Getting the World Bank Out of Development’s Way: The Case for a Project Finance Exception to the World Bank Negative Pledge Clause

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I. INTRODUCTION

A developing country in need of a critical piece of infrastructure looks towards commercial investors to lend the required funds to a state-owned enterprise (SOE) or a partial SOE, which holds the government concession. The rewards look promising to both parties; the commercial investors hope to reap the benefits of a lucrative stream of revenue and the state stands to gain a much needed highway, pipeline, or airport for its citizens and enjoy a portion of the profits itself. However, early in the planning process, the parties realize that some years earlier (perhaps in the middle of its sovereign debt crisis) the developing country signed a loan agreement with the World Bank. This loan agreement, while providing the developing country with some sorely needed funds at the time, included a negative pledge clause barring the state from granting a lien over any public asset to a third party. Thus prevented from securitizing the assets of the SOE or partial SOE, which would include the envisioned project or future revenue streams of such project, the investors become hesitant about the financing. The future of this crucial infrastructure work stands in jeopardy. How can investors finance a project without taking the usual security enjoyed by creditors?

This is the common scenario faced by states that have concluded loan agreements with the World Bank, and the lenders looking to invest in them. During the tumultuous fiscal years of the past few decades, the World Bank, acting in its capacity as lender of last resort, granted unsecured loans to debt-ridden sovereigns. Instead of taking a lien over the state’s assets, the World Bank protected its interests via the broadly worded negative pledge clause (Negative Pledge Clause) embedded in Section 6.02 of the General Conditions governing the terms of the loan.\(^1\) This clause ensures that any lien created on any public assets as security for external debt that

results in priority for a third-party creditor equally and ratably secures all amounts payable by the borrowing state. In short, should such a lien be granted, the World Bank will share in the amounts paid out to the third-party creditor and prevent the creditor from enjoying senior creditor status, undermining the value of any later-granted lien.

The inclusion of the Negative Pledge Clause in World Bank loan agreements thus mitigates the World Bank’s risk in providing unsecured loans by dissuading a developing nation from giving a later creditor priority over its assets. In theory, such a pledge protects both the World Bank, as a creditor, and the sovereign nation, which might otherwise be tempted to engage in excess borrowing, as a debtor. Although these are worthy aims, the barrier that the Negative Pledge Clause constructs around a state’s ability to engage with other creditors is so formidable that the clause may actually hinder a state’s ability to attract commercial investment for project financings. As currently drafted, the Negative Pledge Clause dissuades commercial lenders from investing in exactly the kinds of projects that might further development and enrich a nation, thereby strengthening the nation’s ability to pay back its debts. This is not only unfortunate for the developing countries involved, but it also challenges the raison d’être of the World Bank, which was always envisioned as a multilateral institution designed to promote development.

The Negative Pledge Clause, as presently embedded in World Bank loan agreements, presents problems both of clarity, regarding which types of loan agreements might be implicated, and scope, concerning the vast breadth of loan agreements that are undoubtedly implicated. First, the actual implications of the clause as drafted are not well understood. Key terms such as “own” or “control” (relevant to the definition of a “Public Asset”) have not been defined, leaving would-be creditors guessing as to whether certain entities are “owned” or “controlled” by the state. Therefore, a creditor encounters great difficulty in ascertaining whether the assets in question constitute “Public Assets,” and thus fall under the purview of the Negative Pledge Clause. Moreover, the consequences that would arise from granting a lien to a third-party creditor remain unclear. Would such a breach actually result in the equal and ratable sharing of the payments between the World Bank and the third-party creditor? Or would it create a valid lien in favor of the third-party creditor, but constitute a default of the World Bank loan agreement and subject the state to the corresponding consequences? This issue becomes further muddled because international law, which has neither clear precedent to decide these questions nor choice of law provisions, would probably govern the

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2 See World Bank Could Relax Negative Pledge Clause for Russia, PROJECT FINANCE INTERNATIONAL (May 25, 2012) [hereinafter PROJECT FINANCE INTERNATIONAL], available at http://www.pfie.com/world-bank-could-relax-negative-pledge-clause-for-russia/379055.article (noting that in Russia, there “are a number of sizeable projects in the pipeline, which could go ahead if the negative pledge hurdle were removed”).
interpretation of a World Bank loan agreement.³ This inability to ascertain which assets are covered by the Negative Pledge Clause’s ban on liens and the cost of granting a lien on prohibited assets leaves potential commercial investors wary of involvement with any SOE or partial SOE and ensures that the state cannot effectively assess its options.

Second, the overly broad scope of the Negative Pledge Clause prevents even those liens that would attract investors to projects that develop a state’s infrastructure and provide the state with additional capital. Currently, the Negative Pledge Clause bars a lien on “any public asset as security for External Debt” and allows only two exceptions for “(i) any Lien created on property, at the time of purchase thereof, solely as security for the payment of the purchase price or such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; or (ii) any Lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.”⁴ Neither the “purchase money mortgage” exception described in (i) nor the “ordinary course of banking transaction” exception described in (ii) would apply to a situation where the lien is used to securitize a project to build infrastructure that would generate a stream of revenue. Moreover, although the World Bank can grant waivers of the Negative Pledge Clause, those waivers may only be obtained in an exceptionally narrow set of circumstances (both situation and country specific). The improbability of obtaining such an exception further complicates the ability of the sovereign to induce already skittish lenders to make a million-dollar investment. However, it is important to note that in developing a waiver policy, the World Bank has implicitly recognized that the hold that the Negative Pledge Clause can exert over potential commercial investments needs to be made more flexible.⁵

In the 1980s and 1990s, concerns over the restrictive nature of the Negative Pledge Clause garnered much attention amongst legal scholars and practitioners, particularly where the Negative Pledge Clause interacted with sovereign debt issues.⁶ However, during the economic boom of the late 1990s and early 2000s, these issues receded into the background as

⁴ General Conditions, supra note 1, § 6.02(c).
⁵ See Lewis T. Preston, Memorandum to the Executive Directors: IBRD’s Negative Pledge Policy with Respect to Lending for Investment Projects (Nov. 25, 1992) (discussing the “pressing need” to reconsider the World Bank’s prior view on waivers with regard to new money operations).
investors competed with each other to finance projects in the developing world. With loan conditions during these years trending favorably for borrowers, the Negative Pledge Clause did not present an insurmountable obstacle to attracting project financing. Unfortunately, the recent economic crisis and the resulting decline in private investment outflows to the developing world have resurrected concerns about the role of the Negative Pledge Clause. By introducing waivers in the past, the World Bank has shown itself to be somewhat receptive to suggestions on tailoring the Negative Pledge Clause to suit the development needs of its member states. Given the current concerns over developing countries’ inability to attract private investment for project financings, it is now a particularly opportune moment to suggest new reforms.

