase money mortgages", allows the borrower to procure new assets by obtaining financing with a lien charging the acquired property. Ships, or aircraft, are occasionally purchased by governments pursuant to this technique.[168] Short-term bank loans constitute another type of secured financing expressly permitted under the IBRD's negative pledge clause. The justification for the second exception is derived from the borrower's need to carry out its normal business activities.[169] However, the scope of this exception seems overly broad. As further explained below, an amendment is suggested in order to restrain this exclusion's breadth,

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[167] See The World Bank, General Conditions Applicable to Loan and Guarantee Agreements for Single Currency Loans, Section 9.03(c), supra note 15.
[168] See The World Bank, supra note 162, par. 12, at 5.
[169] See Hurlock, supra note 23, at 359.

for the purpose of assuaging the borrower's spurs to incur excessive short-term debt, while recognizing its commitments in respect of commercial trade.

Finally, even though the alienation of property is not explicitly denoted in the clause, no provision in the World Bank's loan agreements forbids the disposal of public assets by a country, acting either as borrower or guarantor.[170] The absence of provisions regulating the alienation of governmental property thwarts the IBRD from scrutinising the implementation of developing countries' privatization processes. Moreover, due to this deficiency, the World Bank is unable to prevent the debtor from shrinking the pool of assets available to its creditors. Therefore, the IBRD's negative pledge should include a rider providing for the Bank's control and pre-approval of the sale of public assets. Before elaborating on the suggested modifications, the Bank's policy and practice with respect to the negative pledge clause have to be examined, because the tightening up of a provision inevitably dictates a revision of its methods of enforcement.

The World Bank's Negative Pledge Policy

The negative pledge clause's introductory paragraph states the World Bank's general policy as to the security arrangements with regards to loans granted to member countries. "As a general rule, the Bank feels that governments should borrow on the basis of their general credit, rather than charging particular assets or revenues to secure individual loans."[171] In addition to this assertion, it should be remembered that IFIs, such as the IBRD and the IMF, benefit from a special status conferring them priority in the

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[170] Id. at 360.

[171] See Broches, Aron, and Piero Sella. "International Bank for Reconstruction and Development." Foreign Development Lending – Legal Aspects. Ed. Seymour J. Rubin. Netherlands: A.W. Sijthoff/ Oceana Publications Inc., 1971. 79-93, at 84.

repayment of foreign liabilities by a debtor nation. As a result, the risks of not being repaid are theoretically not as elevated for the Bank as they are for other unsecured lenders. Furthermore, it would be paradoxical on the part of the World Bank, a lender of last resort dedicated to reconstruction and development, to draw charges on sovereign assets which yield returns to developing countries.[172] Nevertheless, it is more arduous for a lender to assess the creditworthiness of a borrower, than to lock his assets away from other creditors. From that standpoint, through the negative pledge, the World Bank attempts to find a middle ground between the exclusive use of credit assessment and the taking of formal security.

The IBRD's clause aims at safeguarding the debtor's assets for the benefit of the mass of unsecured creditors. It operates also to curb the debtor's propensity to sustain disproportionate levels of debt. For that purpose, the Bank's negative pledge restricts the debtor's faculty to secure existing indebtedness and to gain access to certain new financings. [173] In 1954, in a memorandum to its Staff Loan Committee, the Bank bluntly articulated the genuine intention behind the IBRD's negative pledge policy:

> The basic purpose of the negative pledge clause is to protect the Bank against the use of governmental resources, or the use of governmental authority to mobilize other resources, to enable other foreign creditors to obtain foreign exchange in preference to the Bank through the creation of liens or priorities.[174]

It thus appears that, aside from protecting its creditor's interests, the World Bank intends to direct the borrower country on the manner in which it may raise foreign capital. In that respect, the ostensible loophole of the IBRD's negative pledge is the borrower's right to sell assets without breaching the clause. The World Bank has

[172] See Hurlock, supra note 23, at 356.
[173] See The World Bank, supra note 162, par. 5, at 2.
[174] See Memorandum (SLC/0/659) cited in The World Bank, supra note 162, footnote 4.

admitted that "privatization, simply put, shrinks the volume of assets which come within the reach of the Bank's negative pledge clause."[175] However, the Bank's philosophy has always included privatization as a panacea, through which an emerging country advances towards development and reduces poverty. The IBRD has been financing divestitures for over two decades, mainly throughout Africa and Central and Eastern Europe.[176] Ironically, the changes occurring in the latter region, where the economy was dominated by public enterprises, have driven the Bank's most recent review of its rigid negative pledge waiver policy.

The Headway of the IBRD's Negative Pledge Waiver Policy

Traditionally, the Bank agreed to waive the clause when its exposure, in absolute and relative terms, was negligible and the waiver did not "pose any risks to the Bank as a creditor."[177] Additionally, "liens created by government-owned or controlled entities on their own assets and for their own borrowings" would be occasionally excluded from the ambit of the clause. Such exceptions would be restrained to entities comparable to autonomous private companies that were not included in the government's budget and that operated outside the country's principal foreign exchange-generating sectors, and for which the activities did not impact on the borrower's capacity to repay the loans.[178] Due to these exacting conditions, the World Bank has been typically disinclined to waive the application of the negative pledge, and has done so only on rare occasions, sometimes even imposing ceilings on the amount a public entity could secure.

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[175] Id. footnote 7.
[176] See Salda, supra note 14, at 154.
[177] See The World Bank, supra note 162, par. 16, at 8.
[178] Id.

