# What is this thing called international financial law? Part 4

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*In this fourth part of what began as a four-part series (but has now been extended to five parts), the author explores the intrinsic nature of international financial law through a brief analysis of the techniques commonly used by professionals in managing risks thrown up by globalised markets. The fifth (and final) part of this series of articles will appear in the next issue of LFMR.*

In the last article, we saw how concepts such as money, monetary obligation and the concept of "payment" require careful scrutiny. It seems that even basic building blocks of international financial markets such as these concepts cannot be taken to be a given, or axiomatic, condition of a legal universe which is similar or identical throughout. What is money in one jurisdiction may not be money in another, or at any rate not the same sort of money. This result derives from the multi-jurisdictional ambivalence of many legal concepts in cross-jurisdictional settings.

In the second article, we saw how this situation was perhaps primarily due to the fact that legal transactions and relationships entered into on the international markets are often caught up in a tug of war not simply between two jurisdictions (the main concern of the traditional legal discipline of private international law, which seeks to identify one single dominant regime). Internatonal financial law (IFL) actually needs to contend with interactions between many more jurisdictions. The very nature of the products and processes that constitute international finance seem to make it so. This peculiar circumstance clearly requires a set of legal tools and techniques which may turn out to be the hallmarks of IFL and, together with the nature of its distinctive subject matter, may constitute it as a distinctive legal methodology.

In the first article of the series, the inadequacy of what was labelled the "shopping basket" approach was discussed in order to emphasise the difficulties a multi-jurisdictional context introduces into the legal equation. Managing legal change becomes particularly onerous when it emanates from more than one – or even just two – potential legal sources. To use a mathematical analogy, IFL seems to deal with geometric, rather than merely arithmetic, progression.

The market deals with this situation quite well. Perhaps its success in doing so is not entirely due to any self-conscious strategy, but the result has been reasonably adequate, in most cases, though not all. How have legal professionals dealt with the situation? Again, relatively well it seems, although too often only after the fact, by reacting to events rather than anticipating them. In part, the job of theoretical analysis is to order experience and practice into a model of legal reality that may even turn out to useful to the professional.

This article will explore further the issues informing IFL, the historic means of dealing with them and some basic model offering some explanation of what is going on.

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Lawyers and jurists, being practical people of affairs, usually like to have an actual example in mind when engaging in legal discussions, and for this reason I shall immediately start by referring to a financial instrument which these days has something of an unsavoury reputation (though, very probably undeservedly so): the derivatives contract, in particular the swap. I will use it to illustrate how cross-border instruments have struck problems in the past and how these have been managed by actual legal practice.

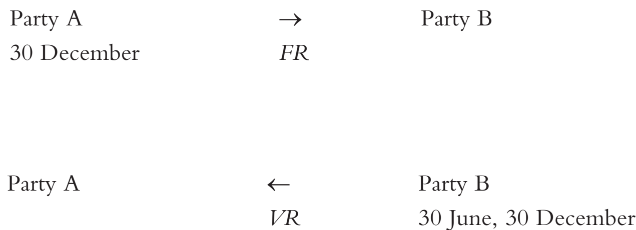
Not too long ago, this now extremely popular instrument sent shudders down the legal spines of many professionals, jurists, regulators and legislators. It has never, of course, ceased to do so. For many, the original problem had to do with the perceived difficulty of understanding and defining the nature of the contract in terms that were familiar or acceptable to lawyers. There is little doubt that when it first gained acceptance in the early 1980s the swap was seen from an economic (and hence legal) point of view as an obviously novel form of transaction. From the point of view of financial practice, the swap opened new markets and linked many together in ways that had never been seen before. Not even the classical Greeks and Romans seemed to have thought of this one.

For those readers who may not be entirely familiar with the workings of this form of derivatives contract, it might be useful to briefly provide (a slightly subversive) outline of the main characteristics of the highly complex relationship referred to by financial operatives and their lawyers as "a swap".

The quintessential structure of most swaps is actually quite simple. It is a contractual relationship where two parties agree to mutually exchange monetary amounts or deliver goods at predetermined dates (not necessarily coincident) over a given period of time. Structurally, the archetypal swap looks something like this:

This does not sound, or look, at all complicated. Predictably, in an *interest rate swap* the involved parties agree to exchange cash flows calculated with reference to interest rates. Typically, party A undertakes to pay B, annually, amounts equivalent to a fixed interest rate (*FR*). B promises to pay A,

every six months, or three months, amounts equivalent to a floating, or variable, interest rate (*VR*). The contract ends on a fixed and pre-determined termination date. A specific example would look something like this:



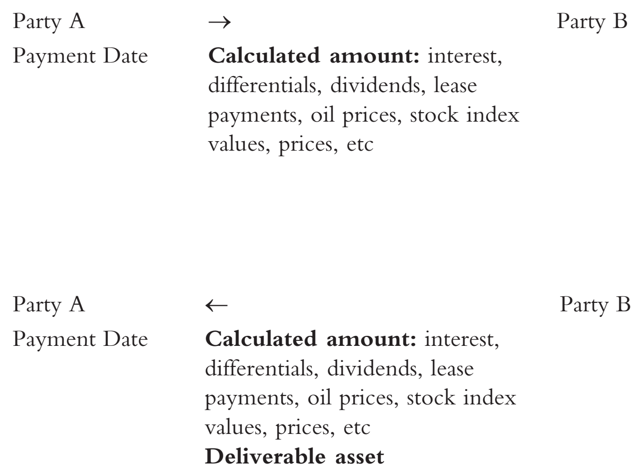

The fixed rate, *FR*, being by its nature, fixed, is a number. For example, "6". *VR* on the other hand, is a market parameter, usually an interbank rate (rates that banks pay or receive on deposits made or received on an international bank deposit market). An example of such a parameter is EURIBOR. The amounts due are calculated with reference to a notional amount, called (not surprisingly) the "notional amount". If so agreed, amounts due on the same date from both parties may be netted out to yield an single payment in favour of just one of the parties (who is said to be happily "in the money").

Why parties should engage in such commitments derives from economic facts such as the nature of their existing indebtedness profile and on their view of where they think interest rates will be going in the future (whether their expectation is that they will rise or that they will fall).

The diversity of contractual forms going by the name of *swap* is enormous. Rather than just facilitating the exchange of interest rates, swap relationships have come to govern exchanges in cash flows, scrip and goods of all sorts. Exchanges may involve currencies, and amounts calculated with reference to any number of conceivable quantative parameters (interest rates, stock exchange indexes, petroleum prices, consumer spending indices, dividends, lease payments, etc) as well as involving delivery of financial instruments and even physical items such as commodities, and other goods.

Some commentators have ascribed much of the recent financial troubles to the existence of the swap market. One of the main culprits in this scenario is the credit default swap. "Credit default swap" is a general term describing more than one technical form of swap contract, and does not denote a single financial relationship; it would certainly not qualify as a *nomen iuris.* Nonetheless, it can be said that in all credit default swaps the exchange of payments is linked to the performance of a set of corporate securities (usually debt securities, but equity is possible): one party pays a certain predetermined amount on a regular basis in return for an undertaking from the other party that upon the occurrence of certain credit defaults in relation to referenced corporate securities, it will accept delivery of these in return for a cash payment (usually the equivalent of the nominal amount). Almost a form of insurance against default, counterparty, or credit, risk.

Schematically, the primal swap (encompassing the full range from the basic cash flow swaps (like the interest rate swap) to delivery swaps (like the credit default swap) would thus look something like an exchange of the following sort:




Although I have simplified the concept of the swap contract, there is no intention to imply that for all or any jurisdictions all possible swap transactions will be regarded as being the same thing, legally speaking (albeit the author feels that there is enough genetic similarity to conceive of a similar core of applicable rules).

While the structure of the primordial swap is deceptively simple, the financial reasoning and economic models underlying the financial expectations incorporated in this form of derivative can be dauntingly intricate and account for much of the conceptual complexity inherent in the instrument. Depending on whether the swap is entered into for the purposes of hedging, arbitrage or speculative activity (the three classic purposes of swap activity), then the underlying economic assumptions, the financial models applied and the mathematical calculations utilised will differ. In addition, even within each category of activity, the nature of the risk being managed or addressed (whether it is interest rate risk, credit risk, market risk, liquidity risk, etc) may differ. This will mean that the underlying assets to which the derivative contract refers will not always be the same (precisely because, being a *derivative* contract, it is said to "derive" its calculations from the underlying primary market, financial assets or situations to which, according to high theory, it implicitly or explicitly always refers).

Indeed, underneath the surface activity of a swap a number of economically significant activities may be in the process of being carried out. It may be that each calculated amount being paid over by a party is actually being received by it on an underlying asset or investment. Thus, to take the simplest case, it may be that the fixed interest paid over to one party may be cash flow sourced in a fixed-income bond owned by the other, who may even skim off part of the receipt before paying over. In a credit default bond it may be that the buyer may actually have an underlying portfolio financially equivalent to the deliverable assets identified by the swap; in case of default, he delivers these to the protection provider who pays over an amount equivalent to their nominal worth. Both parties in this case have implemented hedging strategies. On the other hand any one or both parties may be intermediaries engaged in arbitrage or purely speculative activity, without an underlying position which needs to be hedged.

Whether in a legal context you can or should refer to this underlying complexity, or even refer to why the swap makes economic sense, given certain empirical assumptions, is a question that will be settled differently in different jurisdictions. Some may regard the economic rationale underpinning the instrument as irrelevant, others as being vital to understanding the legal nature of the instrument.

Placing the particular form of swap into a legal pigeonhole has been a particularly difficult task. What sort of contract is it? As mentioned before, this is often a traditional question for most civil law lawyers at contract law level and one that has to be faced by common lawyers in dealing with tax and regulation issues.[1] One can understand why it is a prickly problem when one considers that, other than for the fact that certain cash flows are exchanged, swap contracts can be quite dissimilar to one another and it is sometimes difficult to come up with a neat answer: some swaps provide for initial capital exchanges, others do not; some require payment of set amounts, others payment of differences between amounts; in some, the two legs of the contract are redacted in the same currency while others are not; some provide for delivery of financial instruments or commodities, others do not; and there are glaring differences in the parameters to which otherwise structurally similar swaps refer (with respect to interest rate parameters, equity parameters, commodities parameters, etc). Is there any common thread? Should you take the underlying financial positions into consideration in trying to find one?

How then, would you attempt to characterise the particular swap transaction under review? Does this chameleon-like category of contracts elude systematic description and must classification always be treated on a case-by-case basis? If the foreign currency in one or both legs of the transaction were considered by any particular jurisdiction not to enjoy the privileges of being legal money, then in that jurisdiction the swap might be considered to be a barter contract. Or perhaps since one of the legs may be considered to be of a monetary nature, the swap might then be considered to be a contract of sale. Equally possibly, a swap may be considered to be a commodities contract or a foreign exchange contract. Even if both legs were considered to be of a monetary nature, then the particular swap might be classified as an insurance contract since it might possess a protective component for the risk-adverse party, for which the latter pays. Alternatively, the swap may be seen as a series of forward contracts or as financial futures. Rather more radically, the swap may be seen as being just two mutual loans made by each party to the other (in the case of swaps providing for exchange of principal). Most disturbingly of all, the same swap may be seen as nothing more than a wager or gaming contract. All of these legal characterisations have at one time or other been raised in various jurisdictions.

Perhaps one should take the traditional common law approach and decide that however the parties structure their financial relationship is fine (as long as it is a legal, valid, binding and enforceable contract not contrary to public policy). As we hinted at in previous articles, this only postpones the problem. After all, when the taxman from the Inland Revenue or the official from the regulatory oversight body looks at the contract they may be compelled to characterise it as something *specific* for the purposes of their legislative function (taxation or regulation). Hence a name or an economic or legal substance has to be ascribed to it, sooner or later.

Alternatively, one could perhaps take a civil law approach and be content with some sophisticated analysis of the contract, give it a label and history, and feel tranquil on the basis of that. In IFL this is hardly a satisfying or wise approach to take. It may well be that another relevant jurisdiction or relevant public authority may not configure the relationship in the exactly the same way you had hoped for, when you neatly classified the contract according to local principles.