Thus, with the current economic climate in mind, this article proposes reforming the Negative Pledge Clause to clarify precisely the sorts of financing structures that would fall within the purview of the Negative Pledge Clause and to narrow the breadth of coverage. Part II of this article provides an overview of how the Negative Pledge Clause operates and protects the World Bank as creditor and the sovereign state as debtor. Part III identifies and analyzes the problems plaguing the current Negative Pledge Clause and details the impact these shortcomings can have on an indebted country’s development strategy. Part IV suggests that, given the history of reform efforts and the current need for increased foreign direct investment in the developing world, the time is ripe for reform. Finally, Part V argues that the World Bank should clarify the language of the text and the consequences of a breach in a way that restricts the scope of the clause, as doing so would help ailing economies better their infrastructures. Part V suggests that the World Bank would better achieve its overall purpose of promoting development by including an exception to the Negative Pledge Clause for loans which fund large-scale infrastructure works (i.e., a project finance exception) in order to attract investors to projects that promote national development.

II. OVERVIEW OF THE WORLD BANK NEGATIVE PLEDGE CLAUSE

The World Bank was created in 1944 as one of the Bretton Wood institutions intended to facilitate post-World War II reconstruction and development. From the outset, the World Bank aimed to support foreign
investment in the economies of developing countries.\textsuperscript{10} Its current mission is “to fight poverty with passion and professionalism for lasting results and to help people help themselves and their environment by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.”\textsuperscript{11}

As a financial institution aimed at supporting development, the World Bank often functions as a creditor of last resort to sovereign nations when private investors are concerned with a country’s risk profile.\textsuperscript{12} These loan agreements tend to be unsecured, since “it would be awkward for [a multilateral development bank] charged with the reconstruction and development of such countries’ economies to take security on state assets and then foreclose on them, depriving the borrower country of income-producing assets.”\textsuperscript{13} However, to ensure that later creditors cannot gain security over state assets and threaten that state’s ability to repay its prior World Bank loan, World Bank loan agreements include a Negative Pledge Clause. This clause is standard in all World Bank loans, and therefore plays a role in the ability of nearly all developing country borrowers to offer security to other creditors.\textsuperscript{14}

The relevant text of the Negative Pledge Clause reads as follows:

(a) It is the policy of the Bank, in making loans to, or with the guarantee of, its members not to seek, in normal circumstances, special security from the member concerned but to ensure that no other External Debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such member. To that end, if any Lien is created on any Public Assets as security for any External Debt, which will or might result in a priority for the creditor of such External Debt in the allocation,

\textsuperscript{10} See Int’l Bank for Reconstruction and Development, Articles of Agreement of the International Bank for Reconstruction and Development, art. I (June 27, 2012), available at http://siteresources.worldbank.org/EXTABOUTUS/Resources/IBRDArticlesOfAgreement_links.pdf (“The purposes of the Bank are: (i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes . . . (ii) To promote private foreign investment by means of guarantees or participations in loans and other investment made by private investors . . . .”); Hurlock, supra note 6, at 361; CATHERINE CAULFIELD, MASTERS OF ILLUSION, THE WORLD BANK AND THE POVERTY OF NATIONS 1 (1997) (“The Bank’s business is Third World Development, an activity that might be described as art—for it is certainly not a science—of improving life in the countries of Asia, Africa, and Latin America.”).


\textsuperscript{12} Hurlock, supra note 6, at 345 (Because private capital sources can be reticent to invest in certain countries, the World Bank and EBRD have to provide most of the funding and adopt policies to encourage lending from private commercial sources.).

\textsuperscript{13} Id. at 356.

\textsuperscript{14} See Bradfield & Jacklin, supra note 6, at 134 (“Virtually all developing country borrowers are now affected because these clauses are standard in all World Bank loans . . . .”).
realization or distribution of foreign exchange, such Lien shall, unless the Bank shall otherwise agree, *ipso facto* and at no cost to the Bank, equally and ratably secure all Loan Payments, and the Member Country, in creating or permitting the creation of such Lien, shall make express provision to that effect; provided, however, that if for any constitutional or other legal reason such provision cannot be made with respect to any Lien created on assets of any of its political or administrative subdivisions, the Member Country shall promptly and at no cost to the Bank secure all Loan Payments by an equivalent Lien on other Public Assets satisfactory to the Bank.

(b) The Borrower which is not the Member Country undertakes that, except as the Bank shall otherwise agree: (i) if it creates any Lien on any of its assets as security for any debt, such Lien will equally and ratably secure the payment of all Loan Payments and in the creation of any such Lien express provision will be made to that effect, at no cost to the Bank; and (ii) if any statutory Lien is created on any of its assets as security for any debt, it shall grant at no cost to the Bank, an equivalent Lien satisfactory to the Bank to secure the payment of all Loan Payments.

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

This provision is written to ensure that, in the absence of an express waiver by the World Bank, a lien created by a borrowing nation on public assets with the effect of giving priority to another creditor in the use of foreign exchange will equally and ratably secure the World Bank loan, as well as the interest and charges due on it. A borrowing state is obligated to make an express provision for the World Bank’s ratable sharing in this lien, and if it is not possible in certain situations, to secure the debt for the World Bank by an equivalent lien on other public assets on terms satisfactory to the World Bank.