The major debt crisis that arose in the 1980s, compelled the Bank to revisit its negative pledge waiver strategy. The revised policy was activated by the 1987-88 Mexico debt reduction program and further employed under the DDSR operations. As the transactions sponsored by the IBRD entailed the supply of guarantees in compensation of the debt cutback conceded by the creditors, the Bank granted the waivers in view of two criteria: (1) "the impact that granting a waiver might have on the Bank as a creditor and as a borrower;" and (2) "the relevance of the proposed transaction to the Bank as a development institution."[179]

The first standard, relating to the Bank's lending and borrowing duties, has been assayed according to the position the Bank would be in after the waiver is granted and a prior charge on the borrower's property is created. Hence, in the following cases, the Bank would be prone to waive the negative pledge: (1) if the ratio of secured amounts against the country's outstanding debt did not fatally affect the debtor's capacity to service debt (i.e. the Bank's relative exposure was reasonable), (2) if other creditors waived their rights, and (3) if the borrower country's credit record was satisfactory.[180] Any negative inference resulting from this test might be curbed by a reasonable expectation that such a waiver authorizes the commitment of secured financing that would "lead to an improvement in, or significantly contribute towards, a country's creditworthiness."[181]

As opposed to the issues pertaining to the effects of the proposed waiver on the World Bank, the second criterion addresses the repercussions of the proposed financial

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[179] Id. par. 17.
[180] The World Bank has actually identified 5 factors which are summarized under the three elements identified above, Id. par. 18, at 9.
[181] Id. par. 19.

project on the developing country. In addition to the transaction's financial feasibility, the World Bank had to determine its economic and developmental value before waiving the negative pledge. "The track record of the country in pursuing sound policies and maintaining compliance with Bank and IMF programs" played a part in the Bank's decision to waive the clause's application, and guided its support of debt reduction operations.[182]

Not surprisingly, when providing funds for DDSR collateralization schemes, the Bank did not insist on the enforcement of the provision. However, the Bank's policy strictly confined waivers for ventures not requiring IBRD's financing to a case-by-case approach.[183] Likewise, new secured lending, either to bailout creditors, or for investment projects, was allowed on an exceptional basis, since the Bank had ascertained that the predetermined exceptions built into the negative pledge sufficed to satisfy a country's financial needs.[184]

The collapse of communism and the consequent shift experienced in Central and Eastern Europe, from a centrally planned economy to a market-oriented one, marked a new episode in the evolution of the World Bank's negative pledge policy. Countries, where almost the totality of the assets were state-owned, struggled to raise foreign capital, and the negative pledge provisions they subscribed to when borrowing from development banks, such as the World Bank and European Bank for Reconstruction and Development (EBRD), obstructed their efforts.

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[182] Id. par. 20.
[183] For example, the World Bank granted to Costa Rica a negative pledge waiver that was limited to the specific transaction it was asked for. In all cases, the conditions issued from the Mexican experience have been applied. Id. par. 22-25, at 10, 11.
[184] Id. par. 34, at 14.

The World Bank responded to the post-communist dilemma by working on new norms that would permit the release of the negative pledge for specific project financings. In order to ensure that it does not extend to all borrowers, the adjusted waiver plan identified the eligible countries, providing that, "at least 75 percent of (their) income producing assets are in the public sector."[185] As a prerequisite for granting a waiver, the Bank required the borrowing country to pursue structural reform, evidenced basically by the government's dedication to privatize public enterprises.[186] The Bank's policy also called for the implementation of an "adequate macroeconomic policy framework."[187] In that respect, observance of IMF adjustment programs was viewed as a gauge for the borrower's performance. This test was particularly difficult to pass for transiting countries. Indeed, they were initially unable to muster enough foreign exchange to comply with the programs, and thusly, could not gain access to external capital, since collateralization was impossible without the negative pledge waiver.[188]

Once a country conformed to the "75 percent rule", embarked on a privatization path and demonstrated, either through the IMF or a separate World Bank's assessment, the legitimacy of its macroeconomic framework, a waiver would be granted if the transaction respected certain precise boundaries. The secured funds would be disbursed to a "special-purpose entity with a separate juridical personality, the assets and liabilities

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[185] See IBRD Negative Pledge Policy with Respect to Lending for Investment Projects, at 5, R92-214/2, (Mar. 30, 1993), cited in Hurlock, supra note 23, footnote 135.

[186] « Diversification from the public to the private sector including an appropriate privatization program…and a shift from an administered system to a market economy » were all indicative of the transition process undertaken by the country seeking the negative pledge waiver. See IBRD Negative Pledge Policy with Respect to Lending for Investment Projects, at 5, R92-214/2, (Mar. 30, 1995), Id. at 374.

[187] Id. at 375.

[188] Id. at 378.

whereof must be limited to the project for which the loan secured by the lien is made."[189] Furthermore, the transaction could proceed only for amounts that the foreign lender could not secure in some alternative form, such as a governmental guarantee or private insurance.[190] Finally, the guidelines commanded that the secured lender be held by private interests for a commercial purpose, and that the World Bank did not financially participate in the waived project, thereby subordinating its claim.[191] Once a proposed financing satisfied these requirements, the negative pledge waivers were limited as to their duration and as to the magnitude of assets that fell under the secured creditor's control.[192] Such comprehensive constraints, especially those with respect to the necessity to borrow through a special purpose vehicle and to observe an acceptable macroeconomic adjustment policy, barred most of the Central and East European countries, as well as Russia and the former Soviet republics, from obtaining the waivers they required in order to gain access to private secured loans.[193]

In face of the transitional difficulties encountered by the eastern countries, the EBRD adopted a broader negative pledge waiver policy than that of the World Bank. The EBRD's permissive waiver policy was partly due to a relaxation in the international practice of "the application of negative pledge restrictions so as to permit sovereign obligors, and especially SOEs, to incur secured debt to finance productive projects."[194]

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[189] Id. at 375.
[190] Id. at 376.
[191] Id.
[192] Waivers would be valid for three year-periods with possible two-year renewals; only the « export revenues and other assets of the project » could be the object of a lien; the original maturity of a the secured loan had to be at least five years and a maximum of 12 months' projected debt service obligations could be accumulated in escrow accounts; reserve accounts holding project revenues for future expenditures were limited to six months' projected debt service obligations. Id. at 375.
[193] Id. at 378, see also Asiedu-Akrofi, supra note 17, at 434.
[194] See Limited Waiver of Bank's Negative Pledge Clause, at 1-2, BDS93-140/Rev 2, (Nov. 17, 1993) cited in Hurlock, Id. at 379.