Where is the legal jeopardy? In the fact that the swap may be declared unenforceable or illegal for any number of reasons. Perhaps it may be declared unenforceable since it does not represent a known or legitimate form of contract, or illegal because it appears to be equivalent to an unregistered insurance transaction or to be in the nature of an unregistered security (there was even a question in the US, once, whether it could be considered to be a security). In the latter case, a swap contract may be declared outright to be illegal on the basis that it is an investment contract entered into outside the relevant investment regulations or an instrument peddled by a non-regulated entity. If the swap relationship were considered to represent a set of mutual loans, then in certain jurisdictions, one leg of the swap could conceivably be suspended in bankruptcy proceedings and the other enforced (highly embarrassing for the party that is forced to continue to perform without receiving any counter-performance). More simply, legal jeopardy may lie in the fact that any given derivative transaction may be subjected to more private law rules and public law regulations than the parties had anticipated, thought appropriate or deeply hoped would be applicable.

Mere trade usage, market practice, consuetude, or whatever the terminology used might be, may not save the situation. The existence of a large market in a financial contract – while decisive from the commercial point of view – may yet fail to ensure that the law does not famously act like "an ass".[2] When this happens it can be surprising and economically off-putting, to say the least. One cannot help but recall in this respect how in the late 1980s, German courts declared the flourishing futures market to be trading in illegal contracts. This was done for well-founded technical legal reasons which left most market participants aghast, at least until swift corrective action was enacted in the form of specific remedial legislation. Shortly afterwards, the English case of *Hammersmith v Fulham* [3] declared that derivative contracts entered into by English local councils were invalid and unenforceable. While the decision in the case turned on questions of the statutory construction rather than on an analysis of the legal nature of swap contracts (the issue was whether a swap was a permissible within the meaning of the Local Council Act or *ultra vires* local councils), theoretical issues were nonetheless necessarily raised in varying degrees at various stages of the case. Before the judges could make a final deliberation, the essential nature of the instrument needed to be reflected upon. In particular, was the swap a transaction in the way of a borrowing, or of something else

– risk management, for example. Recourse to an understanding of the commercial purpose and to the economic rationale lying behind the instrument needed to be touched upon. In the event, the fact that the market was well established and the instrument commonly used as a proper financial arrangement for legitimate purposes did not seem to matter in the end. That particular financial activity, in the particular circumstances of the case, was declared to be an invalid one.

There is still the potential for this sort of thing happening again in the future. Voices are being raised by consumer warriors and champions of market stability in previously swap-enthused (and swap-infused) jurisdictions such as the USA, calling for strict regulation in the wake of the financial crisis. Change in regulation may result in certain derivatives considered "toxic" being suspended, or declared illegal, if the more vehement advocates are heeded. More plausibly, certain authorities may wish to confine swap activity to exchanges (at present, technically unworkable, of course) and make all over-the-counter transactions illegal or unenforceable.[4]

After some decades of existence in which the swap market has now grown to be an estimated 16 times the size of the GNP of the USA, world's largest economy, one could assume that the legal validity of the swap would have by now undergone a process of gradual consolidation. However, the potential problems lurking in the shadows of IFL remain. The extent to which the average swap, the ordinary derivative structure or the exotic form of derivative will be received by another jurisdiction involved in a cross-border trade remains an uncertain or moot issue.

How have the markets reacted to this potential problem? By using a number of techniques. These techniques give us an insight into a broader legal technology which has apparently developed in IFL.

## Common techniques in ISDA, international loans and securities issues.

Most swap transactions are now entered into on the basis of the standard market documentation created by the International Swaps and Derivatives Association (ISDA). This particular documentation was developed in the late 1980s as a standard for swap market transactions which it was hoped would be adopted by market participants. It was. The aim was to reduce legal uncertainty through the harmonisation and standardisation of documentation. ISDA itself then acted as a springboard for lobbying activity in various jurisdictions and advocated legislative action on sensitive and highly important areas such netting. By the early years of the 21st century, ISDA documentation had become the market standard for derivatives transactions of all kinds, exhibiting complexity well beyond those of the simple interest rate and currency swap instruments from which it had developed.

One interesting thing about the ISDA documentation is that it encapsulated in many ways the lessons learnt from the early experiences of the international financial markets in loans and securities. As a result, the ISDA swap agreement illustrates rather neatly some of the legal techniques that have developed within the ambit of IFL and which have now become commonplace. Another interesting feature is that, although the ISDA document was born in a common law contractual environment, the techniques used reflected the common threads of a cross-border legal approach in other non-common law jurisdictions sufficiently to be eventually assimilated into these. Even where assimilation was not possible, or for institutional or other reasons not welcomed, the ISDA documentation seems nonetheless to have provided the stimulus for innovation in local law documentation. Indeed, at times, local law versions of the ISDA document were produced, which tracked many of the techniques generated in the common law ISDA environment, translating them into similar local law approaches.

What are these techniques? Essentially, in this regard, the ISDA document reiterates in a highly sophisticated form legal strategies developed on the international debt and equity markets. These can be conveniently considered with reference to the three steps in the IFL interaction protocol illustrated in a previous article, namely:

- characterisation;
- applicable law;
- jurisdiction.

## Characterisation

The first thing to note is that the linchpin ISDA documentation (the ISDA Master) does not attempt a definition, classification or qualification of the nature of the instrument. This may be considered by some to be a rather strange fact. Yet as we shall see, this circumstance is, paradoxically, one of its strong points.

In part this possibly strange circumstance naturally derives from the common law tradition on which the ISDA documentation was based. ISDA documentation as it appeared for the first time in the mid to late 1980s, and as it developed shortly thereafter, was largely the result of the directed brainstorming of a panel of English and American lawyers responding to market pressures for standardised and reliable documentation. As a result, the applicable law expressly provided for was English or New York law (the law of the major financial centres of the international derivatives markets). Normally, common law jurists feel no compelling need to define contract types in the same way as civil law lawyers might.

In part this strange circumstance is due to the fact that the ISDA Master (and the ISDA Schedule) contain only the general terms applicable to relationships which will be governed by specific agreements on a case-by-case basis (through an ISDA Confirmation) – in other words it is only a list of useful clauses to be incorporated (through prior agreement) into subsequent transactions. The operative contract is stipulated through an ensuing further agreement (the Confirmation).

In part this circumstance is also due to the fact that the ISDA Master is supposed to be an umbrella agreement under which multifarious derivatives contracts, having quite

diverse economic, and perhaps legal characteristics, are to be regulated. No single definition may therefore have been practicable.

None of these reasons in the end, however, fully account for the peculiar circumstance. One must remember that, at least initially, just two or so basic forms of swap existed. These involved the exchange of interest rates (interest rate swap) and perhaps principal exchanged with reference to different parameters and currencies (interest rate and currency swap, cross currency swap, basis swap): in these circumstances it would have perhaps been more natural to define the nature of the transactions which were to be governed by the Master Agreement. Rather than providing an idea of what an "interest rate swap" or a "currency swap" was legally supposed to be, perhaps in the preamble or in one of the initial clauses, the only reference throughout is to a generic term "transaction" (which is basically identified as any deal the parties care to enter into and subject to the Master). It seems to have left the whole definitional or referential issue purposely vague and open ended. Even the title of the document ("Master Agreement") is nondescript.

In a sense, the fact that the instrument is not placed in any legal category by the parties or given too precise a legal description ends up being rather convenient for a cross-border instrument. At the very least it avoids the imposition of sets of rules that the parties do not feel relevant. To have identified the contract more precisely in reality may have run the risk of slotting it into a legal category which may not have led to the desired outcome – somewhere. Had the contract been innocently coloured as an "exchange" contract, for example, this may have led to an implication in some jurisdictions that it was therefore definitely a barter relationship or definitely involved a sale of some sort (especially in the case of cross-currency swaps). At an even more mundane level, it may have meant running the unnecessary risk of limiting the reach of the agreement. One of the reasons that the ISDA document enjoyed such hegemonic growth over the decades may be ascribed to its open-endedness, its ability to absorb within its initial legal architecture any new financial instrument created by the markets.

By contrast, the European Master Agreement (EMA), a rival standard document for derivatives produced by the European Banking Federation, enumerates in its Annexes a series of careful definitions of major derivatives contracts.[5] Some may contend that this creates rigidity and goes some way to explaining the perceived preference of the markets for the ISDA scheme. One should also note that the wide definitions extant in the EMA appeared over time only *after* the fact, ie only after the creation by the market of new transactions built up onto the primal swap chassis. Had they occurred prior to market developments, they may to some extent have unwittingly encountered problems. To give an extreme example: the EMA defines what constitutes a "Cross Currency Rate" swap; the potential problem here might be whether this will also automatically cover equivalent instruments cited using slightly different nomenclature, such as "interest rate and currency swap" or "cross currency swap" or "cross currency and interest rate swap" (all common terms for the same phenomenon) Being vague (albeit in a legally precise sort of way), ISDA in effect seems to have avoided creating the sort of linguistic and definitional straitjacket consequent on being too committed to a definition. To be fair, the EMA does try to use the definitions sparingly and in limited contexts.[6]

It is worth noting that notwithstanding its penchant to define, the EMA does not utilise any definition to indicate the *legal nature* of the derivatives transactions concerned. The definitions appear to be merely descriptive and used for the purposes of contractual interpretation (in essence, creating convenient internal short-hand references for drafting purposes).[7] Undoubtedly, this is partly the result of the intractable nature of derivatives (often for private or public law purposes difficult to characterise legally in an all-inclusive manner). It may also reflect some premonition of the danger of doing so in a multi-jurisdictional setting.

No one need suggest that the descriptive rather than prescriptive nature of the characterisation in ISDA, was, at least initially, due to deliberate policy. It may have just been the result of a lawyer's inclination to describe the mechanics of the legal relationship in contract rather than worry about thinking about, or giving it, a *nomen iuris*. The point here is that this technique has stuck, because it works. The opposite would have worked far less successfully in a cross-border environment. In a domestic situation it is convenient to give an instrument a *nomen iuris* so as to evidence the intentions of the parties and exclude to the extent possible alternative characterisation by a court or authority. In a cross-border environment, this is a extremely delicate issue. The last thing one wants to do is to limit the options available, and worse, perhaps inadvertedly choose the wrong ones, when others are equally open to it under the normal rules of construction.

## *Characterisation: legal lowest common denominator*

Having said that, the drafters of any cross-border document know full well that precautions must be taken. Whether it has been through hard experience or through careful thought (probably both), the practise of IFL has yielded a number of discernible strategies, some of which are evident in the ISDA document, in bond documentation and in international loan documents. Often the obvious technique is that of finding a reasonable, legal lowest common denominator.

Perhaps unexpectedly, a cross-border interest rate swap entered into on the basis of the ISDA document is not expressly characterised as an exchange "of interest". In accordance with the meaning of the terms of the agreement (in particular of the ISDA Definitions), one party is deemed to pay the other "an amount equal to" an amount, which, in the case of both parties, is calculated by multiplying a notional amount by a number that is referenced to an interest rate. Arguably this is not the same thing as paying interest. This may be mere casuistry, or it may not be (perhaps it should be an important point – after all, interest is paid on a debt instrument and it may be inappropriate to categorise a swap as a debt instrument). Again, it is note-

worthy that the contract does not precisely define the nature of the flows as interest – to many, because it should not.

On another, vital point, the contract is very specific. Any cash flows between parties are characterised as being contingent on one another. Each parties' obligation to pay the other is subject to the other party not being in default (which amongst other things means that it must have honoured its payment obligations).[8] This is very useful. It should avoid the swap being characterised as being, at least in the intentions of the parties, a set of two independent parallel loans. Some courts may disregard this (some have) or miss the point entirely, but at least the document has made an effort to establish the concept.