In order to understand whether the Negative Pledge Clause applies to a certain transaction, we must first understand what assets are covered by the clause. By its own terms, the clause applies to “Public Assets,” defined

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15 *General Conditions, supra note 1, § 6.02.*
in Appendix Section 79 of the General Conditions as “assets of the Member Country, of any of its political or administrative subdivisions and of any entity owned or controlled by, or operating for the account or benefit of, the Member Country or any such subdivision, including gold and foreign exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions, for the Member Country.” As interpreted by the World Bank, this broad definition also covers assets that are indirectly owned or controlled by the State. Ibrahim F.I. Shihata, former General Counsel of the World Bank, has clarified that the definition of Public Assets “covers (i) assets owned exclusively by the government, a government agency or subdivision or a government-owned enterprise; (ii) assets . . . owned by an enterprise controlled directly or indirectly by the government due to one of the following factors: (a) majority ownership of voting shares or voting rights, (b) other arrangements or circumstances that enable the government to effectively control the actions of the enterprise, e.g., a concentrated minority shareholding when the rest of the shares are scattered among shareholders none of which has a similar or stronger role than that of the government, or (c) effective government control through statute or regulations; and (iii) assets belonging to an entity which is neither owned nor controlled by the government but which operates in fact for the account of or the benefit of the government alone.”

The General Conditions define a “Lien” as “[including] mortgages, pledges, charges, privileges and priorities of any kind.” Combined with the expansive definition of a “Public Asset,” the scope of these terms ensure that few transactions are exempt from the Negative Pledge Clause’s coverage, except for those specifically exempted by Section 6.02(c)’s “purchase price” and “ordinary course of banking transaction” exceptions. These exceptions cover, respectively, those liens created solely as security for debt incurred to purchase specific property and those short-term liens incurred as a part of day-to-day business. As the World Bank has explained, the clause applies not just to formal security interests, “but to any arrangement that provides a preference for a creditor with respect to property.” Examples of such non-formal security structures that are still covered by the Pledge include set-offs (i.e. the settlement of mutual debt by offsetting one debt claim against another), arrangements permitting creditors to surrender their claims to pay taxes (establishing creditor priority with respect to revenue), or arrangements where the sovereign

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16 Id. app. ¶ 79.
17 Conable, supra note 6, ¶ 9 (“Therefore, the Negative Pledge Clause applies not only to assets owned directly by a member but also to assets which it owns indirectly and to assets of entities which operate for its account or benefit.”).
18 SHIHATA, supra note 3, at 319. The intricacies of what it means to “own” or “control” an entity will be explored in more depth infra Part II.A.
19 General Conditions, supra note 1, app. ¶ 59.
20 Conable, supra note 6, ¶ 11.
nation agrees not to sell off certain exports until it has first “sold” enough of those exports to a creditor to satisfy an antecedent debt.\(^{21}\)

The Negative Pledge Clause was thus drafted broadly in order to give the World Bank the greatest possible comfort in its position as an unsecured lender. The clause pursues twin objectives: “preventing a situation in which significant assets of the debtor are ‘allocated’ to other creditors, thereby effectively subordinating the unsecured creditors; and inhibiting a debtor from incurring excessive liabilities.”\(^{22}\) As stated by the World Bank, “[t]he basic purpose of the Bank’s negative pledge clause . . . has always been to protect the Bank against the commitment of governmental resources, or the use of governmental authority to mobilize resources, to enable other foreign creditors to obtain foreign exchange in preference to the Bank through the creation of liens or other priority interest.”\(^{23}\) Indeed, the World Bank’s mission as a development institution forces it to engage in a difficult balancing act. On one hand, the World Bank must support fiscally troubled sovereigns by offering loans with favorable terms, but on the other hand, the World Bank must protect its own credit rating. The Negative Pledge Clause represents the compromise between these aims, allowing a sovereign to borrow money without risking its assets while simultaneously ensuring that the present and future properties of the sovereign will be available to satisfy the World Bank’s claims.\(^{24}\)

By allowing this compromise, the Negative Pledge Clause benefits both the World Bank and the borrowing nation in several crucial ways. First, it protects the World Bank as a creditor by protecting the repayment ability of the borrowing nation. The World Bank relies on its high credit rating, allowing it to borrow funds cheaply and lend at low rates.\(^{25}\) Without the Negative Pledge Clause as a backstop against a borrowing state encumbering its assets, the World Bank’s credit rating might drop.\(^{26}\) Maintaining a high credit rating is key in ensuring that the World Bank can continue to function as a lender of last resort.

Likewise, the Negative Pledge Clause allows the World Bank to retain a high credit rating without taking security on state assets (which, of course, would be another way for the World Bank to ensure repayment and prevent a latter creditor from encumbering properties).\(^{27}\) Given the World

\(^{21}\) Id. ¶ 11; see also Asiedu-Akrofi, supra note 6, at 444–45 (noting that a broad definition can “include activities which though having the practical effect of security, do not in form give rise to a security interest”).

\(^{22}\) Conable, supra note 6, ¶ 3; see also Asiedu-Akrofi, supra note 6, at 422 (“Thus the clause attempts to reduce the risk to creditors of the borrower tying up the existing assets or future income streams to particular external creditors.”); Hurlock, supra note 6, at 347.

\(^{23}\) Conable, supra note 6, ¶ 34.

\(^{24}\) See SHIBATA, supra note 3, at 304.

\(^{25}\) See Hurlock, supra note 6, at 364.

\(^{26}\) See id.