The European Bank affirmed that borrowers' resources might even expand as a result of creditors easing up on their negative pledges. In the context of the post-communist transition, the negative pledge waiver was considered by the EBRD as a facilitator for public entities, which could acquire private capital "without relying on the continued support of, and control by, the state that accompanies the extension of sovereign guarantees."[195] Accepting the viewpoint of its European counterpart, the World Bank eventually amended its negative pledge policy. Both shortcomings of the original waiver approach were addressed by the Bank's management as follows: 1) compliance with a macroeconomic adjustment program as a eligibility factor was dropped and replaced by the World Bank's judgment that the borrower country was "making progress in privatization and... moving toward a market economy... [while] experiencing improvement in its macroeconomic situation and [that] the waiver of the negative pledge clause would be deemed further to contribute to the accomplishment of the above goals"[196]; and 2) the World Bank renounced to the creation of special utility vehicles and assumed the EBRD's line according to which, permitted "liens would be restricted to project-related assets and would be allowed to secure only financing of the acquisition, construction or development of properties which are part of the project financed, without any further recourse to other parties or assets."[197] Immediately thereafter, the World Bank's authorities sanctioned the collateralization of loans contracted by Russia and

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[195] Id.

[196] See IBRD Negative Pledge Policy with Respect to Lending for Investment Projects, at 1-2, R93-199 (Nov. 24, 1993) cited in Hurlock, Id. at 384.

[197] Id.

other states of the former Soviet Union. Said loans would notably allow borrowers to finance their oil well operations and, hence, strengthen their sources of revenue.[198]

Although the post-communist conjuncture, which affected centrally planned economies, obliged the World Bank to loosen its negative pledge waiver strategy, the general practice has not changed. Waivers are only granted exceptionally and on a case-by-case basis. Moreover, the request for a waiver goes through a multi-levelled process that is at risk of daunting any government wishing to acquire secured credit.[199] Not surprisingly, some borrowers do not bother to engage in such an uncertain endeavour – choosing instead to contravene their obligations.

The Enforcement of the IBRD's Negative Pledge

In commercial lending, the breach of the negative pledge clause confers upon the creditor the grounds needed to sue the defaulting borrower and, in certain circumstances, the party who has taken security and thereby forced the clause to be violated. Additionally, properly drafted clauses play a preventive role, since the pledge of assets may divulge a debtor's hurdle to access credit and impel the unsecured lender to act before the debtor becomes insolvent. The World Bank is allegedly relying on its negative pledge clause to prevent other external creditors to preferably grasp a country's foreign exchange. Nevertheless, when a borrower encroaches on the negative pledge provision,

[198] The World Bank. "Policy Research Department, Transition and Macro-Adjustment Division, Volume 4, Number 3." (April 1993) 15 Feb. 2005 <http://www.worldbank.org/transitionnewsletter/pdf/April93.pdf>.
[199] "A proposed waiver must be recommended by the country director, through the Regional vice president (in consultation with the vice President and General Counsel and the Director, Credit Risk Department), to the Managing Director (MD) concerned. The proposed waiver is then submitted to the Board for approval." See The World Bank, supra note 159.

the sole measure that appears to be enforced by the IBRD, is to discontinue the flow of its funds until the violation stops.

For instance, Turkmenistan, which possesses potential to generate wealth due to its important gas reserves, has been precluded from obtaining IBRD's loans for the past few years. In fact, since 1995, the Bank has only disbursed about a third of the funds it committed to in terms of aid for this country.[200] The violation of the IBRD's negative pledge clause represents one of the main reasons for the Bank's disinclination to grant new loans to Turkmenistan.[201] Likewise, in March 2001, the World Bank "expressed reservations" about the projected issuance by the Indonesian government of sovereign bonds. That transaction would have involved the securitization of proceeds derived from the export of West Natuna natural gas to Singapore.[202] The Bank raised concerns that such an enterprise would breach its negative pledge clause.[203] Recently, a project aiming to enhance the commercial appeal of a port in the Philippines dragged on, due to the borrower's inobservance of the negative pledge. Although its progress suffered from political unrest, the venture was postponed by 11 months because the Subic Bay Metropolitan Authority (SBMA), a Philippines' government-controlled corporation, offered preferential guarantees to two domestic banks.[204] In order to comply with the Bank's negative pledge requirements, the public agency had to purge the liens and swap

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[200] The World Bank. "Turkmenistan Country Brief 2004." 16 Feb. 2005 <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/TURKMENISTANEXTN/0,,menuPK:300743~pagePK:141132~piPK:141121~theSitePK:300736,00.html>.
[201] Id.
[202] See The World Bank. "Indonesia, March 28, 2001." 16 Feb. 2005 <http://lnweb18.worldbank.org/eap/eap.nsf/Attachments/Indonesia/$File/Indonesia.pdf>.
[203] Id.
[204] See The World Bank. "Implementation Completion Report (SCL-41110) on a Loan in the Amount of US$60 million to the Republic of Philippines for a Second Subic Bay Freeport Project. (14 Apr. 2004) 16 Nov. 2004 <http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2004/04/27/000090341_20040427102427/Rendered/PDF/272820PH.pdf>.

them for superior credit costs.[205] Since in that case the borrower was not a government, the negative pledge debilitated SBMA's right to grant security on all of its outstanding debts, both foreign and domestic. As a result, this impingement compelled the Philippines' Department of Finance to assume a credit risk through the issuance of a sovereign guarantee and inflicted additional charges on the public corporation in the form of an increased interest rate. In addition, as the IBRD's loan to the SBMA was guaranteed by the Philippines' government, its assets were therefore cloaked by the general provision fettering the collateralization of foreign debt. Thus, it occurs that, when lending to a state-owned enterprise, the World Bank does not exact formal security from either of the borrower or the guarantor, but the effect of the negative pledge is to hypothecate the assets of both.