In IFL, spelling out the nature of the instrument at its most rudimentary level is often the safest course to take. In the case of the interest rate swap, the legal characterisation of the relationship can be quite complex and certainly counts at least at the level of public norms such as tax and regulatory purposes. Even at its most fundamental contractual level, any question will in theory and practice always turn on whether the cash flow payments are to be considered totally independent of one another or to be dependent obligations, ie part of an entire, or indivisible, contract, a flawed asset, a conditional payment, or a contingent performance of some other sort or other. Qualifying the relationship at its most essential level is an obvious safeguard.

International bond issues have traditionally done this in some detail. While a domestic security issue (irrespective of the name given it: "bond", "note", "debenture") will normally not need to specify the normal attributes of a security, nor the nature and mechanics of ownership and payment obligations, international issues take pains to do so. By nature, international debt instruments straddle a number of jurisdictions: the issuers, those of the arranging and management group of banks and financial institutions, the jurisdictions of the clearing and holding systems, the jurisdictions associated with appointed paying agents, as well as those of actual investors. Consequently, there is a need to avoid the risk of recharacterisation in more than one jurisdiction. As a result, a number of fundamental legal features within the natural expectations of the issuer and arrangers have been traditionally underscored. One is negotiability. Although much has been written on what constitutes negotiability in relation to a security and to what extent it can be taken for granted, there seems to be unanimous agreement that it should be an attribute associated with an international bond instrument.[9] The aim is to ensure that the security can be sold and that upon subsequent delivery to the investor who buys it in good faith and for value, that investor obtains good and full title. Provisions of the following sort, normally redundant in a domestic setting, are therefore duly inserted in the terms and conditions of the issue:

> "Subject as set out below, title to the Notes, Receipts and Coupons will pass by delivery. The relevant Issuer, the Guarantor, the Trustee and the Paying Agents will (except as otherwise required by law) deem and treat the bearer of any Note, Receipt or Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes."

In addition to establishing in legal terms the stated intention of creating a transferable instrument, these and other provisions also attempt to ensure that the issuer is not subject to double jeopardy which may otherwise arise through the application of laws other than that of the contract.

Particular care is taken in spelling out the legal characteristics of the Temporary and Permanent Global Bonds which constitute the mainstay mechanism of international bond issues. The stock lending market is also focused on the issue of characterisation.[10]

## Characterisation: illegality

What strategies have derivatives documentation, bond issue documents and loan agreements adopted against the risk of the instrument, transaction or relationship, being characterised, declared illegal, unenforceable, void or voidable? In a local financial transaction, this is not a major item of concern, since the parties should already be aware of whether a financial transaction (however innovative) is likely to be illegal or unlawful (either at the level of contract law, or at the level of financial legislation). At least, it is possible to do the research relatively quickly and at relatively low cost. In cross-border transactions, access to quick and reliable information on relevant jurisdictions may be less available. Typically, IFL strategies involve the following countering techniques:

### *An obligation to provide legal opinions and perhaps to update these on a regular basis*

Cross-border loan agreements provide for a legal opinion to be furnished by the Borrower attesting to the fact that the loan and its provisions are legal, valid and binding, and enforceable and (ideally also) admissible in evidence. This is not needed when the loan is local since both parties should be fully aware of the indigenous municipal law (aside from issues of internal *intra vires*). As noted in a previous article, the opinion will state the law at the time it is given and there is no obligation on the part of the professional to keep it updated during the life of the transaction, although in more complex transactions this may in theory be a conceivable option.[11] In any case, all one can hope for is to obtain comfort only in relation to the initial legality or validity of the transaction; change in law risk clearly cannot be managed by recourse to a mere opinion, however authoritative, since that opinion can only refer to the legal situation as existing at the time of issue.

Accordingly, although in its ancillary "Schedule" documentation the ISDA enables a party to ask for a legal opinion to be provided as a condition precedent, it does not include such a condition in the Master (which it could have). Over the years, on the other hand, the ISDA has provided a collective safeguard on one particularly delicate question (netting) by soliciting legal opinions from numerous jurisdictions on the validity of certain provisions in its document, making them available to members and

updating them at regular intervals.[12] It has also rigorously pushed for cross-product netting under a single applicable law in order to reduce the necessity of numerous legal opinions.

*Default (… ?)*

If a legal opinion will not safeguard you, what do you do to guard against supervening illegality? Make the occurrence of an illegality event a default. Loan agreements have tended to be quite straightforward on this issue and declare it a default whenever the agreement and its provisions cease to be lawful, valid or enforceable.[13] Even bond issues (which are notoriously lighter in their lender protection clauses than loan documents) will declare an event of default (giving rise to termination rights on the part of bondholders) when any guarantee becomes illegal or the security ineffective (albeit the concept is often coached in broader language[14]). Swaps and other derivatives contracts include similar provisions. ISDA for example provides that a party may, but is not obliged to, declare a termination event if it becomes

> "unlawful for a party to perform any absolute or contingent obligation to make a payment or delivery or to receive a payment or delivery in respect of [a] Transaction or to comply with any other material provision of [the] Agreement relating to such Transaction."[15]

Is this an effective strategy? Logically, no, it shouldn't be. Should a contract be considered illegal or unlawful, it is most likely also going to be declared void *ab initio* or be voided (ie annulled, invalidated, quashed, avoided or nullified – there are slight pedantic differences), which in turn means it will cease to be binding on the parties – if ever it was. Since the default for illegality is part of an invalidated contract, then it too may not be considered valid or effective (the conditional tense is obligatory here to take account of the possibility that not all jurisdictions may think exactly this). How do you get round this? Basically in at least four ways. In the case of supervening illegality, you hope that the default falls into a prior period when the contract would still be considered to have been valid and that therefore this fact in some way gave you a right to damages in the manner you had anticipated. Also, there is always the hope that some satisfaction can be had under principles of unjust windfall, restitution or similar doctrines.

Another popular device in IFL is to create a pre-contractual or non- or extra-contractual liability which by definition would not be affected by the invalidity of the contract. This is achieved by recourse to representations and warranties, and equivalent devices. One or both counterparties to the financial documentation makes a series of representations as to his or their legal status and powers and as to the legality and enforceability of the transaction and warrants these to be complete, true and accurate.[16] If these assurances turn out not to be correct, then there may be a case to argue for non-contractual misrepresentation or equivalent remedy, or to argue that these statements formed part of a collateral arrangement of some sort. The ISDA version provides perhaps amongst the most succinct versions of this type of representation (loan agreement provisions tend to be more long-winded): each party declares that

> "(i) **Status**. It is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation and, if relevant under such laws, in good standing;
> (ii) **Powers**. It has the power to execute this Agreement and any other documentation relating to this Agreement to which it is a party, to deliver this Agreement and any other documentation relating to this Agreement that it is required by this Agreement to deliver and to perform its obligations under this Agreement and any obligations it has under any Credit Support Document to which it is a party and has taken all necessary action to authorise such execution, delivery and performance;
> (iii) **No Violation or Conflict**. Such execution, delivery and performance do not violate or conflict with any law applicable to it, any provision of its constitutional documents, any order or judgment of any court or other agency of government applicable to it or any of its assets or any contractual restriction binding on or affecting it or any of its assets;
> (iv) **Consents**. All governmental and other consents that are required to have been obtained by it with respect to this Agreement or any Credit Support Document to which it is a party have been obtained and are in full force and effect and all conditions of any such consents have been complied with; and
> (v) **Obligations Binding**. Its obligations under this Agreement and any Credit Support Document to which it is a party constitute its legal, valid and binding obligations, enforceable in accordance with their respective terms (subject to applicable bankruptcy, reorganisation, insolvency, moratorium or similar laws affecting creditors' rights generally and subject, as to enforceability, to equitable principles of general application (regardless of whether enforcement is sought in a proceeding in equity or at law))." (1992 version)

While parts (ii) and (iii) are not uncommon in purely domestic transactions, and part (v) might be inserted as part of a belt-and-braces approach (getting the other side to commit to something which you should already be informed on), parts (i) and (iv) are obviously the fruit of cross-border experience. They denote less lawyer laziness as such, than empirical necessity. Corporate documents will more often than not be in the counterparty's language and direct access to local official registers difficult or time consuming. Aside from local counsel's opinion, it has been found useful to have direct statements from the other party (as it avoids problems of lag times and of questions of fact surfacing which were unknown to local counsel[17]).

*Specific illegality provisions.*

Specific illegality provisions are often inserted in cross-border documentation. While the standard loan agreement tends to create a specific detailed clause only for the occurrence of lender illegality (when it becomes unlawful for a lender to lend or fund its advances to a borrower; borrower illegality is dealt with in the more general clauses), derivatives documentation, some securities issues, project finance and securitisation documentation usually outline in greater detail what constitutes an illegality event.

Sophisticated cross-border documentation pays great attention to defining illegality and unlawfulness. This would not be necessary in a domestic context, as domestic agreements are content to simply assume the current local concept (illegality, unlawfulness, unenforceability, invalidity, etc) without needing to describe what the parties and their advisors are deemed to have knowledge of. The concept of what constitutes illegality, unlawfulness and invalidity is an extremely broad one that will differ across jurisdictions. Cross-border documentation therefore tends to refer to the pathological occurrence giving rise to illegality as widely as it can. Descriptions of what constitutes an invalidating event will be such as to trigger a default in relation to any number of common situations. The idea is to encompass situations where the transaction is deemed void, or voidable, for formal invalidity and substantive invalidity, for statutory illegality or for reasons of unconscionability or unfairness, for reasons of public policy, because it is considered improper or illegal in purpose or unlawful in intent or illegal in its underlying rationale or *causa*, etc – without being too specific or not being specific enough. It also attracts concepts of unenforceability (which is not the same thing, but has much the same practical effect). Attention is paid in particular to covering borderline cases.

The areas that are addressed in IFL tend to be the following: direct *genetic illegality* (internal and external) concerning the contract or the parties to the transaction. In other words, any rule or interpretation which makes the obligations in it invalid because of their intrinsic nature (eg an illegal or unenforceable purpose); any lack or alleged lack of authority or capacity of the parties to enter into the contract (classically, corporate *ultra vires* ) (see ISDA provision above). It should also cover illegality related to *performance*. The situation where the contract itself is lawful, but its performance in another jurisdiction is not. For this reason, the imposition of, or any change in, any exchange controls, capital restrictions, debt moratoria, asset freezes or any other similar restrictions imposed by any monetary or other authority, however described, should be caught by the legal net.

Third parties should also be considered. In particular those affected by illegality may not be solely the direct parties to the deal (debtor, creditor, any guarantors, any other credit support parties) but also other players in the process of international finance. Given the nature of the cash flow process and of the cash flow itself, which, as we saw in a previous article, may not be the same as in the domestic situation, illegality affecting settlement and market processes need to be addressed. These events may be the subject not just of illegality clauses, but also of specific clauses covering credit events, market and project disruption, delivery and settlement disruption of various sorts.[18]

A particular feature of cross-border IFL transactions is the degree to which the consequences of illegality are carefully detailed. In domestic contracts, the consequences of illegality are ineluctable and unavoidable, as they would necessarily affect both parties, being subject, as they are, to the same law. In a cross-border situation, illegality may only affect part of the instrument, transaction or relationship, in one, but not all involved jurisdictions. Hence certain clauses may make particular sense in IFL situations, whereas they might not otherwise in a domestic setting. In cross-border contracts, a severability clause would be inserted. This clause provides that if any provision of the contract were to be prohibited in any jurisdiction, then this would not invalidate the rest of the provisions in the contract.[19] Mitigation clauses of various types are introduced. These aim of these is to ensure that in certain cases, including illegality, reasonable steps are taken to avoid or attenuate damage (since not all jurisdictions may require a party to mitigate[20]). The Loan Market Association standard loan agreement, for example, provides:

> **"Mitigation**
> Each Finance Party shall, in consultation with the Company, take all reasonable steps to mitigate any circumstances which arise and which would result in any amount becoming payable under, or cancelled pursuant to, any of Clause 8.1 (*Illegality*), . . . including (but not limited to) transferring its rights and obligations under the Finance Documents to another Affiliate or Facility Office."