\(^{27}\) Of course, even if the World Bank were to take security on a sovereign entity’s assets, enforcing such security might prove difficult. See Maciej Chmielewski, How to Improve the Effectiveness of the
Bank’s position as a development institution charged with reconstruction of a faltering economy, it would be discomfiting for the World Bank “to take security on state assets and then foreclose on them, depriving the borrower country of income-producing assets.”28 Additionally, the refusal to take collateral may encourage an important watchdog function. An early treasurer of the World Bank stated that “the Bank’s real security lay in the sound economic and financial position of the borrowing country. . . the taking of collateral weakened the Bank’s ability to induce the country to ‘keep his house in order’ because in taking collateral, the Bank would have less reason to ‘inquire deeply’ into conditions in the borrower’s country.”29 In effect, the existence of the Negative Pledge Clause enables the World Bank to avoid the embarrassment of potentially foreclosing on the very developing country it purports to help while simultaneously inducing World Bank experts to keep a close eye on the state’s economy.

Arguably, the Negative Pledge Clause also benefits the borrowing country by limiting its borrowing capacity.30 The concern is that borrowing countries might mortgage their critical export earnings for extended periods in order to meet current needs.31 The Negative Pledge Clause thus discourages asset stripping and the overextension of resources.32 Although this is a paternalistic justification for the Negative Pledge Clause, the fact that many countries borrowing from the World Bank do not have solid fiscal track records may lend it greater credence.

Therefore, despite the problems that plague the current incarnation of the Negative Pledge Clause, it is important to remember that it serves an important purpose in allowing the World Bank to securely function as a creditor of last resort and restrain developing countries’ potentially ill-advised borrowing capacity. Any proposed change to the Negative Pledge Clause must keep in mind the importance of protecting the World Bank’s ability to maintain its credit rating and ensuring that the borrowing country does not become vulnerable to wolfish creditors.

28 See Hurlock, supra note 6, at 356.
29 Conable, supra note 6, n.3.
30 See Asiedu-Akrofi, supra note 6, at 423 (“[T]hese [negative pledge] clauses may operate as a check against excessive borrowing by enabling the lenders to insist on sharing in a particular security transaction thereby making potential creditors wary of lending. In this respect, a negative-pledge clause may help achieve . . . a limit on the borrowing capacity of the debtor.”).
31 See SHIBATA, supra note 3, at 314.
32 See Hurlock, supra note 6, at 347–48 (“In theory, a negative pledge clause provides the further benefit of preventing a borrower from entering into subsequent borrowing that would overextend its resources.”).
III. PROBLEMS WITH THE CURRENT WORLD BANK NEGATIVE PLEDGE CLAUSE

The Negative Pledge Clause, as currently written and interpreted, is unclear in its application and overly broad in the scope of financing structures it covers. Certain key terms are not defined, leading to confusion over whether the Negative Pledge Clause might apply to a particular transaction. Moreover, the law that would govern any adjudication of the Negative Pledge Clause remains uncertain and thus the consequences of a breach cannot be easily predicted. Perhaps even more concerning than the question of whether the Negative Pledge Clause applies to a particular transaction is the extensive breadth of the proposed projects that the Negative Pledge Clause does apply to. The surrounding uncertainties and expansive reach of the Negative Pledge Clause hike up transaction costs and potentially hinder the most development-friendly types of private-public collaboration.

A. Uncertainties in Applicability and Enforcement

The confusion over the application of the Negative Pledge Clause centers around the concepts of ownership and control because the Negative Pledge Clause does not clarify how such ownership or control should be determined. In order for the Negative Pledge Clause to apply to a particular transaction, the assets in question must be “Public Assets,” defined as “assets of the Member Country, of any of its political or administrative subdivisions and of any entity owned or controlled by, or operating for the account or benefit of, the Member Country or any such subdivision . . .”33 “Ownership” is not defined in the General Conditions. However, a World Bank memorandum has indicated that the term is generally regarded as referring to direct or indirect ownership.34 Unfortunately, this high-level definition does not illuminate precisely which companies are considered to be SOEs when ownership is not by a simple majority, as is often the case when dealing with chains of partially-owned subsidiaries.

For example, 55% of Company A is owned by Company B, and 75% of Company B is owned by State X. There are two different methods by which the ownership of Company A could be calculated for the purposes of determining if the Negative Pledge Clause applies: intermediate majority ownership calculation or a dilution calculation. An intermediate majority ownership calculation examines the corporate ownership structure to determine if intermediate majority ownership of the voting capital stock or other ownership interests by one or more of the SOEs exists all the way up

33 General Conditions, supra note 1, app. ¶ 79.
34 Conable, supra note 6, ¶ 9 (“Therefore, the negative pledge clause applies not only to assets owned directly by a member but also to assets which it owns indirectly . . . .”).
the chain of ownership. Thus, because Company A is majority-owned by Company B, which is majority-owned by State X, State X would own Company A for Negative Pledge Clause purposes.

Dilution calculation would calculate the state’s equity stake in the company in question as the product of the state’s direct equity stake in a parent SOE multiplied by that parent SOE’s equity stake in the subsidiary. Thus, multiplying State X’s ownership of Company B (75%) by Company B’s ownership of Company A (55%), we find that Company A is 41.25% owned by State X. Because this is not majority ownership, State X would not own Company A for purposes of the Negative Pledge Clause. This example shows that, depending on the ownership calculation method chosen, the Negative Pledge Clause may or may not apply to a particular entity—an uncertainty sure to be disconcerting to any company wondering if it can offer potential investors a lien on its assets.

“Control” is another term not defined by the General Conditions, though it is generally regarded in World Bank literature to refer to direct or indirect control. In discussing potential types of control, the former General Counsel of the World Bank suggested that indirect control might be achieved through majority ownership, concentrated minority ownership when the majority of shares are scattered, government control through regulation, or enjoyment of the full benefit of the company’s assets. However, despite this guidance, a precise understanding of what it means to control a company for purposes of the Negative Pledge Clause remains amorphous. Might indirect control also be obtained through contractual arrangements, use of board seats, or weighted voting arrangements? Is control obtained if state directors are responsible for most of the business’s day-to-day decisions, but must seek supermajority agreement from non-state directors for fundamental corporate change? Given the haze that surrounds the definitions of ownership and control, a company or would-be investor cannot accurately determine if the restrictions of the Negative Pledge Clause will factor in a proposed transaction, thus clouding their ability to gauge the consequences of granting a lien.