Three Amendments to Improve the IBRD's Negative Pledge Clause

Having considered the foregoing issues carefully, the three following comprehensive amendments to the IBRD's negative pledge clause are now proposed:

1. Amend subparagraph 9.03 (c) (ii), which allows the debtor to create *"any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred."* As the *ordinary course of banking transactions* is not defined in the World Bank's contract, the line between an ordinary and an anomalous course of transactions is not clearly traced. Therefore, a borrower might engage in a series of secured short-term bridge loans, without ever breaching the clause. This broad exclusion hazards the Bank's lending position and is at

[205] The SBMA paid a higher interest rate to the Development bank of the Philippines in lieu of the assets' pledge, and required a sovereign guarantee to replace the security granted to the Philippines National Bank; Id.

risk of encouraging irresponsible borrowing behaviour on the part of any country running short of liquidity. Henceforth, this subparagraph should confine the negative pledge exception to liens that a government has to consent to in order to carry out its import and export activities.[206]

2. Include a provision pursuant to which, the World Bank has to be consulted before a country sells or otherwise alienates its property. The current state of affairs permits a borrower to raise capital by selling its assets. It follows that the negative pledge's objective is theoretically frustrated by the debtor's leeway to deplete its own assets without allotting the proceeds to the repayment of the Bank's loan, or generally, to the improvement of its financial situation. Therefore, the IBRD should not only promote privatization, but also ensure that it is performed properly and that it procures desirable corollaries. This might be achieved, at least in part, through the insertion of a control mechanism in the negative pledge clause.

3. Proffer a comprehensive and predictable negative pledge waiver procedure. The present waiver policy is constricted and complicated and it is not clearly established who may obtain a waiver and when. By forsaking the negative pledge clause for commendable borrowers, the World Bank may send a constructive signal to the financial community and let certain developing countries, particularly the middle-income ones, access to secured and unsecured credit at lower costs. Obviously, a waiver should not be granted without scrutiny and pursuant to loosely applied criteria. However, the Bank, having developed selectivity measures and methods to assess sovereign debt sustainability, possesses the instruments it needs to implement a scrupulous waiver

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[206] See Hurlock, supra note 23, at 352.

policy. Such an approach might confer more flexibility to sound borrowers, while preserving the Bank's excellent creditor status.

In the final chapter of this piece, policy justifications with respect to each of the proposed amendments are propounded, and details are given as to the implementation of such amendments.

CHAPTER FIVE

LESSONS FROM THE PAST AND GUIDANCE FOR THE FUTURE

More than anytime before, the problems facing the poorest nations are given consideration by the international community.[207] Although slowly, developed countries muster resources to aid their less fortunate counterparts. Despite this tardiness, there is optimism that the Millennium Development Goals, which set the target of 2015 to halve extreme poverty, can still be met.[208] A new method of financing has been advanced by the United Kingdom, in order to commit future official aid for the neediest countries, and in order to use such pledges as leverage to raise private funds.[209] With good cause, international aid has been predominantly directed towards the most impoverished regions. The HIPC initiative and propositions for total debt relief and new pledges of money are intended to transfer more resources to the poorest developing countries.[210] However, as certain emerging economies will have to struggle with rising borrowing

[207] Major donors' aid commitments have substantially rose since the Monterrey Conference; see The World Bank, supra note 93, at 111. Moreover, important leaders have promised to honour these commitments and to make 2005 a "breakthrough year" for international aid; see Sachs, Jeffrey. "How to halve world poverty." The Economist, The World in 2005 January 2005: 68.

[208] Id.

[209] HM Treasury. "The International Finance Facility." (April 2004) 16 Feb. 2005 <http://www.hm-treasury.gov.uk/documents/international_issues/int_gnd_intfinance.cfm>.

[210] "Debt relief, Clean slate." The Economist 2 Oct. 2004: 73.

costs and a reduced demand for their goods and services, many challenges remain to foster growth of, and to secure the progress made by middle-income nations.[211]

The financial actors tackling international debt issues have stressed the importance of creating incentives to deal with indebtedness before a crisis, as well as the need to address debt problems of middle-income countries.[212] The behaviour of borrowing governments may be influenced by the legal tools possessed by their creditors. Multilateral institutions, such as the World Bank, should make the best use of their contractual covenants in order to induce responsible conduct on developing states and to support those which act reliably.

In the following sections, it is explained how the suggested amendments to the IBRD's negative pledge clause would foster a preventive role and would encourage the authorities of middle-income countries to adopt proper policies in respect of debt sustainability.

The Case against Short-term Borrowing

The past ordeals, like the major debt crisis of the 1980s, bequeathed important lessons, which lenders and borrowers should not forget. One such lesson is that the huge earnings resulting from high oil prices should not be used to inflate the developing world's debt as was the case before the crisis, when OPEC countries saved in western banks which, in turn, lent massively to emerging markets.[213] It is not foreseeable that this

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[211] See Bew, Robin. "Living with the slowdown." The Economist, The World in 2005 January 2005: 12.
[212] See para. 51 of the Monterrey Consensus cited in Herman, Barry. "The Paris Club and The Monterrey Consensus (Chair's introductory statement for the session on the Paris Club at the DMFAS Conference)." (13 Jan. 2004) 16 Feb. 2005 <http://r0.unctad.org/dmfas/pdfs/herman.pdf>.
[213] "Oil revenues, The $300 billion bonanza." The Economist 25 Sept. 2004: 85.

pattern will recur in the short term, since oil-export revenues, in constant terms, are far from their peak of the late 1970s.