The ISDA document appears more sophisticated. In clause 6(b) the 2002 version provides for an actual mechanism which aims to preserve acquired rights and especially rights under security and collateral associated with the transaction. There is a touchingly pious thought in clause 6(b)(iii):

> "**Two Affected Parties**. If an Illegality under Section 5(b)(i)(1) . . . occurs and there are two Affected Parties, each party will use all reasonable efforts to reach agreement within 30 days after notice thereof is given under Section 6(b)(i) on action to avoid that Termination Event."

This last provision is a pragmatic one. One suspects that its strength will depend on the range of other transactions (not subject to an illegality event) that the parties have with each other and on the power of market sanctions associated with preserving reputation.

Sometimes the impulse to isolate the transaction from illegality can be taken to extremes. The Loan Market Association loan document provides that:

> "**Jurisdiction of English courts**
> The courts of England have exclusive jurisdiction to settle any dispute arising out of or in connection with this Agreement (including a dispute regarding the existence, *validity* or termination of this Agreement)." (my emphasis)

The World Bank's position is even more sanguine: the International Bank for Reconstruction and Development (IBRD) current Standard Loan Conditions provides:

> "Section 8.01. *Enforceability*
> The rights and obligations of the Bank and the Loan Parties under the Legal Agreements shall be valid and enforceable in accordance with their terms *notwithstanding the law of any state or political subdivision thereof to the contrary.* Neither the Bank nor any Loan Party shall be entitled in any proceeding under this Article to assert any claim that any provision of these General Conditions or of the Legal Agreements is invalid or unenforceable

because of any provision of the Articles of Agreement of the Bank." (my emphasis)

The legal result of these provisions in any relevant jurisdiction may be doubted. The forensic courage demonstrated is nonetheless to be admired.

## Applicable law and jurisdiction

Establishing the governing law and the applicable jurisdiction is an important safeguard in IFL. However, contractual provisions are not foolproof and may not provide complete certainty. They should also not be credited with the power to insulate a transaction from other laws, which is never fully possible (the actual or notional location of the rights and assets involved will often attract jurisdiction from other courts).

Nonetheless, in order to reduce the risk associated with multi-jurisdictionality, cross-border contracts provide for express choice-of-law and jurisdiction clauses. The parties expressly choose a governing law and then expressly submit to the jurisdiction of the courts of that governing law. IFL documents often also provide for the appointment of agents for service of process, so that even the formalities of submission are clearly complied with. These last two elements are typically cross-border features. Normally, jurisdiction clauses in domestic contracts are absent or only appear to specify domicile and jurisdiction in one city rather than another, within the same legal system.

In cross-border transactions, the choice of a system of law external to the borrower or to a counterparty is often said to be the principal means of insulating counterparties from the risk of change in local law. This is true in the sense that the governing law may be able to ignore changes in local law rules of the counterparty that the other party pleads. However, it is also true that if the local court in the jurisdiction subject to a change in law event feels it has jurisdiction, it may even apply the foreign governing law (true) but subject to its own mandatory rules of law or local legal principles. It would seem imperative therefore that to the extent possible, not only applicable law, but also jurisdiction, is fixed to the court of the governing law (the chosen court), and other fora excluded.

How this attempted in IFL? Not only is the choice of jurisdiction made expressly, but each party agrees that the court of choice is the most appropriate and convenient court to settle any disputes; it also waives the right to argue to the contrary.[21] This is a necessary precaution to take in order to forestall an application to the court by the other party arguing *forum non conveniens* or similar doctrine. Such an application would argue that the court in question was not the most appropriate forum to hear the dispute, that there was possibility of an injustice being effected, or that there was another court of competent jurisdiction. If the court confirmed the *non conveniens* application it might issue an injunction or other order which prevented the commencement or continuation of proceedings. In theory it could do this either with respect to proceedings in its jurisdiction or even to one begun abroad in relation to a defendant subject to its order.[22]

Express exclusion clauses help reduce the risk that the chosen court might decline jurisdiction. One would have thought that the next step would in practice have been to develop strategies to confer upon this chosen court exclusive jurisdiction. In reality, while it is not uncommon to see exclusive jurisdiction clauses, it is more common not to. The standard documentation for derivatives and the loan market standards, for example, actually provide for *non-exclusive* jurisdiction and the right of financing parties to be able to bring proceedings in more than one jurisdiction, in their unfettered discretion. This is not in contradiction with the aim of fixing jurisdiction in the court of choice. Underlying the practice is the practical reason that a debtor's assets may be in more than one jurisdiction. Being able to sue in those jurisdictions on the debt without endangering the primary action in the chosen jurisdiction of the contract is obviously desirable for a financing party. One must keep in mind that the benefit of this liberal approach to proceedings is in fact usually confined to creditors, not debtors. The loan market standard is quite clear on this:

> "This Clause . . . is for the benefit of the Finance Parties only. As a result, no Finance Party shall be prevented from taking proceedings relating to a Dispute in any other courts with jurisdiction. To the extent allowed by law, the Finance Parties may take concurrent proceedings in any number of jurisdictions."

No mention of the debtor.

ISDA and other derivatives documentation are less discriminatory (naturally, since in many derivatives, each party is at the same time both creditor and debtor):

> "each party irrevocably . . . agrees to the extent permitted by applicable law, that the bringing of Proceedings in any one or more jurisdictions will not preclude the bringing of Proceedings in any other jurisdiction. (clause 13 (b) ISDA)."

Exclusive jurisdiction clauses are not recognised in all systems.[23] In order to avoid invalidity of the entire jurisdictional architecture of the transaction it is therefore prudent to make the jurisdiction non exclusive. Project finance documentation is more complicated. International bonds documents tend to be explicit – a typical provision reads as follows:

> "Nothing contained in this Condition shall limit the right of any Noteholder to take Proceedings in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction, whether concurrently or not."

Undoubtedly, the last part is a direct waiver of any right to apply for a stay on the basis of a doctrine of *lis alibi pendens*. Without this stipulation, the door is wide open for the debtor to argue before the chosen jurisdiction, or other court chosen by the creditor, that the procedure should be stopped because there are parallel proceedings going on elsewhere.[24]

So, these IFL strategies attempt to fix jurisdiction in the chosen courts, while being fully aware that full isolation of

the transaction may not be possible. One thing that is usually attempted is to reiterate the hegemony of the primary applicable law. Bond issue documents need to be particularly robust on this issue: the counterparties – investors – involved and their associated jurisdictions are especially numerous compared to loans and derivatives. There may be provisions similar to the following that purport to underscore the binding and preferential nature of the orders made by the primary court:

> "The [Issuer and/or Guarantor] has further irrevocably and unconditionally agreed that a judgment in any such Proceedings brought in the [chosen primary] courts shall be conclusive and binding upon it and may be enforced in the courts of any other Jurisdiction."

Admittedly this is one-sided and in favour of creditors; presumably the reverse should also work.

## Meta strategies

Having tackled one of the thornier issues in a cross-border contract and one for which there is no obvious, easy answer (illegality), we can now indicate the general meta-strategies that seem to be adopted in IFL to manage similar issues.

### *Level 1: Information and monitoring strategies*

It has often been commented how distance from the debt and the lack of direct contact with the debtor in cross-border transactions generates added potential risk of loss for the creditor.[25] IFL documentation is therefore attuned to information gathering, authentication and monitoring strategies. Initial information is primarily gleaned through the use of the legal device of representations, warranties and covenants and undertakings. Born in the common law environment, where remedies for misrepresentation are ancient and well entrenched, representations are traditional stock-in-trade. Civil code and other jurisdictions may not possess identical or even similar legal institutes but seem to have nonetheless adopted the practice enthusiastically.[26] Any good treatment will list them.[27] The types of representations commonly found in IFL documentation may be summarised as follows:

1. Representations relating to the legal matters: these include ones relating to the validity of the obligations entered into at law, in particular, to the capacity of the debtor to enter into them, to the status of constitutional documents, the existence and validity of governmental authorisations; in project finance, and corporate finance, in particular, to the validity of concessions, insurances, security and guarantees, of project agreements, and stakeholder agreements. They also include: assurances that there is no conflict between the transaction and the terms of previous commitments nor contravention of any existing agreements; legal matters such as (nonexistence of) litigation and other proceedings, of exchange controls and capital controls, withholding tax, and other direct and indirect taxes; compliance with specific regulations (eg securities, environmental and sectorial regulations).
2. So-called "commercial" or factual representations relating to the financial condition of the counterparty and the reliability of information contained in corporate accounts and information memoranda.

Covenants in the context of information monitoring are undertakings of various kinds that require the counterparty to keep the other party abreast of current information regarding its business and its financial condition.

IFL documentation contains representations and undertakings to a more extensive degree than in most domestic agreements. Their greater use is not just a matter of convenience, but amongst other things, expedites an essential investigatory function. Depending on the nature of the markets involved, they are often a major means of obtaining information and assurances regarding crucial aspects of the deal, when it is not otherwise practicable to obtain them in the time available or in the circumstances of the transaction. Where the market is fast, furious and sophisticated (such as the derivatives market), then there is often little time to devote to a full due-diligence process before the window of opportunity closes and the deal must be done. In situations where the counterparty is in what are considered relatively unsophisticated environments, information flows may be felt to be too slow, opaque and unreliable (as in many project finance or acquisitions in developing nations).

### *Level 2: focus the law*

In a domestic situation the legal sanction is a familiar one. The rules and the remedies are known. In a multi-jurisdictional setting, this may not be the case for every potentially involved jurisdiction. The legal sanction needs therefore to be concentrated in the most appropriate place. How do you do this? As we saw, choose an applicable law, and a governing jurisdiction as the primary seat of dispute resolution. But is that enough to isolate the transaction from the effects of other jurisdictions? No. The notional and physical location of the rights and assets will attract other jurisdictions. So what strategies are available?

*Structural.* To the extent possible, allocate rights and assets in a suitable place. The tendency for the market and its lawyers to create escrow accounts for cash flows, trustees for security rights, intermediated security and securities is, in effect, exactly this. The assets or the rights are located structurally in a single place and, it is hoped, insulated from the impact of any jurisdictional reach other than the one desired. Cash flow heading from European buyers to a foreign energy supplier are channelled into a London escrow arrangement to serve the debt on a project financing provided by international parties. It is hoped that this will insulate the financial assets from the local jurisdiction of the energy supplier. Global bonds sitting in a clearing system concentrate bond-holder rights in two, rather than numerous, jurisdictions (that of the applicable law of issue and of the clearing systems); if not totally, at least more so than otherwise would have naturally been the case. Bankruptcy remote vehicles are created in structured finance to insulate

against the jurisdiction of Originators. Swap garages provide similar jurisdictional concentration.[28] Commercial convenience is a prime motive; this is often based on providing enhanced legal certainty which in turn is facilitated by jurisdictional reduction. Mandatory rules pertaining to the insolvency or taxation rules associated with a counterparty's jurisdiction may pose a limit to the efficacy of the technique. Hence, preserving or controlling the identity of the counterparty is important through the use of stringent assignment and transfer clauses. By "physically" focusing jurisdiction, perhaps one can hopefully succeed in focusing the law.[29]

The other means of focusing the law applicable is contractual. These contractual techniques aim to *safeguard* the hegemony of the primary law, *insulate* it so far as possible from the application of other laws, and *stabilise* potentially relevant laws.

In order to firmly establish the applicable law, the counterparty may be asked to represent and warrant that the choice of the governing law will be recognised and enforced in its jurisdiction of incorporation and agree that any judgment obtained in the chosen jurisdiction in relation to the transaction will be recognised and enforced in its jurisdiction of incorporation. When dealing with public entities, a waiver of sovereign immunity, given in accordance with common principles of public and private international law, is required to avoid the risk of non-judiciability in relation to a foreign sovereign entity.[30] Concentration of creditor rights in a trustee structure (or equivalent), as in international bond issues, together with associated non-petition and non-action agreements (structured finance), are in a domestic situation merely convenient; in an international arena, they constitute another means of imposing the hegemony of the primary applicable law.