**B. Uncertainties in Governing Law**

It is also difficult to foresee what law would apply to adjudication of a security interest granted in violation of the Negative Pledge Clause. The General Conditions do not specify a governing law. Agreements between the World Bank and sovereign nations are generally regarded as having the same status as treaties, and are thus deemed subject to international law.
However, assuming that international law would apply to the interpretation of the Negative Pledge Clause raises a host of problems. For example, would substantive international law govern the interpretation, or would international law rather look to a choice of law doctrine to determine the substantive governing law? If it is the former, there exists no on point rule of international law to which an interested party can look to for guidance on how the Negative Pledge Clause might be interpreted. Rather, an interested party would have to divine from the general principals of treaty interpretation how an international court might read the loan agreement. If it is the latter, there is no concrete international law choice of law doctrine to help reliably anticipate which substantive governing law would be chosen. Although international law has come a long way in the past few decades, it still remains a fairly amorphous body of law, particularly when dealing with the concrete realities of interpreting a loan agreement.

It is also worth noting that a debate exists under many national jurisprudences over the consequences of granting a lien on assets in violation of a negative pledge clause. The issue in debate is whether a lien granted in violation of a negative pledge clause fails to create a valid security interest in a third-party creditor, or whether such a lien would be valid, but expose the breaching party to contractual remedies. On the one hand, some cases and commentary suggest that a negative pledge clause is in itself a security interest, ensuring that it takes priority over all

(1959) (“Every loan agreement between the World Bank and a member state . . . is an international agreement ‘governed by international law,’ as both parties to such agreements have international legal personality. These agreements are ‘treaties’ in the broad sense of the term, as a matter of international law, and are registered with the United Nations as such.”); SHIHATA, supra note 3, at 434 (“The Bank’s loan and guarantee agreements with its member governments are treaties governed by international law. The validity of these agreements is determined by international law alone; they are wholly insulated from any conflicting provisions of domestic legal systems. The Bank’s loan and guarantee agreements with members are also typical of treaties in providing for the resolution of any disputes between the parties by binding arbitration conducted under international law rules.”); Raymond M. Auerback, Governing Law Issues in International Financial Transactions, 27 INT’L LAW 303, 303–04 (1993) (“In other cases normally the lender determines the choice of governing law, which is most frequently the law of the lender’s domicile. The main exception to this rule is a loan made by a multilateral institution such as the International Bank for Reconstruction and Development (IBRD) or one of its regional offshoots, whose agreements may be governed not by a specifically chosen municipal law, but by what might loosely be termed ‘public international law.’”); see also Hugh N. Scott, The Enforceability of Loan Agreements Between the World Bank and Its Member Countries, 13 AM. U. L. REV. 185, 190 (1963–1964) (“The fact that the [World] Bank’s loan agreements are governed by international law has various results. The interpretation of the agreement will depend on international law, the rights of the parties will be given effect by international law and the remedies available to enforce these rights will be those available under international law.”).

subsequently created liens. On the other hand, some legal commentators have pointed out that, if the initial lender “wanted the benefits of security, they should have taken security.” Thus, “negative pledge covenants in fact provide little protection to unsecured lenders when the breach is accompanied by dissipation of assets. The covenants usually confer on the negative pledge nothing more than the rights to sue for damages, and assuming that the loan agreement is correctly drafted, to accelerate the original debt.” A third, compromising view has also emerged: that the negative pledge should “more clearly be viewed as neither secure nor unsecure and, instead, will occupy a new mezzanine staked out between the two poles.” Perhaps most unnerving for would-be lenders, “[u]nder certain circumstances, the negative pledge lender is able to sue a third party creditor who knowingly enters into a secured credit agreement with the borrower for damages.”

Given this lack of agreement over the consequences of breaching a Negative Pledge Clause in domestic law and the uncertainty in predicting what substantive law will govern the Negative Pledge Clause, it becomes particularly risky for a potentially state-owned company or would-be investor to contemplate any transaction that might require adjudication of the issue. It is also possible that would-be investors would have reputational concerns when participating in a transaction that could violate a World Bank loan agreement. However, despite the risk to SOEs and investors of structuring a transaction to include a lien, it is perhaps the World Bank itself that is most hurt by the murkiness surrounding the language and enforcement of the clause. Indeed, the World Bank has been extremely loath to challenge a problematic grant of a security interest.

Because these uncertainties discourage the World Bank from bringing potential breaches of the Negative Pledge Clause to a court or tribunal, “[i]n practice, [the Negative Pledge Clause] has not stopped governments and SOEs from granting security for loans, though such grants technically constitute a breach of contract under the loan agreement.” Occasionally, the World Bank has threatened to punish a breach of the Negative Pledge Clause by refusing to disburse further funds to the borrower state.

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39 See Asiedu-Akrofi, supra note 6, at 439–40.
40 Arkins, supra note 38, at 202; see also Chmielewski, supra note 27, at 10 (“Under United States law, it is generally recognized that the negative pledge clause does not bestow upon the lender any real rights over the borrower’s assets.”).
41 See Bjerre, supra note 38, at 312; see also GOODE, supra note 38, at 201 (suggesting that the affirmative negative pledge does no more than create a contractual right in the initial creditor); Arkins, supra note 38, at 198 (”[I]t would be foolhardy to try to give it the force of formal security.”).
42 See Bjerre, supra note 38, at 314.
43 See Chmielewski, supra note 27, at 17.
44 See Hurlock, supra note 6, at 349. In addition to the uncertainties in enforcement, the World Bank may also choose not to challenge these impermissible grants of security interests because it would be awkward for it to foreclose on a nation’s assets or because it recognizes that many of these transactions encourage development. See discussion supra Part I.
45 See Chmielewski, supra note 27, at 57 (noting that “[t]he violation of the IBRD’s negative pledge
However, these threats have not amounted to a systematic castigating reaction to breach of the Negative Pledge Clause. Thus, the unclear drafting and enforcement proves problematic for states, investors, and the World Bank alike. Naturally, the World Bank’s reluctance to enforce the Negative Pledge Clause undermines the clause’s efficacy. If the Clause’s purpose is to secure state assets for the repayment of the World Bank loan, the World Bank must be able to challenge a breach of the provision that safeguards these assets. However, “such defaults have rarely if ever been used as grounds for acceleration of a loan to a sovereign borrower—which also raises the question of the utility of a negative pledge clause in the World Bank’s loan agreements.”