Nonetheless, external short-term borrowing is repeatedly cited as a mode of financing that exacerbates debt problems, rather than solving them. As discussed in Chapter 3, near-term bridge loans, designed to clear up developing countries' liquidity shortage, overstrained them. Likewise, short-term indebtedness was an important factor in the initiation and aggravation of the East Asian crisis of 1997.[214] As a result, the Paris Club acknowledged that "LONG-TERM DEBT SUSTAINABILITY, as apart from merely filling short-term financing gaps, shall be the GUIDING PRINCIPLE for debt relief also for middle-income countries, as has long been the case for the poorest countries (the HIPC countries)."[215] Moreover, the "Monterrey Consensus," a declaration of principles adopted by representatives of developed and developing states at the International Conference on Financing for Development in March 2002, affirms that "debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations. (para. 47)"[216]

The World Bank has also recognised that short-term lending had led to problems in the past and may be harmful in the future.[217] In the eventuality of higher interest rates, the surge of short-term external debt may weaken the financial viability of borrowing

[214] See Stiglitz, supra note 11, at 110, 132, and 236; See also DMFAS Meetings. "Inter-regional Debt Management Conference – the World Association of Debt Management Offices – the DMFAS Advisory Group meeting, Geneva, 10-14 November 2003." 16 Feb. 2005 <http://r0.unctad.org/dmfas/meetings1103.htm>.
[215] See Hansen, Bjorn Brede. "The Evian Approach – Talking Points." (Geneva, 10 November 2003) 16 Feb. 2005 <http://r0.unctad.org/dmfas/pdfs/hansen.pdf>.
[216] See Herman, supra note 214, at 2.
[217] See The World Bank, supra note 71, at 11 and 61; see also the World Bank, supra note 93, at 15.

countries.[218] Indeed, liabilities with a maturity of one year or less may be defaulted upon when the repayment capacity of a debtor is impaired by soaring borrowing costs. Therefore, lending policy, especially that of development institutions, should be oriented towards reduction of the countries' exposure to near-term debt.

It is submitted that, by allowing "any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred", the World Bank's negative pledge clause is at risk of inciting sovereign borrowers to seek out short-term secured financing and face unsustainable levels of debt. Additionally, with the current version of the negative pledge provision, the Bank is shorn of a preventive instrument that would allow it to deal with problematic indebtedness before a default on repayment occurs. Hence, if the clause was more strict and allowed trade finance exclusively, a default on the negative pledge would be triggered when a borrower enters into secured financing, in an attempt to seal liquidity cracks. The Bank's personnel might then intervene in time and, in conjunction with national authorities, conceive a strategy to correct a country's particular situation before it defaults and falls into a crisis.

The Case for Securing Trade Finance

Figures, with regards to insurance provided by official export credit agencies to exporters from developed to developing countries, show that middle-income countries receive the major part of gross disbursements emanating from these guarantees.[219] The

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[218] In Central Europe, for instance, short-term debt increased from $1.5 billion to $17 billion between 2002 and 2003. Globally, a more important share of new syndicated loans (17.9 %) had a maturity of one year or less in 2003 than in 2002 (15 %), see the World Bank, supra note 93, at 27 and 53.

[219] Id. at 138.

credit agencies' involvement is even more significant in low-income countries, the imports of which are covered by export credits in proportions, varying from 7 to above 40 percent.[220] This data illustrates the dependence of developing countries on external financing in order to carry out international trade. Overall, the share of trade finance going to the public sector has declined.[221] Yet, financing state-owned enterprises is crucial in countries where the governments still occupy an important segment of the economy. China, a state-dominated economy, collects the greatest amount of official export credits in the world.[222] Turkmenistan, which has been cut off from the IBRD's aid, due in part to a negative pledge clause breach, has the highest ratio of export credits to imports.[223]

There are several benefits to confining the short-term borrowing exception to trade finance, as opposed to applying it broadly to banking transactions. In addition to enhancing accession of less creditworthy countries to private capital through international trade, the variety of sources where this type of financing originates from may diminish costs for borrowers, through competition among trade finance providers such as commercial banks, official export credit agencies, multilateral development banks, insurance firms, suppliers, and purchasers. Moreover, some of the latter agents are in better position than others when it comes to assessing the creditworthiness of a borrower. Also, certain creditors may repossess goods granted as collateral more easily than others. The supplier, extending the payment terms to its buyer, and the purchaser, prepaying the goods to be delivered, enjoy both of these advantages. On the one hand, firms supplying

[220] Id. figure 5.10, at 138.
[221] Id. figure 5.4, at 131.
[222] Id. figure 5.9, at 131.
[223] Id. figure 5.10, at 138.

particular goods acquire good knowledge of the market in which they operate and of the customers with which they are transacting.[224] On the other hand, the stoppage of supplies to a non-paying customer is more effective and threatening than a financial institution's foreclosure proceedings.[225] Similarly, western legal systems, like civil and common law, which a supplier in dominant position may impose as governing the contract, allow the seller to reclaim goods more swiftly than banks can execute their guarantees.[226] Finally, it is easier and cheaper for a supplier to sell repossessed goods, than for a bank to dispose of collateral.[227]

The short-term borrowing exception to the World Bank's negative pledge clause would benefit largely from the adoption of language and methodology more analogous to that used by commercial lenders to sovereign entities. This would result in allowing the borrower: 1) to secure short-term financing from any source, but solely for the importation of goods; and 2) to secure financing of a business producing exportable assets, but uniquely for the purpose of guaranteeing external indebtedness incurred for the operation of such enterprise, and as long as the lien is created on similar exportable assets produced in connection with said business.[228]

Paradoxically, the espousal of provisions used in private lending, while consolidating its creditor's status, would offer the World Bank the occasion to use the negative pledge clause for two developmental purposes. Firstly, the borrower would be prevented from running into detrimental short-term debt, or at least the Bank could

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[224] Id. at 134.
[225] Id.
[226] Id.
[227] Id.
[228] See Hurlock, supra note 23, at 352.

monitor the borrower's actions in that respect. Secondly, developing countries would have greater access to the trade financing that is essential for their growth.

The Pace and Price of Privatisation

It is frequently contended that the private market may entail substantial gains over a centrally planned economy. The objective of maximising returns on investment commands a private enterprise to function more efficiently than governments do. Innovation and wealth creation are also stimulated by the profit incentive. Private businesses, as opposed to state monopolies, usually face competition, and thus, have to perfect their modes of production. It results that consumers reap competitive prices and greater choices from the private sector, while the government may focus on its core missions.