Rather than risk the application of mandatory rules of local law in insolvency proceedings in the jurisdiction of incorporation of the debtor (which may give different results from those anticipated and/or agreed to by the parties), creditors in IFL documents utilise a central technique in IFL that I would dub "*the pre-emptive strike*". The basic idea behind a range of legal devices and strategies is to rescue a transaction before it meets the iron fist of potentially unfriendly jurisdictions. The prime historical example of this technique was the swap industry's insolvency clause. Prior to legislative reform in the USA in the early 1990s, it appears that it was theoretically open to a US insolvency judge to implement an automatic stay with respect to outstanding executory contracts (such as a continuing swap) which, during insolvency administration, were proved to be unfavourable to the insolvent debtor. This in essence meant that at the worst (if the swap was considered a mutual loan) that one leg of the swap (the solvent party's) would remain on foot while the other would be stayed (pay first, wait for payment in bankruptcy currency – not a great deal for the creditor). At best, if the swap was considered an indivisible contract, but out of the money for the debtor, it would be stayed (and could not be netted out in favour of the creditor), or perhaps repudiated. What the market needed was that insolvency netting be recognised, which it later was. In the meantime, it devised a provision which effectively made insolvency and pre-insolvency a default. In turn this gave a party the contractual right to terminate early and effect close-out netting, *ab istanti*, one second before the bankruptcy regime kicked in, so that the debt subjected to the regime would be a net debt or net credit. ISDA reads:

> "If . . . "Automatic Early Termination" is specified in the Schedule as applying to a party, then an Early Termination Date in respect of all outstanding Transactions will occur immediately upon the occurrence with respect to such party of an Event of Default . . . and *as of the time immediately preceding the institution of the relevant proceeding or the presentation of the relevant petition*. "[31] (my emphasis)

Those representations and warranties, undertakings and other clauses incorporated in IFL which refer to the financial condition of the creditor have a similar function.[32] As early warning devices they act to place the creditor in a position to have a right to be aware of any deterioration in the debtor's finances and (in project and corporate structured finance) business condition. It is intended that breach of the information undertaking or any changes in the economic standing of the debtor would trigger a notional misrepresentation, a circumstance deemed an event of default. This gives creditors the right to withdraw from the financing on the basis of the applicable law – before things get worse, the debtor fails, and its assets are subjected to the insolvency or liquidation proceedings of another jurisdiction. The cross-default clause[33] and material adverse change clause should be read in this light, since they are inserted less with a view to claiming damages for breach, than in relation to pre-emptively exercising termination.[34]

Provisions dealing with mandatory rules of foreign law such as the *pari passu* clause also evidence a similar intent. A typical *pari passu* clause requires the debtor to confirm that its payment obligations under the transaction documents rank at least *pari passu* with the claims of all its other unsecured and unsubordinated creditors, except for obligations mandatorily preferred by law. In reality whether they do, or do not, cannot be changed by the mere declaration of the debtor. (It is doubtful whether the clause can effect rateable subordination of other creditors in insolvency, though this argument has been tried.) If, however, it is discovered that the assurance is not true or accurate, then that fact gives the creditor an excuse to leave the deal.[35] Similar considerations can be made in relation to the negative pledge clause: it is doubtful that it creates any new security or insolvency valid rights in any relevant jurisdiction; in the event, its main purpose is to allow a lender to exit gracefully before having to compete with more privileged (secured) creditors.[36]

In the context of IFL, to *stabilise* a law usually means freezing its rules over time. While most legal systems provide that legal rules may not be applied retroactively, they also provide that any change in law is possible and does affect the contractual relationship. Consequently parties may agree themselves that the law to apply to the contract will be the rules of law applying at the time of agreement (through so-called "stabilisation" clauses). Despite the fact that stabilisation agreements of this sort

may or may not be effective, the idea of insulating against change in laws (in particular in regulations) is an attractive one. Changes in law in the debtor's or even the creditor's jurisdiction may translate into added costs or financial risks for the creditors (change in tax law, or in regulatory ratios). In whatever form it takes (including moratoria, freezes, exchange controls, added capital adequacy requirements, etc) public (state or governmental) intervention in relevant jurisdictions will usually lead to one of four results: a reduction in the rate of return from the financial asset; reduction of return on a creditor's overall capital; an actual additional cost or expense; or a reduction in the amounts due, payable or received from the asset. What strategies are utilised to avoid this unpleasant result? Again, the "pre-emptive strike" stratagem based on the representations, warranties, undertakings and certain specific other clauses used in the transaction documentation and relating to change in law events (specific tax, illegality, material project permits and contracts clauses, for example)

### *Level 3: in drafting agreements be aware of (and beware of) the multi-jurisdictional context*

In IFL more than two legal systems will normally be interacting and the conflicts between these systems may not result in the application of a single system and its rules, even when only one court is seized of jurisdiction. The nature of the players, product and process involved in IFL will lead to this situation. The number of laws impinging upon a transaction – taking account of public norms as well as private law rules – will not just be a simple addition of jurisdictional systems (an arithmetic progression) based on the intrinsic nature of the product and the law which governs it, more like a matrix of relationships that unfolds geometrically as players and processes are involved both initially and during the course of its existence. Certainly, the actual legal rules that will apply to a given IFL situation will be derived from the stated law of the contract (private law), and the applicable mandatory public norms relevant to it (the subject of the next article). Each of these norms has a content. Since, however, these various norms interact in complex ways, in reality the resulting applicable content may not be simply that of the stated law. This is definitely so from the point of view of the legal practitioner. A court may need to apply different laws, resolve conflicts in an attempt to maintain the expectations (or perhaps not) of the parties involved. The resulting applicable legal content may not be the content of one single law, but the residual content resulting from interaction. We are in effect describing a vectorial result: not the result of a single force but the resulting effect of two or more forces pushing in different directions. For this reason, IFL documents have seemed to have developed a series of appropriate techniques such as the search for the legal lowest common denominator and the techniques described below. Whether it is common law or in other legal systems, the result is to craft the documentation so that as little as possible is left to the court to interpret or construe, imply or impose. IFL documentation tries to create its own vectorial result.

## Please define

A distinctive technique is the extensive use of contractual definitions to describe, fix and extend legal concepts. In the extensive "definitions" section and other parts of contracts, otherwise banal legal concepts are often described in bewildering detail. This can be a mere drafting technique (seemingly gone mad), yet it is more than that. Objectively the emphasis on defining what might already be well defined serves the purpose of ensuring that concepts that might be differently construed or interpreted by relevant courts (the chosen court of jurisdiction and applicable law, courts imposing mandatory local rules) are fixed in their legal content. This strategy is an appropriate manner in which the parties in IFL deal with the otherwise foreign or unorthodox concepts imported into the agreement by virtue of its cross-jurisdictional setting. Given that the concept of what constitutes security will vary from jurisdiction to jurisdiction, IFL documentation will, for example, typically include wide definitions of what is meant by security, encumbrance and security interest.[37] For example:

> "any mortgage, charge (whether fixed or floating), pledge, lien, hypothecation, encumbrance, title retention or other security agreement or security interest of any kind whatsoever and howsoever arising".

This sort of definition copes with the fact that common law mortgages and civil code mortgages can be quite different legal things and that title retention arrangements may not be considered to be a security interest. Another version emphasis intentionality:

> "'Security Interest' means any mortgage, pledge, lien, charge, assignment or Italian law equivalent for the purpose of providing security, hypothecation or other security interest or other encumbrance securing any obligation of any person *or any other type of preferential arrangement created with the primary intention of conferring security*." (my emphasis)

Some create an economic concept independent of the legal form:

> "Security Interest means any mortgage, pledge, lien, charge, assignment, hypothecation or security interest or any other agreement or arrangement *having a similar economic effect*." (my emphasis)

Borrowers on the other hand, need to defend themselves by negotiating more stringent criteria:

> "a mortgage, charge, pledge, lien or any other security interest securing Indebtedness *and shall not include* any interest not constituting a real right (right in rem) in an asset or property, a mere contractual right or a mere possessory right." (my emphasis)

Given the potential uncertainties surrounding what money and cash might be taken to be, it is sometimes a good thing to define it by using a provision such as the following:

> "Cash means cash in hand or on deposit with any primary national bank or international bank, in each case

denominated in Sterling, Euros or US Dollars, free of restrictions on withdrawal or transfer."

Another commonly found definition which has evolved over time is the definition of what constitutes insolvency. Insolvency regimes notoriously vary around the world.[38] In consequence, IFL documentation typically defines an insolvency in relation to a wide spectrum of concepts which are felt to catch most common legal concepts of bankruptcy and liquidation procedures.

Nothing is taken for granted: so concepts like illegality, impossibility, *force majeure*, market disruption, the minutiae of financial and banking concepts (including interest period computation, which differs according to local banking custom) are clearly defined, to establish the parties' intentions. Important legal concepts such as "set off" are also defined in detail.[39] Corporate law concepts (holding company, subsidiary, control, merger, amalgamation, etc) are addressed. Even the very concept of what is to be regarded as "law", "regulation" and "authorisation" is punctiliously defined, since not all legal systems have identical concepts.[40] Perhaps to avoid any sense of existential abandonment, the concept of what constitutes a "person" is also sometimes provided![41]

Since it may not be practicable, cost effective or even possible to anticipate or ascertain the precise definition given in any set of jurisdictions to one or more any of myriad of concepts employed in cross-border transactions, the accepted strategy seems to be to provide a wide gamut of catch-all concepts into which, it is hoped, local concepts will fit.

## Spell out the legal effects

To the extent possible, IFL documentation attempts to leave as little space as possible to manoeuvre within the sea of legal possibilities associated with any contractual text. To do this, the documentation tends to spell out the legal effects intended by the parties, which, if not contrary to mandatory rules of law in any relevant jurisdiction, should be found to be acceptable and thus hopefully implemented.

Since the consequences of breach of contract, or of promises made, is usually a complicated matter in most jurisdictions, IFL documents need to make the consequences explicit rather than delegate to judicial assessment. Hence, what constitutes a breach (called a "default") is very clearly outlined. An event of default is then said to lead to what is traditionally called an "acceleration" or "termination" of the loan. While common law jurisdictions normally allow parties to terminate a contract for breach of condition (treat the contract as *ipso facto* discharged) without necessary recourse to judicial pronouncement, this is not always the case in other systems, unless of course the contract explicitly provides for this option and this option is upheld by the relative court. So best to spell out the fact that repayment will be due upon the occurrence of the defined default. This should also help avoid potential problems associated with questions of whether the breach can be described as serious enough to warrant termination (even in English law the question of quality of breach can be a complicated one[42]). Even where termination is possible on demand, some jurisdictions require that a reasonable time be given to the debtor to pay;[43] rather than leave it to the judge, the IFL contract usually expresses a clear intention in this regard.[44]

The exact legal nature of what happens upon breach of a contract is an equally complicated matter. According to the jurisdiction one is dealing with, the concepts involved can be quite different.[45] Does it give rise to right to damages with a subsidiary right to ask for specific performance (the common law position) or a right to ask for performance with a subsidiary right to damages (the civil code tendency)? Does termination or acceleration mean setting aside the contract, repudiating it, rescinding it, resolving it, treating it as discharged or merely avoiding the benefit of the natural term of the contract originally stipulated in the debtor's favour (thus converting a term arrangement to a demand obligation)? All these results might be possible somewhere, and may denote substantive, not just technical, differences. In IFL it is better to state in plain English (or other vernacular) what exactly is intended.[46]

Perhaps the idea is not to terminate the contract but to keep it on foot and expect continued performance. Not all defaults indicate lost causes. In structured finance and project finance transactions a certain flexibility is often called for. So one would need to be certain that while one waits around for performance, that this is not mistaken for affirming the contract (ignoring the breach) with the consequence that one is expected to perform (eg continue to lend, keep the facility commitment active and open) while unsure of the counterparty's future performance. An *exceptio non adimpleti contractus* ("I need not perform, since the other hasn't") is available in many jurisdictions as a temporary or conditional release of the obligation to perform. Not in all. Thus it is prudent to include it in IFL documents in an explicit manner. This means that certain non-performances of undertakings, or of conditions precedent, will translate into draw stops (no notice to drawdown an advance under a loan facility can be made), and suspension of other rights (under the principal agreements, or under connected material agreements, eg the right of equity investors to receive dividends or subordinated loan payments from a project).