Given the World Bank’s unwillingness to arbitrate potential breaches of its Negative Pledge Clause, SOEs and investors may choose to take on the risk of closing a transaction that includes a grant of security interests. However, the uncertainties outlined above prompt a certain amount of caution when doing so. Even for SOEs and investors who are willing to consummate a transaction where a security device is envisioned, the presence of the Negative Pledge Clause hikes up transactional costs. Reluctant to use a straightforward lien to ensure their security interest, investors will often create quasi-security devices, which grant repayment benefits similar to those of foreclosure on a security interest to the investor, as an attempt to structure around the problem. These devices include the right of set-off, advance payment arrangements, long-term sale contracts, lease contracts, and trusts. In effect, such quasi-security structures “consist of transactions which may not in law create security interests, but nevertheless have the practical effect of security interests.” The search for appropriate quasi-security work-arounds can hike up legal fees and cause other inefficiencies related to erecting these structures.

In addition to the potential elevated costs of using a quasi-security device instead of a straightforward lien, “[i]ncreased resort to quasi-security devices would not only threaten to undermine the security function of [the Negative Pledge Clause], but would also contribute to the blurring of the distinction between payment arrangements which create security interests and those which do not.” These quasi-security devices defeat the spirit, if not the letter, of the law by undercutting the protection that the Negative Pledge Clause is meant to offer the World Bank as creditor of last

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46 Hurlock, supra note 6, at 359.
47 See Conable, supra note 6, ¶ 31 (“[T]here are indications that certain financing transactions are being constructed in ways essentially intended to circumvent the reach of negative pledge clauses.”).
48 Asiedu-Akrofi, supra note 6, at 444.
49 Id. at 458.
Indeed, the World Bank General Counsel has made clear its condemnation of the growing use of quasi-security devices. A 1990 memorandum to the Executive Directors of the World Bank on negative pledge policy suggested that the Negative Pledge Clause prohibits all such quasi-security devices: “[T]he negative pledge clause applies not only to formal security interests such as mortgages and pledges of collateral but to any arrangement that provides a preference for a creditor with respect to property.” Indeed, the 1990 memorandum even hinted that the World Bank might take corrective action against countries continuing to permit quasi-security devices compromising the Negative Pledge Clause. However, the 1990 memorandum did little to dampen the practice. Ten years later, this problem was still continuing to the extent that it prompted the General Counsel to reiterate the Bank’s policy in no uncertain terms: [A]ttempts to circumvent the negative pledge clause should not be seen as acceptable to the Bank. On the contrary, to the extent that other creditors try to abuse and avoid the protection that the Bank was given through its loan agreements, the Bank should try to oppose this and establish that these abuses are not acceptable.

It is possible, of course, that the World Bank’s disapproval of the use of quasi-security devices has failed to dissuade SOEs and investors because, despite its strong opposition to quasi-security devices, the World Bank has not laid out clear guidelines as to exactly what structures are considered impermissible security interests. Indeed, in a section entitled “Transactions Possibly Outside the Reach of the Clause,” the 1990 memorandum notes that “[q]uestions may be raised as to whether certain types of transactions having similar economic effects to liens are covered by the clause.” This uncertainty adds yet another layer of confusion to

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50 See Conable, supra note 6, ¶ 32 (“However, there is a risk that the sort of techniques that have hitherto been of marginal relevance to the essential integrity of the Bank’s negative pledge policy might be applied in respect of new money and [debt and debt service reduction] operations on a scale which will have a major impact on the continued effectiveness of the Bank’s policy.”).

51 Id. ¶ 11.

52 See id. ¶ 34 (“[I]f there are cases where countries systematically abuse or try to circumvent the intent of the clause, this would raise concerns about the overall creditworthiness of that country for Bank lending, and consequently be a subject for resolution in the context of our overall country dialogue and operational program.”).

53 SHIBATA, supra note 3, at 308.

54 Conable, supra note 6, ¶ 14. Notably, these transactions “include advance payment arrangements, long term sales contracts, lease contracts, and trusts. For example, a member might sell commodity receivables, such as receivables for oil deliveries, on a limited recourse basis. Such arrangements may have the same economic effect as borrowing secured against those earnings but may not be a technical violation of negative pledge clauses. Similarly, a member might enter into a sale and repurchase arrangement with respect to gold, whereby the member would agree to sell gold for a specific amount on terms that it will, at the option of the purchaser, buy back the gold for a higher
determining in what situations the Negative Pledge Clause applies.

With all of this confusion over which companies are controlled or owned by the state, which law would apply to any enforcement mechanism, what the consequences of a breach might be, and which quasi-security devices are impermissible, it is little wonder that the exercise of structuring a transaction with a potential state-actor is fraught with pitfalls. There are two harmful results that might occur from this situation. First, uncertainty might dissuade would-be investors from investing in otherwise worthwhile projects or increase the transaction costs for doing so. Second, such uncertainty could lead to SOEs impermissibly granting liens in violation of the spirit of the Negative Pledge Clause, thus undermining the World Bank’s tenuous position as creditor of last resort. Although opposite reactions to the same problem, neither path supports the World Bank’s mission as a development institution.