Therefore, it seems logical for the World Bank to champion privatisation of state-owned enterprises as a means to "achieve economic development and poverty reduction."[229] Nevertheless, governments continue to play a predominant role in many emerging economies. For instance, more than one half of the fifty-two developing countries surveyed by the World Bank manage their electrical power sector entirely through state-owned enterprises.[230] Pleading the protection of national interest, certain governments have partially privatised otherwise public enterprises and have limited access to foreign investors, or have utterly halted privatisation plans.[231]

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[229] See Salda, supra note 14, at 154.
[230] See the World Bank, supra note 93, figure 6.3, at 153.
[231] For instance, the Polish government has retained control of the partially privatised PKO BP Bank and has limited the number of shares available to foreign purchasers; see Samcik, Maciej. "Rzad sprzeda wiecej akcji PKO BP. *(The government will sell more shares of PKO BP.)*" Gazeta Wyborcza (Warsaw) 2 Nov. 2004.

Some commentators have condemned the manner in which the IMF and the World Bank have handled the privatisation issue.[232] Their principal argument does not concern privatisation as such, but rather the unbridled rhythm at which it is implemented. As the economic growth of any country relies on the effective use of its resources, the prerequisite for development is the existence of an environment propitious to sound utilisation of these resources. Consequently, one of the underlying principles of reform should be the following:

> That during the early phases of development, when an economy is no more than a collection of fragmented markets and regions, the establishment of government institutions, the construction of infrastructure and the direct participation of the state in key areas of the economy are not only desirable but indispensable preconditions for the growth process.[233]

In the absence of a legal framework regulating competition, hasty privatisation of state owned firms may bear ill effects. As such, although the government picks up higher proceeds from selling a monopolistic enterprise, consumers often suffer the abuse of the newly privatised entity, which dominates the market without constraint.[234] In the same way, engaging in a privatisation process before proper institutions are put in place, may be detrimental to workers that are laid off on efficiency grounds and that do not have satisfactory training to allow them to be relocated to more productive jobs.[235] An even more perverse upshot of mismanaged privatisation, is the misappropriation, by corrupted officials, of revenues that would have otherwise been allotted to social programs, or for

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Also, the South African Minister of Public Enterprises "told parliament that he had no plans to sell off any of the large state-owned companies that have long been destined for privatisation." See "South African privatization, On hold?" The Economist 24 June 2004.

[232] See Stiglitz, supra note 11, at 54.

[233] See Ibrahim, Musa Jega. "An Evaluation of The Developmental Implications of The World Bank and IMF Lending Policies." Development Studies Association Conference (2003) 16 Feb. 2005 <http://www.devstud.org.uk/publications/papers/conf03/dsaconf03ibrahim.pdf>, at 3.

[234] See Stiglitz, supra note 11, at 56.

[235] Id. at 56-57.

the repayment of public debt. Corruption of public agents typically arises in badly governed countries with a scanty legal structure. Unfortunately, these marks bring about another important problem linked with rushed privatisation of public enterprises: asset stripping by the new owners.[236]

The former Soviet Union is probably the prime example of mismanaged privatisation. The set of conditions called for by the IMF and endorsed by the World Bank, mingled liberalisation and privatisation, both to be realised promptly and concomitantly.[237] What ensued was a series of bungled transactions profiting only to friends of the regime. As if the messy privatisation was not enough, liberalisation policies tempted owners to send out a myriad of newly acquired assets to safe havens offshore. Through this ploy, the Russian economy has been deprived of billions of dollars.[238]

In modern economics, law is believed to inspire the deeds of economic actors by crafting incentives. In that same vein, governments fulfil a central role in shaping the institutional orderliness, that is indispensable to proper development.[239] Cognisant of the importance of encouraging state reform in developing countries, the World Bank has adopted a governance agenda and now participates in institution building by providing loans " to support a program of policy and institutional actions, for example, to improve the investment climate, diversify the economy, create employment, and meet applicable

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[236] Id. at 58.
[237] Id. at 142.
[238] Id. at 144.
[239] See Tshuma, Lawrence. "The Political Economy of the World Bank's Legal Framework for Economic Development." Social & Legal Studies, 8 (1999): 75-96. Rpt. in International Economic Regulation. Ed. Jane Kelsey. Aldershot, England; Burlington, VT: Ashgate/Darmouth, 2002: 179-200, at 88-89.

international commitments."[240] While advocating sound management of a country's resources, the Bank does not, however, contemplate the timing and sequencing of the privatisation process, nor does it appreciate the manner in which the sale of public assets is accomplished.

The negative pledge clause should be amended in order to confer a say in the alienation of state-owned assets on the IBRD. Without going as far as a plain interdiction, the clause could provide for a pre-approval procedure. By availing itself of yet another feature of the commercial negative pledge provision, the Bank would strengthen its dual role of creditor and development institution: 1) it would impede its debtors' asset stripping; and 2) it would have a tool to pore over the borrower countries' privatisation schemes.

Selective Waiving

As strong institutions and good policies impact favourably on a country's economic performance, it is rational on the part of foreign lenders to give preference to sovereign states from which an outstanding management may be expected. For some time now, several multilateral and bilateral donors have been taking into account the quality of governance in selecting the receivers of their funds, even if the most important contributors have yet to follow their lead.[241] Customarily, economic reform has been detached from democratisation, and governance has been assessed by the World Bank,

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[240] See The World Bank. Operational Manual, Operations Policies: Development Policy Lending, OP 8.60." (August 2004) 16 Feb. 2005 <http://wbln0018.worldbank.org/Institutional/Manuals/OpManual.nsf/tocall/AD55139DFE937EE585256EEF00504282?OpenDocument>, at 1. See also Tshuma, Id. at 78-79.