Normally, in domestic contracts, the general damages due after breach are not particularly detailed since they are in essence given conditions of the local law which are well known to participants and their lawyers. Certain special damages may, however, need to be specified should these be of a technical nature (think of break costs, for instance). Historically, clauses would simply state something like:

> "If the Loan is declared immediately due and payable as stated above, the Borrower shall reimburse the Bank for all losses and expenses, including loss of profit, incurred by the Bank in consequence of the event of default and/or of the acceleration of the Loan."

IFL documentation is far more sophisticated (some of this has now rubbed off onto domestic documents).

Prudence dictates that even if one is sure of how damages will be given in one's own jurisdiction, how they will calculated in another is less amenable. Consequently, a deal of

space is devoted to detailing the nature of the damages defaulting parties are expected to pay. Reliance loss and expectation loss (*lucrum cessans and damnum emergens*), or similar ideas, are concepts that can be expected to be applied in most jurisdictions, but better to be clear about it in the acceleration clause and elsewhere.

One of the abiding differences between legal systems may lie in the manner in which discharges are allowed and effected in relation to no-fault non-performance (impossibility, impracticality, *force majeure*, frustration, supervening illegality, hardship). Damages due and the apportionment of loss in these circumstances is the subject of detailed provisions in IFL documents. The parties wish to strike the balance themselves to the extent that is deemed allowable in any relevant jurisdiction.

Related to these concerns is the manner in which space is devoted to tactical forensic questions that are normally questions pertaining to the rules of procedure and of evidence. Strikingly, a number of traditional clauses in IFL loans are devoted to creating presumptions of a purely procedural, evidentiary, nature. For example, it is usual to state that the books of the agent bank or lending syndicate shall be *prima facie* or conclusive evidence of the debt owed. Whether this provision will be upheld in any particular court will be a matter of local law. Good to have it in, on the chance the parties can effectively mould the presumption.

## Provide alternative contractual solutions

Normally IFL documentation posits alternative routes to the traditional ones of acceleration and termination for breach. Fallback provisions are popular. Parties often prefer technical market solutions to the prospect of leaving it all to the court in another – or even one's own – country. The advantages of prescribing action for crisis management are obvious. At the individual level, it may make more sense to provide for an agreed change of counterparty (to another company within the group, as for example happens in the case of illegality clauses, tax clauses and increased-costs provisions) than to shut down a potentially viable deal. At the collective market level, it is probably a more efficient means of coping with market disruption events of various sorts than to wait for lengthy legal proceedings to end. In those jurisdictions where the first choice of remedy involves compelling performance of the contract rather than awarding damages or termination of the contract, fall-back agreements may turn out to be particularly attractive.

## Make it extra-contractual

One of the common IFL stratagems is to convert contractual obligations into extra-contractual (tortious, delictual) obligations. To the extent that representations are statements on the basis of which a party enters into or performs a contract, then, according to traditional common law principles, they would give rise to extra-contractual liability for misrepresentation. They may also be contractual terms. Civil law systems have no similar traditional doctrine for statements, though in many, one is slowly developing. The interesting thing to note is that IFL documentation treats certain statements as sources of liability independently of their exact legal nature. The civil code-inspired EMA, for example, blithely includes the concept of misrepresentation in its legal structure, even though it may not be known (as such) according to the civil law legal system that might be chosen to govern it:

> "*Misrepresentation*. Any representation by the party in the Agreement proves to have been incorrect on the date as of which it was made and the other party determines in good faith that, as a result thereof (or of the matters of fact or law which were not correctly stated), the balance of its risks and benefits under the Agreement is materially adversely affected." (section 6(1)(iv) General Provisions)

Usually it is said that if the statements prove to be incorrect, then this gives rise to a right to damages.

This extra-contractual device is a potentially powerful tool especially when combined with other clauses that make the representations and warranties evergreen (repeating at regular intervals, eg interest payment dates), attempt to establish their survival even if the contract is terminated and perhaps identify them as the necessary presuppositions or antecedent conditions on which the decision or commitment to enter into the transaction was based in the first place. It may be hoped that all this opens the way to some recourse to tortious or precontractual remedies.

Contract has been transformed into delict.

## Keep it simple

IFL documentation evidences a marked tendency to simplify matters by concentrating on the description of the *results* of legally relevant events, rather than trying to define those same events in precise legal terms. While the law in one's own jurisdiction is prescriptive and must be complied with, foreign law is not. It may or may not in fact be complied with by the counterparty. However, if your counterparty does not, this would normally not constitute a relevant legal fact in relation to your law. It would not constitute a breach of any legal obligation owed to you. This normally is never a problem that arises in domestic transactions, since both parties are in the same jurisdiction and what the other party does elsewhere is essentially his legal business.

Not so in cross-border transactions, where the players, the product and the process is always "elsewhere". Breach of law in the other jurisdiction would still not constitute a breach of any legal obligation owed to you. However, it may in fact inhibit or constrain performance under your contract since the counterparty feels bound by the foreign law and would not want to breach it. Possible breach of foreign law may even excuse his further performance in *your* jurisdiction.[47] The complicated approach is to assess each possible situation and deal with it individually. This can be done and to a certain extent is (see the illegality problem above).

The simple approach is to convert foreign legal questions to *situations of fact* and to create a *synthetic debt*.

If there is a change of foreign law affecting a counterparty, then this is considered to be a question of fact.[48] Through the type of contractually provisions we have seen above, this change in the fact situation then becomes legally relevant inasmuch as it gives rise to right to terminate the agreement and/or ask for damages. It does not matter what the nature of the foreign law is. You have converted *foreign law* into *local fact*.

Now, if this change in law prevents or excuses the performance of an obligation by the foreign party, this is not necessarily the same as saying that it nullifies all obligations he may have towards you. In the extreme, he may not be obliged to perform and your jurisdiction may even accept this. However, this does not mean that *the fact* that he is excused or discharged (a *foreign* fact, due to a *foreign* law)[49] cannot constitute a legally relevant basis for another separate and independent liability. If this is true, then it should be open to you to create a new debt which is triggered by the *fact* that the foreign law has changed. The purported vitiation of the old obligation by effect of foreign law gives rise to a new obligation to hold you harmless from the effects of this situation. This new debt is created through an appropriately worded indemnity clause, which is characterised as a legally separate and independent stipulation from the prime obligation in the contract. This is a typical IFL ploy. Indemnity provisions and explicit characterisations of this sort are common:

> "**Separate Indemnities**. To the extent permitted by applicable law, these indemnities constitute separate and independent obligations from the other obligations in this Agreement, will be enforceable as separate and independent causes of action, will apply notwithstanding any indulgence granted by the party to which any payment is owed and will not be affected by judgment being obtained or claim or proof being made for any other sums payable in respect of this Agreement."

As unduly refined as it might first appear, this particular ploy seems to have worked, even in the foreign jurisdiction. One example is the history of the tax gross-up clause. In its simplest form, this clause provided that should a change in law impose a withholding tax, then the debtor has to top up payments so as to make good this shortfall. A simple (if to the debtor, painful) financial concept which caused legal turmoil in a number of jurisdictions. A number of South American countries (reeling under one of the cyclical South American debt crises) and under the influence of the (to some, infamous) Calvo doctrine duly decided to outlaw the provision. Some European countries looked at it askance, its validity tainted by suspicion of invalidity.

For many jurisdictions the problem was a constitutional one. According to the constitutional provisions of some European constitutions, for example, each citizen is said to have to contribute to the common good (pay his taxes) according to his means (meaning, proportionally to his wealth). If the gross-up clause looked as if the creditor was (through an legal act of assumption) transferring his taxation obligation to the debtor (the withholding tax imposed was a tax on the recipient not the payer), then it would be in contravention of constitutional principles. The solution was to create a synthetic debt. The original succinct clause then exploded into copious wordage which, in essence, clarified the situation legally. The debtor would pay the tax to the authorities on behalf of the creditor and then pay a top-up amount to the creditor by way of separate debt. Legal devilry? Perhaps, but it seemed to satisfy the authorities and the gross-up clause – synthetic debt version – now sails international legal waters without foundering on normative rocks.

Visually, this process can be portrayed as in Figure 1.

For the sake of absolute clarity: if an indemnity clause also has the effect of turning a contractual *claim* into a *debt* (it may, or may not, depending on the jurisdiction), then it also transmutes one legal relationship of one nature into another of a different nature. If it does not, then at the very least the new claim is substituted for the old (which, naturally, need not imply that the old claim is extinguished). Important legal consequences flow from the view taken.

A similar approach is taken in relation to the question of currency. Being fully aware of the problems associated with foreign currency obligations,[50] the markets have evolved

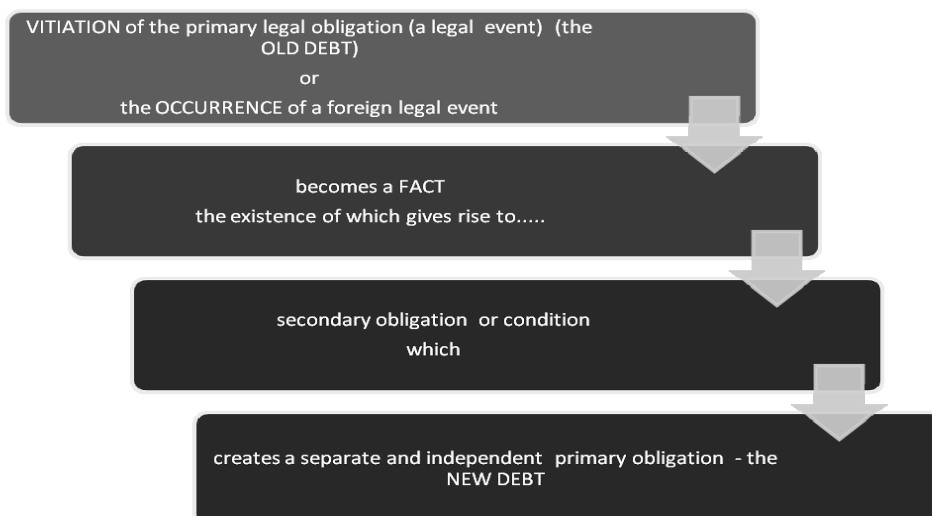



**Figure 1**

sophisticated provisions that expressly identify the currency of account and that of payment. Moreover, the multi-jurisdictional context means that there is always a possibility that one encounters a jurisdiction which might not recognise judgement or enforcement in the appropriate currency according to the expectations of the parties. So what do IFL documents provide for? Synthetic debt, of course. Although the clauses are long and complicated (alas, very few are not these days), the essence of a typical provision runs along the following lines:

> "*Contractual Currency.* If for any reason a payment is made in a currency other than the Contractual Currency and the amount so paid, converted into the Contractual Currency at the exchange rate prevailing at the time of such payment for the sale of such other currency against the Contractual Currency, as reasonably determined by the payee, falls short of the amount in the Contractual Currency payable under the Agreement, the party owing such amount shall, as a separate and independent obligation, immediately compensate the other party for the shortfall."

Keeping it simple has a very practical consequence. Blanket representations and warranties as to the legal circumstances of the borrower and his assets (status, powers, title, litigation, regulatory compliance) often act as surrogates for lengthy due-diligence processes (which of course should in theory be carried out where possible and economically feasible). At times, embarking upon legal and factual due diligence into the affairs of a corporate counterparty whose assets straddle several jurisdictions is impracticable. It would require a legion of lawyers and other professionals attesting to numerous legal and factual circumstances. This should be done, where it can be done. However, the level of protection is not absolute. Turning foreign legal circumstance into local legal fact and creating a synthetic debt is a powerful alternative.