C. Expansive Scope of the Negative Pledge Clause

The indeterminacies surrounding the proper application and enforcement of the Negative Pledge Clause complicate easy structuring of projects whenever a potential state actor is involved. Where it is not clear if an entity would be considered a SOE, third party investors may be uncertain if their proposed financing would be caught by the Negative Pledge Clause, and such uncertainty can dissuade investors or lead to higher transaction costs. This is a problem regarding uncertainty around the edges of what the Negative Pledge Clause covers. However, an even more serious problem is that the Negative Pledge Clause’s expansive reach prevents the development-friendly projects that unambiguously do fall within the realm of the Negative Pledge Clause. Because the Negative Pledge Clause prohibits liens on all “Public Assets,” because “Public Assets” is defined broadly, and because “Liens” is interpreted broadly, all proposed loans to a SOE must overcome the hurdle of the SOE’s inability to provide creditors with a security interest. This hurdle can hinder the rescue of fiscally troubled states or block the sorts of public-private partnerships that build national infrastructure. In doing so, the Negative Pledge Clause might be fostering a developing state’s dependence on World Bank funds, a situation which runs counter to the World Bank’s expressed purpose.

For those unambiguous state-actors, the Negative Pledge Clause operates as a near total block on granting security interests in the SOE’s property, and this is particularly true when coupled with the World Bank’s amount at a set time. Although structured as a sale rather than a borrowing, the transaction could in substance be viewed as a loan to the member secured by gold, the difference between the sales price and the purchase price of the gold being interest payable on the loan.” Id.

55 See discussion supra Part I.
56 See discussion supra Part II.A.
designation of quasi-security devices as impermissible. Such an extensive barrier, with no exceptions given for extreme situations, can impede a rescue scenario to the detriment of both lender and borrower. Preventing a rescue stands as a concern any time an agreement includes a negative pledge clause, but the danger is particularly heightened with the World Bank Negative Pledge Clause because World Bank loan agreements are usually made with fiscally vulnerable states.

This risk was most clearly illustrated in the early 1980s. In 1982, the international financial system was under threat from the severe indebtedness of several developing counties and the related exposure of commercial banking systems. In response, the U.S. government called for emergency short-term financing to four highly indebted countries: Mexico, Argentina, Brazil, and Yugoslavia. Unfortunately, the Negative Pledge Clause (and similar commercial loan agreements with negative pledge clauses) did not include exceptions for emergency short-term funding. Thus, “[t]he provision of this essential bridge financing was almost precluded... because of the widespread use of negative pledge covenants in both official and private international loan agreements with sovereign borrowers.” Obviously, hindering a rescue serves neither the interests of the World Bank nor the faltering state; it is unsatisfying for any lender to “share ‘equally and ratably’ in the ashes.”

Preventing a rescue is the most dramatic example of how a Negative Pledge Clause can prove inimical to the interests of both the developing country and the World Bank. A less flashy, but ultimately more dangerous problem (due to its commonality), is the hindrance of the types of private-public partnerships most likely to aid in developing a state. The Negative Pledge Clause squarely interferes with private-public partnerships constructing large infrastructure projects. These types of massive public works usually require state participation, but are unlikely to come to fruition in a developing country without private foreign direct investment. Commercial foreign investors, however, are loath to fund a project where they are unable to take security on state assets owned by a sponsor or project company.

Most economists would agree that diminishing the flows of foreign

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57 See Asiedu-Akrofi, supra note 6, at 445 (“Moreover, the inclusion of quasi-security devices in the list of prohibited transactions under NPCs will deprive borrowers of the flexibility necessary to engage in several ordinary commercial transactions.”).
58 See Arkins, supra note 38, at 201 (discussing other scholars who have noted “the dangers of negative pledge clauses, in their inflexibility and in particular the manner in which they effectively outlaw a ‘rescuing’ creditor from saving a ‘drowning’ debtor from impending insolvency”).
59 See Bradfield & Jacklin, supra note 6, at 131.
60 See id. at 133.
61 Bradfield & Jacklin, supra note 6, at 133.
62 See id. (“The lesson drawn from this experience is that unrestricted negative pledge covenants, as commonly used in international loan agreements, can seriously damage the interests of both the sovereign borrower and the lender, to the ultimate detriment of the international financial system.”).
63 See Arkins, supra note 38, at 201.
direct investment (FDI) to a developing state hurts its economy. As a general matter, “[FDI] is an integral part of an open and effective international economic system and a major catalyst to development.”64 When FDI occurs in optimum conditions, it can even “bring entirely new kinds of activities into the host economy, changing the production possibility frontier—the development trajectory—available to the country. Far beyond simply adding more capital to a host economy, FDI can be the conduit to the cutting edge of research and development (R&D), production technology, and management expertise in use around the world.”65

Obviously, the existence of the Negative Pledge Clause does not completely staunch FDI flows to the country in question. However, the Negative Pledge Clause may have the effect of drying up the exact types of FDI flows that are most integral to development—those flows contributing to the construction of large public infrastructure works which stand to directly benefit the people of the developing country and to bring in advanced technology and expertise. One criticism of FDI’s role in development is that the benefits of the investment are often siphoned off to foreign investors, leaving little in the way of real benefit to the developing country.66 However, when FDI is harnessed for public projects, much of the benefits remain with the developing country.67 For example, even if foreign investors receive the profits from a toll road they financed, the local state still enjoys the efficiency and convenience of improved national transport.