[241] See Dollar, David. and Victoria Levin. "The Increasing Selectivity of Foreign Aid. 1984-2002." World Bank Policy Research Working Paper 3299 (May 2004) 18 Jan. 2005 <http://econ.worldbank.org/files/35475_wps3299.pdf>.

"in terms of having good order and discipline in the management of a country's resources."[242] What is more, the development of trade and industry has been deemed to lay ground for democracy. Indeed, the prevailing doctrine professes that a democratic system may only be established once the economic conditions allow it.[243] According to some observers and policy-makers, the democratic process may even obstruct the actions that need to be undertaken by the government in order to materialise the economic reform.

As measured by median per capita growth rates, empirical evidence demonstrates that, outside of eastern Asia, democracies, "political systems characterized by popular participation, genuine competition for executive office, and institutional checks on power", surpass dictatorships in economic development.[244] The success of East Asian autocracies may be partly attributed to the implementation by their governments of Western-like policies, targeted towards exports and the involvement of private enterprise.[245] The edge of developing democracies over totalitarian regimes springs from the qualities inherent to systems where governments are accountable to the people. Democratic governments are hypothetically inclined to look after the society's general welfare. In fact, the electorate has the faculty to persuade its representatives, as opposed to repressive leaders who respond only to factions which maintain them in power.[246] Also, contrasting with political monopolies, the democratic policy-making process is enhanced by the checks and balances on the exercise of state authority.[247] Finally, the

[242] See Tshuma, supra note 239, at 81.
[243] See Siegle, Joseph T., and Michael M. Weinstein, and Morton H. Halperin. "Why Democracies Excel." Foreign Affairs September/October 2004: 57-71, at 57.
[244] Id. at 58 and 59.
[245] Id. at 62.
[246] Id. at 64.
[247] Id.

openness of democratic systems facilitates the flow of information, bolsters transparency and predictability of the governmental apparatus, and warrants a relative political stability – all of which are essential factors of economic growth.[248]

Based on these findings, the IBRD might wish to embrace an additional mission, cognate to one which has already been embraced by its European counterpart: the promotion of democracy among its members.[249] For the time being though, the World Bank is blocked from weighing political criteria when disbursing loans, or when attaching conditions to them.[250] It has been suggested that certain amendments be made to the Bank's Articles of Agreement, and that "democracies should qualify for larger levels of funding, and their leaders, as legitimate representatives of their societies, should be granted considerable flexibility in identifying development priorities and strategies."[251] Arguably, such an amendment would constitute a desirable shift in the World Bank's policy. In relation to the negative pledge clause, advancement towards democracy might be impelled through the incorporation of political criteria in the evaluation of a waiver request.

Complementarily to democratic factors, the excellence of a borrower country's institutions and policies should become a factor in determining whether or not the Bank waives its negative pledge provisions. The World Bank currently ranks the performance

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[248] Id. at 65.
[249] See "Taking on Turkmenbashi." The Economist 26 July 2001. In this instance, the EBRD sent an open letter to Turkmenistan "objecting to the lack of democratic as well as economic change in the country." See also: The European Bank for Reconstruction and Development. "Political Aspects of the EBRD Mandate." 16 Feb. 2005 <http://www.ebrd.com/pubs/insti/poli/aspects/aspects.pdf>. "The Agreement Establishing the European Bank for Reconstruction and Development includes a significant political element in that it specifies that the Bank may conduct its operations in countries of central and Eastern Europe which not only are proceeding in their transition towards market-oriented economies, but also are applying principles of multiparty democracy and pluralism."
[250] See The World Bank, IBRD Articles of Agreement, Article IV, Section 10, supra note 13.
[251] See Siegle, Weinstein, and Halperin, supra note 243, at 68.

of its members and utilises the Country Policy and Institutional Assessment (CPIA) index for the allocation of the resources of its IDA branch.[252] In the same way, the CPIA scores the middle-income IBRD borrowers, which, incidentally, have been improving their policies and institutions over the period 1999-2003.[253] Furthermore, an independent unit within the World Bank, known as the Operations Evaluation Department (OED), "provides an objective assessment of the Bank's work and its clients' performance" to the Board of Executive Directors, and prepares an Annual Review of Development Effectiveness.[254] Thus, the OED might offer relevant insights, and collaborate with the IBRD in appraising a borrower's waiver demand.

Aside from the norms of governance, the World Bank's waiver practice should include gauging a country's capacity to sustain its public debt. To that effect, the Bank might draw from the method worked out by the International Monetary Fund, which estimates debt sustainability notably to determine when financing is appropriate, and what levels of it are appropriate.[255] A sustainable debt is one that "can be serviced without an unrealistically large future correction in the balance of income and expenditure."[256] In order for public debt to be sustainable, the borrower should not be found in any of the following situations: 1) debt restructuring is, or is expected to be, needed; 2) debt grows faster than the borrower's ability to service it; and 3) the borrower accumulates debt with knowledge that a significant reduction of expenditures will be

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[252] See The World Bank. "Policy-Based Lending, Conditionality, and Development Effectiveness." 19 Jan. 2005 <http://siteresources.worldbank.org/PROJECTS/Resources/Session2AjayChhiabberAC.pdf>.
[253] Id.
[254] Id.
[255] See The International Monetary Fund. "Assessing Sustainability." (28 May 2002) 20 Jan. 2005 <http://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf>.
[256] Id.

necessary in order to service it.[257] Thus, an assessment of sustainability combines the notions of solvency and liquidity, and, especially in the case of a sovereign borrower, has to account not only for the actual ability to repay, but also the willingness to do so.[258] This thesis does not purport to exhaustively discuss the IMF's assessment technique. For the purposes of this piece, it suffices to highlight the fact that such tools exist and that the World Bank, just like the IMF, has made steps forward in their elaboration.[259]

Therefore, it is suggested that the World Bank adopts a waiver policy that would allow a borrower state to secure external debt when precise policy and financial thresholds are met. Several benefits are foreseeable out of a clear and predictable waiver mechanism. In addition to the incentives to democratisation that were discussed above, the waiving of the IBRD's negative pledge would send a positive signal to private investors about a country's political and financial posture. Such an indicator would, in turn, contribute to a decrease in the cost of financing, the fluctuations of which are considered as impediments to debt sustainability.[260] Furthermore, a renewed negative pledge waiver policy may meet specific financing needs in emerging markets.