In summary, although the IFL approach is informed and sophisticated, it is functionalist and reductionist. It fixes upon the fact (performance is limited or prevented). This is because there are too many possible factual and legal situations to be easily and comprehensibly identified *a priori*. Upon the occurrence of this fact (the features of which are in some provisions minutely detailed, while in others generally outlined) a synthetic debt is created and enforced.

## A natural legal vehicle

The popularity of common law in financial documentation seems to be due to the circumstance that English law and New York law are the legal systems of the two largest financial centres on the globe and the linguistic home of the commercial *lingua franca* of the modern era. It is also due to the respect given to the judicial systems with long historic experience in financial and international matters. Common law documents are popular for international financial transactions since their traditional drafting techniques have naturally exhibited many of the desirable features indicated above (less focused on explicit legal conceptualisation, more concentrated on practical procedures and actual legal effects). In this sense, the attractiveness of English common law is the result of the demands of IFL. It is the natural vehicle for many IFL techniques. If Chinese or Persian law had been as innately flexible, their respective languages widely understood, and had governed the primary centres of international financial, then to the extent that they reflected the requirements of IFL, Chinese and Persian documents would undoubtedly have enjoyed a similar widespread popularity. Equally, if English law had not shown itself to be responsive to the demands of IFL, and German or French law had historically possessed the same requisite flexibility and open-ended attitude (the legal system trying to fit commercial needs, not commercial needs, the system), then one of the latter, rather than the former, may now have been the preponderant paradigm (even if it needed to be translated[51]). We are witnessing, of course, what has now turned out to be a classic situation of increasing economic returns and of a process of legal "lock in".

Since no one system of law may necessarily reflect the intentions of the parties to an international financial transaction, even English law documentation has evolved in response to experience. The legal cross-fertilisation that is a constant feature of the international markets has indeed introduced concepts such as *force majeure* into documentation (this is not an English legal concept; English law uses the legal concept of "frustration") and extended the concepts of impossibility and hardship, as well as underscoring the appropriateness of alternative remedies. It will gradually have to come to terms with concepts such as "good faith", just as it has had to adapt to foreign concepts of what constitutes, and what does not, legally enforceable "security". This is an interesting area for future research.

## Not *lex mercatoria*

As I have argued before,[52] the concept of a *lex mercatoria* is not applicable to IFL. It is true that in IFL documentation the markets have developed their own set of standard clauses. It is also true that the parties to IFL documents describe in great detail the legal effects of what they are doing and it is also true that they attempt to create alternative fall-back provisions. Almost as if developing as set of home-grown legal consequences for the use by a market élite freed from the chains of local legalities. None of these things is, however, the equivalent of creating a law that will be independent from the other relevant laws applicable to the instrument, transaction or relationship. Keeping the consequences simple and describing the legal lowest common denominator is a strategy born not of any illusion that IFL is an isolated legal island unto itself, freed of legal context. Rather it is the result of coping with and attempting to manage multi-jurisdictional settings in the middle of which it finds itself firmly embedded.

Nowhere is this more evident than with respect to public law, the final topic in this series of articles. ■

1 (2009) 3(2) *LFMR* 163.

2 Mr Bumble's words in Charles Dickens's *Oliver Twist* – and no offence is of course intended. An exculpatory disclaimer, fully protective of the author, is deemed included in this footnote.

3 *Hazell v Hammersmith and Fulham LBC* [1990] 2 WLR 17 (Div Ct); [1990], 2 WLR 1038 (CA); [1991] 2 WLR 372 (HL).

4 One persistent issue is whether derivative contracts entered into on the private market should be treated as if they were futures contracts, which by law can often only be traded on an official exchange. Following the 1987 stock exchange crisis, Wall Street firms feared that in overreacting to the role of such contracts in the sudden nosedive of the primary market, the authorities would declare such agreements illegal since not carried out on a futures exchange, jeopardising existing trades.

5 In the Derivatives Annex, "Derivatives" are defined as: "(a) over-the-counter market transactions, including, but not limited to, forward, swap, option, cap, floor, and collar transactions, any combination of these and any other similar transactions, the object of which is (i) the exchange of amounts of money denominated in different currencies, (ii) the delivery or transfer of currencies, securities, financial instruments, commodities, precious metals, energy (including but not limited to gas and electricity) or any other assets, (iii) the payment of money, if either the obligation to make such payment, or the amount thereof, is contingent upon market-related, credit-related or other events or circumstances, (including, but not limited to, the level of interest or exchange rates, credit spreads, prices, market or economic indices, statistics, weather conditions, economic conditions or any other measurement), (iv) any combination of the foregoing, or (b) any transaction referred to in Section 1(2)(a) of this Annex." (Product Annex for Derivative Transactions Art 1 (1)). In the Interest Rate Transactions Annex an interest rate swap is defined as: "'Interest Rate Swap' means a Transaction in which (a) one party pays, once or periodically, amounts of money (the "Floating Amounts") in a specified currency calculated on a specified notional amount (the "Notional Amount") in such currency and a specified Floating Rate, and (b) the other party pays, once or periodically, either (i) amounts of money (the "Fixed Amounts") in the same currency calculated on the same Notional Amount and a specified Fixed Rate." A definition is also provided for a "Cross Currency Rate Swap". This document was produced from a preponderantly civil code environment and crafted to be subjected to civil code laws as well as common law principles. One author comments: "Reflecting perhaps a surge in European pride, a European master agreement has been developed on Civil Code principles which can be used across borders. These forms tend to be substantially shorter than the ISDA master agreement, in part reflecting reliance on domestic Civil Codes rather than the less precise Anglo-Saxon common law of England or New York", SK Henderson, "Master Agreements, Bridges and Delays in Enforcement, Part 1" (2004) 10 *Journal of International Banking and Financial Law* 394.

6 Although, like the ISDA, the EMA refers initially to the general concept of "Transactions", it then requires reference to specific Product Annexes which name and define specific contract types.

7 Query: will all jurisdictions see it this way?

8 Cl 2 (a)(iii)(1) of the 1992 and 2002 ISDA Master Agreement provides that the obligation of each party to make any payment or delivery under a swap transaction (as specified in a relevant Confirmation) is subject the condition that no event of default or potential event of default with respect to the other party has occurred and is continuing. S 6(a) of the ISDA Master provides that a party may designate a termination event in respect of all outstanding obligations if the event of default occurs in respect of a counterparty. The combined effect of these provisions is to make the performance of each party legally contingent on the performance of the counterparty.

9 A fully negotiable instrument needs to be capable of transfer to another person by endorsement or by delivery so as to enable the transferee to sue and enforce it in his own name; crucially, a transferee who takes a current and apparently regular instrument in good faith and for value obtains a good title in spite of any absence or defect of title in the transferor. In English law the characteristics common to negotiable instruments have found expression in the case-law decided before 1882, and are now embodied in codifying statute. A further technical characteristic of common law negotiability is that valuable consideration is presumed, so that there is no necessity to state it in the instrument (Halsbury's Laws of England/Bills of Exchange and other Negotiable Instruments (Vol 4(1) (2002 Reissue))/1. Bills of Exchange, Cheques and Promissory Notes/(2) Negotiability/302). Civil code countries use different categories of legal thought in relation to negotiability, negotiable instruments and securities generally. US law also seems to be different to English law in important respects. It is not settled whether securities are meant to be fully negotiable. Not surprisingly, the relevant EU Directives only refer to the concept of "transferability". The MiFID Directive 2004/39/EC defines transferable securities as "classes of securities which are negotiable on the capital market" (save for enumerated exceptions and leaving open the question of what constitutes being "negotiable").

10 In this regard, the EMA standard is particularly attentive and takes great care in detailing the precise legal implications of what happens to securities and rights in securities in a repo or stock lending transaction: *"Transfer of Title. Retransfer of Securities. (a) Transfer of Title.* Unless otherwise agreed, any delivery or transfer of securities or other financial instruments ('Securities') or any other assets (including, in respect of Derivative Transactions, any other underlying assets of such Transactions) by a party to the other pursuant to the Agreement shall constitute a transfer to such other party of the unrestricted title to such Securities and/or assets or, if customary in the place where delivery is to be effected, of a legal position (such as a coownership interest in a collective holding of Securities, the position as beneficiary of a trust or another form of beneficial ownership) which is the functional equivalent of such title (including, in each case, an unrestricted right to dispose of such Securities and/or assets) and not the creation of a security interest; the use of the terms 'margin' or 'substitution' shall not be construed as

indicating an agreement to the contrary. The transferor of any Securities and/or assets shall, accordingly, (i) not retain in respect of those Securities and/or assets any ownership interest, security interest or right to dispose and (ii) execute all documents reasonably required to effect such full transfer. As far as transfer of Securities is concerned, if registered Securities are to be transferred, the transferee may dispose of the Securities received before the transfer is entered into the relevant register; if the entry depends upon a circumstance beyond the transferor's reasonable control, the transferor does not warrant that such entry will be effected. *(b) Retransfer of Securities.* An obligation to return or retransfer any Securities is an obligation to transfer Securities of the same kind as such Securities. Securities are 'of the same kind' as other Securities if they are of the same issuer and the same type and nominal value and represent identical rights as such other Securities; if all such other Securities have been redeemed, redenominated, exchanged, converted, subdivided, consolidated or been the subject of a capital increase, capital reduction, call on partly paid securities or event similar to any of the foregoing, Securities 'of the same kind' means the amount of Securities, money and other property (together 'Substitute Assets') received in respect of such other Securities as a result of such event (provided that if any sum had to be paid in order to receive such Substitute Assets, an obligation to transfer them shall be conditional upon payment by the transferee of such sum to the transferor)."

11 (2009) 3(1) *LFMR* 66.

12 ISDA has devised a surrogate system for regular updating of opinions on a collective basis. A similar system has been put in place by the International Capital Markets Association in relation to its standard Global Master Repurchase Agreement (GMRA). Legal opinions covering the GMRA deal with the enforceability of the netting provisions of the GMRA as well as its legal validity as a whole. In addition, the opinions address the issue of recharacterisation risk (in respect of both the transfer of securities and the transfer of margins).

13 The Loan Market Association standard Loan Agreement provides for the following representation to be made by the Borrower: **"Binding obligations.** The obligations expressed to be assumed by it in each Finance Document are, subject to any general principles of law limiting its obligations which are specifically referred to in any legal opinion delivered pursuant to Clause 4 (Conditions of Utilisation) or Clause 25 (Changes to the Obligors), legal, valid, binding and enforceable obligations." Failure of the representation constitutes an event of default.

14 Often the language is functionalist: an event of default is said to occur if the the guarantee "is not, ceases to be, or is claimed by the Guarantor not to be, in full force and effect"; similarly in relation to the securities in question. The intent and effect of this language is the same as that of a normative declaration.

15 1992 ISDA Master, cl 5(b)(i).

16 As part of a string of other representations of a legal and factual nature. See following for more detail on these.

17 And which, by the way, are usually excluded from the ambit of the local opinion by express provision in the assumptions and qualifications sections of the same.

18 Questions of the nature of international securities and of the *situs* of the rights associated with international finance exacerbate the problem.

19 An example: "Any provision of this agreement which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof or affecting the validity or enforceability of such provisions in any other jurisdiction." The validity of these clauses may be questioned at law and in the domestic situation the result will be well known. Nevertheless, there is a chance that they may be legally effective in a cross-border case and having them is probably better than not. The civil code-inspired EMA documentation offers a particularly pragmatic solution: "*Severability.* In the event that any provision of the Agreement is invalid, illegal or unenforceable under the law of any jurisdiction, the validity, legality and enforceability of the remaining provisions in the Agreement under the law of such jurisdiction, and the validity, legality and enforceability of such and any other provisions under the law of any other jurisdiction shall not in any way be affected thereby. *The parties shall, in such event, in good faith negotiate a valid provision the economic effect of which comes as close as possible to that of the invalid, illegal or unenforceable provisions*" (my emphasis).

20 Common law systems tend to reflect the basic English principle that the plaintiff must take all reasonable steps to mitigate the loss which he sustained consequent upon the defendant's wrong, and, if he fails to do so, he cannot claim damages for any loss which he ought reasonably to have avoided. See *Chitty on Contracts* (London, Sweet & Maxwell, 30th edn). Civil law codes and other systems of law do not necessarily contemplate a similar duty.

21 For example ISDA: "***Jurisdiction***. With respect to any suit, action or proceedings relating to this Agreement ("Proceedings'), each party irrevocably: – (i) submits to the jurisdiction of the English courts, if this Agreement is expressed to be governed by English law, or to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City, if this Agreement is expressed to be governed by the laws of the State of New York; and (ii) waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have any jurisdiction over such party."

22 *Forum non conveniens* is a staple topic in most books on private international law. The following is an interesting work specifically devoted to the theme: RA Brand and SR Jablonski, *Forum Non Conveniens History, Global Practice, and Future Under the Hague Convention on Choice of Court Agreements* (New York, Oxford University Press, 2007).

23 Modern enforcement conventions, such as the European Convention on the recognition and enforcement of judgements, require that in certain circumstances parties may not

create exclusive jurisdiction in respect of certain matters. The literature is extensive.

24 Sometimes this approach might be allowed on the reasoning that to allow multiple processes would be oppressive, unjust or vexatious, or unduly onerous for the defendant or on the basis of a policy against forum shopping. In England see *St Pierre v South American Stores (Gath and Chaves) Ltd* [1936] 1 KB 382, 389; *MacShannoon v Rockwell Glass Ltd* [1978] AC 795.

25 This has been perceived as a concern from the beginning. The following comment made with reference to the market in the early 1980s is indicative of the general concern highlighted by bankers: "The success of the syndicated loans market over the past 15 years has been unmitigated due largely to its flexibility in raising large amounts of credit at very short notice for a wide range of borrowers. This flexibility is based on close personal contacts between major participating banks, and clear guidelines within international banks regarding acceptable minimum spreads and exposure to major borrowers. Syndicated lending has enabled banks to satisfy unprecedented levels of credit demand while managing a diversified loan portfolio. However, there is a risk of potential loss to banks through lending to borrowers with whom they have no direct contact." B Howcroft, "Marketing a Eurocurrency Syndicated Loan" (1985) 3(1) *International Journal of Bank Marketing* 43–53.

26 The EMA standard, created to be subjected to non-common law systems of law, nonetheless reproduces virtually identical representations to those in the common law ISDA. The author has personally been involved in the negotiation of loan and project finance documents written in English but subjected to non-common law regimes (ranging from Portuguese, to Swedish to Japanese law) where the representations given by the borrower are almost verbatim copies of those found in an English law document. This seems to be the case not only in documents produced by the global law firms (mostly with common law heritage, where legal inertia is understandable) but also in local firms familiar with IFL techniques.

27 The author has realised that he has not yet cited one of the luminaries in the field of international financial law and this is a good place to do so. For an informed and comprehensive treatment of the content of traditional representations and warranties see P Wood, *The Law and Practice of International Finance*, series (London, Sweet & Maxwell).

28 It was possible to shift or originate ("garage") the swap transactions of a company and/or its subsidiaries in a special-purpose vehicle which was guaranteed by the company or the transactions otherwise collateralised. Often a single-purpose company was incorporated in a different jurisdiction from that of the swap counterparties.

29 This technique can also be used to cover transitory risk such as the so-called *Herstatt* risk (the risk of a bank or company going bust over the weekend, or overnight). To limit the risk in a swap transaction a clause such as the following might be inserted as a special condition to ISDA: "***Escrow.*** If, by reason of the time difference between the cities in which payments or deliveries are to be made under Section 2(a)(i), it is not possible for simultaneous payments or deliveries to be made on any date on which both parties are required to make payments or deliveries hereunder, either party may, at its option upon three days notice to the other party and in its sole discretion, notify the other party that payments or deliveries on such date are to be made in escrow. In such case, the deposit of the payment or delivery due earlier on that date shall be made by 2.00 p.m. (local time at the place for the earlier payment or delivery) on that date with an escrow agent agreed between the parties or (failing such agreement) which is a commercial bank or other financial institution independent of either party, with a minimum net worth of US$100,000,000 or its equivalent in another currency, selected by the notifying party, accompanied by irrevocable payment or delivery instructions (i) to release the deposited payment or delivery to the intended recipient upon receipt by the escrow agent of the required deposit of the corresponding payment or delivery from the other party on the same date accompanied by irrevocable payment or delivery instructions to the same effect or (ii) if the required deposit of the corresponding payment or delivery is not made on that same date, to return the payment or delivery deposited to the party that paid or delivered it into escrow. The notifying party shall pay the costs of the escrow arrangements and shall cause those arrangements to provide that (A) in the case of a payment obligation under Section 2(a)(i), the intended recipient of the payment due to be deposited first shall be entitled to interest on that deposited payment for each day in the period of its deposit at the rate offered by the escrow agent for that day for overnight deposits in the relevant currency in the office where it holds the deposited payment (at 11:00 a.m. local time on that day) if the payment is not released by 5.00 p.m. local time on the date it is deposited for any reason other than the intended recipient's failure to make the escrow deposit it was required to make in a timely fashion and (B) in the case of a delivery obligation under Section 2(a)(i), the intended recipient of the delivery due to be deposited first shall be entitled to compensation as and to the extent provided for in the relevant Confirmation or elsewhere in this Agreement if the deposited delivery is not released by 5.00 p.m. local time on the date it is deposited for any reason other than the intended recipient's failure to make the escrow deposit it was required to make in a timely fashion." Recent events in the Lehman Brothers bankruptcy have once again emphasised the value of delocalising legal risk to a suitable jurisdiction.

30 A typical state of the art clause is to be found in ISDA: "**Waiver of Immunities.** Each party irrevocably waives, to the fullest extent permitted by applicable law, with respect to itself and its revenues and assets (irrespective of their use or intended use), all immunity on the grounds of sovereignty or other similar grounds from (i) suit, (ii) jurisdiction of any court, (iii) relief by way of injunction, order for specific performance or for recovery of property, (iv) attachment of its assets (whether before or after judgment) and (v) execution or enforcement of any judgment to which it or its revenues or assets might otherwise be entitled in any Proceedings in the courts of any jurisdiction and irrevocably agrees, to the extent permitted by applicable law, that it will not claim any such immunity in any Proceedings."

31 Loan version: **"Action if Bankruptcy**. If any Event of Default described in clauses (a) through (e) of Section . . .

shall have occurred and be continuing with respect to the Borrower, the Commitments (if not theretofore terminated) shall automatically terminate and the outstanding principal amount of all outstanding Loans and all other monetary Obligations shall automatically be and become immediately due and payable, without notice or demand."

32 Representations and warranties, covenants, financial undertakings (ratios), and conditions which have the function of (a) preserving the identity of the counterparty; (b) maintaining the purpose of the financing; (c) preserving the priority of security and collateral; (d) maintaining the quality and quantity of assets (asset disposals clauses, change in business provisions, asset maintenance undertakings, project covenants); (e) monitoring the condition of the borrower and of the group; (f) constituting cash flow undertakings (in relation to dividends, interest, sale proceeds, cash sweeps).

33 A simple cross-default provision would make the default by the debtor under any of its extant agreements a default under the agreement which includes the cross-default clause.

34 "Premptive strikes" are not foolproof and may be subject subsequently to analysis under the rules of fraudulent conveyance and preference rules, *actio pauliani* and the like. Nevertheless, even material adverse change clauses (probably the most vulnerable ) seem to have been accepted by many courts and it is also not without note that cross-default clauses have become popular even in domestic contracts.

35 Useful if the discovery is made prior to insolvency occurring. A lot less so afterwards.

36 A more effective strategy to ensure priority is to create actual structural subordination, as is done in structured corporate finance.

37 For the purposes of the negative pledge clause, but not only.

38 For a comprehensive introduction, see P Wood, *Principles of International Insolvency* (London, Sweet & Maxwell, 2007, 2nd edn).

39 A typical provision: "**Set-off** means set-off, offset, combination of accounts, right of retention or withholding or similar right or requirement to which the payer of an amount under Section 6 is entitled or subject (whether arising under this Agreement, another contract, applicable law or otherwise) that is exercised by, or imposed on, such payer."

40 Take, for example, the following conventional provisions taken from debt and derivatives instruments: "'**Authorisation**' means an authorisation, consent, approval, resolution, licence, exemption, filing or registration (Loan); a '**regulation**' includes any regulation, rule, official directive, request or guideline (whether or not having the force of law) of any governmental, intergovernmental or supranational body, agency, department or regulatory, self-regulatory or other authority or organisation (Loan); '**law**' includes any treaty, law, rule or regulation (as modified, in the case of tax matters, by the practice of any relevant governmental revenue authority) and 'lawful' and 'unlawful' will be construed accordingly." (ISDA)

41 "A '**person'** includes any person, firm, company, corporation, government, state or agency of a state or any association, trust or partnership (whether or not having separate legal personality) or two or more of the foregoing". A trust is not a person, nor is a partnership, under English law.

42 Memories of the intense case-law and scholarly discussion on the distinction between breach of condition, breach of warranty, breach of intermediate terms and on fundamental breach still haunt discussions.

43 Civil code jurisdictions often do. Even some common law jurisdictions, cf *Bank of Baroda v Panessar* [1986] 3 All ER 751.

44 In a more general sense, what happens in cases of non or partial performance by the debtor is usually dealt with not solely in relation to the lender–borrower relationship. Where creditors and payment flows are subject to different jurisdictions, there is a great deal of attention paid to spelling out the nature and consequences of the relationship within the creditor syndicate itself (eg in relation to sharing clauses, payment cascades and set off). For a masterly treatment of this issue, see A Mugasha, *The Law of Multi-Bank Financing: Syndications and Participations* (McGill-Queen's University Press, 1997).

45 See eg any good comparative law publication: K Zweigert, H Koetz and T Weir, *An Introduction to Comparative Law*, English trans (Oxford University Press, various editions) vol II, chs 12 and 13.

46 IFL acceleration clauses are more explicit than would otherwise be expected in a domestic loan.

47 Some jurisdictions will not enforce an obligation which requires a party to perform an illegal act in another jurisdiction. In English law: *Foster v Driscoll* [1929] 1 KB 470 CA; *Regazzoni v KC Sethia* (1944) Ltd [1958] AC 301 HL; *Toprak Mahsulleri Ofisi v Finagrain Cie Commerciale Agricole et Financière SA* [1979] 2 Lloyd's Rep 98 at 114; *Euro-Diam Ltd v Bathurst* [1990] 1 QB 1 at 15, [1987] 2 All ER 113 at 120 (affd [1990] 1 QB 30, [1988] 2 All ER 23, CA); *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] QB 728, [1989] 3 All ER 252. In Europe generally, see the possible application of the Rome Convention on the law applicable to contractual obligations.

48 Which is already in line with the approach in many jurisdictions which regard foreign law as an issue of fact, not law. This whole area of learned discussion is highly complicated and sometimes seems to verge on the merely philosophical. In the end, whatever the philosophical position taken (foreign law is unusual fact or it is special law) the point surely is that the contents of any relevant foreign law will still need to be formally pleaded and proved by the party interested in referring to it, otherwise a Court might ignore the issue, or assume there is none, or that the contents of the foreign law are the same as those of it own local regime.

49 It would be different situation if it was due to your local, mutually shared law.

50 See (2009) 3(3) *LFMR* 248ff.

51 Think that could be unlikely? At one stage, a non-English law was extremely popular on the financial markets even if in translated form (the text was not in one of the official vernaculars of the legal system, but in English), and still appears to enjoy a dignified position: behold Swiss law.

52 P Sebastianutti, "The Capital Markets", in M van Empel (ed), *Financial Services In Europe* (Dordrecht, Kluwer, 2008), 70ff.