The Need for Public Spending

Once the motives of the proposed amendments to the negative pledge clause have been addressed, a question remains: what countries will be served by a remodelled clause? While the tightening up of the clause (i.e. limitations on short-term borrowing and alienation of assets) is aimed at containing the inauspicious tendencies of poorly

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[257] Id. at 4.
[258] Id. at 4, 5.
[259] See DMFAS Meetings, supra note 214.
[260] See The International Monetary Fund, supra note 255 at 6.

managed states, the waiver proposition confers more autonomy to IBRD's middle-income borrowers. This objective appears to be commendable in light of the high demand for infrastructure projects in developing countries and of the inevitability of public entities' participation in the financing of such projects.[261] Investment from the private sector requires a suitable level of protection against credit risks. As such, spurring the access of state agencies to capital markets, and mitigating the hazards faced by creditors constitute two challenges that emerging economies must surmount with respect to infrastructure financing.[262]

Recently, some developing countries' governments have expressed their desire to publicly fund important projects for the development of roads, ports and other infrastructures.[263] Such countries should be allowed to grant security interests in guarantee of external debt, when complying with predetermined conditions established along the lines of the present chapter. For instance, debt-service accounts might be set up offshore in order to secure a loan conceded by a foreign financier. If used cleverly, the substantial international reserves hoarded by many developing nations free up possibilities for them to approach the credit market with a certain leverage.[264] At a time when many experts dread an upsurge of interest rates, awarding trustworthy emerging democracies the right to use this leverage might not only be beneficial to them, but also to the world as a whole.

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261 See the World Bank, supra note 93, at 151.

262 Id. at 161.

263 See "South Africa's economy, Pulling out the stops." The Economist 30 Oct. 2004: 54; and "India's foreign-exchange reserves, Promises to keep." The Economist 6 Nov. 2004: 77.

264 The developing countries had more than 1,000 billion dollars of foreign reserves in 2003, see the World Bank, supra note 93, figure 2.7, at 44.

CHAPTER SIX

CONCLUSION

The principal objectives of this paper were to assess the negative pledge clause comprised in the standard conditions of the IBRD's loan and guarantee agreements, and to verify whether its provisions meet the legal objectives usually pursued by this type of covenant. In addition, this dissertation endeavoured to evaluate the impacts of the negative pledge's current version on the developmental mission engaged in by the World Bank.

Firstly, the attributes of the negative pledge employed in private international lending were discussed. Applying the rules of common law jurisdictions, which usually govern international loans, three features found in a clause enforceable before courts were isolated: 1) the lender should insist on an "affirmative negative pledge" clause, which, in case of breach, provides for the automatic creation of a security interest in favour of the negative pledgee; 2) the borrower's capacity to alienate its assets should be curbed; and 3) the exceptions to the negative pledge rule should be narrow and precise.

Subsequently, the trends adopted in sovereign borrowing were examined. The adverse effect of excessive short-term liabilities on debt sustainability was ascertained. Moreover, it was observed that collateralization played an important role in the aftermath of the 1980s debt crisis, and that security, as a risk-mitigating factor and a device facilitating recovery of claims from public entities, may constitute an appealing tool for certain creditors. Furthermore, the interference of negative pledge covenants with secured lending to sovereigns and the necessity to grant waivers, particularly during a foreign debt restructuring, were pointed out.

Chapter 4 was devoted to the analysis of the IBRD's negative pledge clause. It was posited that, while restraining a state ability to guarantee present and future debts, the World Bank's negative pledge provision may, in fact, impel a debtor nation to incur near-term debt. Furthermore, the lack of any deterrent, with respect to the sale of governmental assets in the IBRD's loan conditions, was denounced. Consequently, three amendments to the Bank's negative pledge clause were suggested as follows: 1) the scope of the exception, which authorizes to secure banking transactions maturing not later than one year after their incurrence, should be redefined in order to limit the recourse to short term debt, while allowing the borrower country to pursue its commercial activities; 2) the negative pledge clause should provide for a mechanism involving the IBRD in the sale of public property, so to avoid the depletion of the debtors' assets; and 3) the waiver procedure should be revisited and take into account the financial needs of developing countries, the interests of the Bank as a lender and borrower and its tasks as a development institution.

Finally, the proposed amendments were justified on policy grounds. The case was made against short-term borrowing, which has brought a fair deal of problems to emerging states. On the flip side, the argument was made in favour of trade finance, which is a more appropriate and flexible means to achieve the goals sought by the short-term debt exception to the Bank's negative pledge. Impetuous privatization was criticized for creating social problems and for inciting corruption. Thus, the modification suggested in this thesis would allow the World Bank to use a contractual provision to fulfill a legal function (preventing the alienation of assets) as well as a policy-focused one (monitoring privatization). The benefits of sound governance and democracy on government decision-making and sovereign resource allocation were portrayed. Therefore, it was suggested to include governance considerations and even, democratic ones, into a negative pledge waiver assessment, subject to a World Bank's charter amendment. Instruments employed by the World Bank to evaluate policy criteria, as well as debt sustainability, were identified. It was then submitted that the methods already in operation at the Bank might supply the controls required to implement the reform of the negative pledge waiver policy.

Far from solving all sovereign debt problems, this thesis demonstrates how a complex legal covenant interacts with the financing patterns of developing countries. It underlines the potential impacts of the current version of the IBRD's negative pledge clause on the behaviour of borrowing states and contends that the proposed amendments would contribute to responsible and constructive conduct of several administrations heading up emerging economies. Therefore, without resorting to often criticized conditionality, the World Bank, by curbing precarious public debt management and supporting conscientious governmental initiatives, would advance the pursuit of growth and poverty reduction.

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