In particular, in developing states where the government owns most of the nation’s resources, the Negative Pledge Clause “can greatly inhibit these countries’ ability to obtain funds from external sources for many types of secured lending, such as project or equipment financing.”68 For example, the Negative Pledge Clause countered attempts to attract financial assistance to many Eastern European states following the breakup of the U.S.S.R in 1992.69 Because the majority of the former Soviet states’

64 OECD, FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT 3 (2002), http://www.oecd.org/daf/investmentfordevelopment/1959815.pdf. Of course, this conception of FDI as a beneficial good may assume economic conditions that favor low barriers to market entry and a competitive environment. See, e.g., INST. FOR INT’L ECONS., FDI IN DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION 19 [hereinafter FDI IN DEVELOPING COUNTRIES], available at http://www.piie.com/publications/chapters_preview/53/1iie258x.pdf.
65 Theodore H. Moran et al., Conclusions and Implications for FDI Policy in Developing Countries, New Methods of Research, and a Future Research Agenda, in DOES FOREIGN DIRECT INVESTMENT PROMOTE DEVELOPMENT? 375 (Theodore H. Moran et al. eds., 2005).
66 See FDI IN DEVELOPING COUNTRIES, supra note 64, at 21 (“Instead of filling the gap between savings and investment, [foreign investors] may lower domestic savings and investment by extracting rents and siphoning off capital through preferred access to local capital markets and local supplies of foreign exchange.”).
67 See Moran et al., supra note 65, at 377 (“The creation of externalities means that foreign investors cannot appropriate for themselves all of the benefits that their activities bring to the host economy.”).
68 See Hurlock, supra note 6, at 349.
69 See Asiedu-Akrofi, supra note 6, at 428.
economies were government-controlled, widespread adoption of the Negative Pledge Clause in World Bank loan agreements threatened to preclude commercial funding for the region. The Clause proved so troublesome that the World Bank resorted to waivers of the Negative Pledge Clause to tempt private investors. These waivers, of course, were project-specific and the Negative Pledge Clause has continued to remain a hurdle in recent Russian transactions.

By interfering with public-private partnerships, the Negative Pledge Clause causes a developing state to face difficulty in finding commercial investors to help with public development, and those commercial investors that do agree to come aboard may demand terms extremely unfavorable to the state as comfort. As a result of such interference, developing countries may look away from FDI and commercial investors as palatable sources of funding and towards development banks instead. In short, because the expansive scope of the Negative Pledge Clause dissuades private investors from the most development-friendly of loans, sovereign nations may replace a search for commercial funds with dependence on development bank loans. This is ironic since the goal of such banks is often to help create an attractive market for commercial investors and wean the developing state off of multinational institutional funds.

This potential dependence on development banks has garnered its fair share of critics. According to Catherine Caufield, author of a landmark book critiquing the World Bank, “massive lending is creating an international dependency problem, a permanent underclass of nations that have lost much of their self-reliance, self-confidence, and self-respect.” Indeed, it has been widely acknowledged that the role of development banks should be to steer underdeveloped countries towards sustainability through effective use and growth of private markets instead of continual reliance on development funds. As the prominent Volcker Commission put it, “because ‘economic resource and growth potential have come to reside largely in the private sector’ the Bank Group ‘must change the way it does business, emphasizing its role as a mobilizer of resources—private and public, intellectual and financial—and not as a lender of money to governments.”

IV. TIMELY REFORM

In addition to engendering confusion around the edges of what is

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70 See id. at 431–32; see also discussion infra Part IV.
71 See PROJECT FINANCE INTERNATIONAL, supra note 2 (reporting on recent waiver discussions between World Bank officials and Russian investors).
72 See CAUFIELD, supra note 10, at 336–37.
permissible, the Negative Pledge Clause hinders the projects most likely to benefit developing nations and encourages dependence on multilateral funds instead of growth of private markets. Given that this outcome benefits neither the World Bank nor the affected countries, reform of the Negative Pledge Clause is in order. Indeed, the World Bank has previously shown itself to be receptive to reform when faced with similar criticisms of the Negative Pledge Clause.

The 1990 memorandum to the World Bank’s Executive Directors on Negative Pledge Clause policy stated that, “Given the far-reaching scope of the Bank’s [N]egative [P]ledge [C]lause, the Bank has always recognized that it should be administered with some flexibility.” In response to this memorandum, the Executive Directors confirmed that it was the Bank’s practice to grant waivers in connection with debt service reduction operations. There were two main criteria given for when a waiver is granted: first, the impact that the waiver might have on the World Bank in its capacities as creditor and borrower, and second, the relevance of the proposed transaction to the Bank as a development institution.

However, although these general criteria were subjective enough to permit a waiver in a wide range of financings, the World Bank narrowly construed waiver-eligibility by evaluating eligibility in connection with a number of potentially disqualifying factors. Such factors included: the magnitude of the amounts being secured in relation to the World Bank’s exposure in the country; the resulting preferred and superior debt in relation to the country’s total outstanding debt; the existence of negative pledge waivers from third-party creditors; and whether the scheme would increase the involvement of other creditors and thereby reducing the Bank’s relative exposure. Given these strict standards, in practice the World Bank has only waived the Negative Pledge Clause in circumstances where the World Bank’s exposure would either be de minimis or where the lien was created by a government entity on its own assets and as security for its own borrowings (provided the government entity conducted itself like an autonomous private company without material financial significance to the government’s ability to service the loans).

During the late 1980s and early 1990s, certain Latin American countries restructuring their sovereign debt were able to persuade the World Bank that they met all relevant criteria for the Negative Pledge Clause waiver. Additionally, the special plight of ex-soviet states struggling with transitional economies in the same era convinced the World

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74 Conable, supra note 6, ¶ 16.
75 SHIHATA, supra note 3, at 312.
76 See id.; see also Asiedu-Akrofi, supra note 6, at 430.
77 Conable, supra note 6, ¶ 18.
78 See id. ¶ 16.
Bank of the need to broaden its waiver policy for new money operations. As the former World Bank General Counsel put it:

At that time, the Bank recognized the special, albeit temporary, dilemma faced by countries which were in active throes of transition to market economies, but were in a situation where the vast majority of their economically significant assets were still owned directly by the government, political or administrative subdivisions of the government, or entities controlled by or operating for the account or benefit of the government, all of which fall under the purview of the Bank’s negative pledge clause. The perception was that foreign investment, and particularly loans from private sources to enterprises in countries in transition, may be difficult to attract on an unsecured basis.

To deal with this situation, the World Bank adopted a five-year waiver policy with respect to liens securing repayment of a loan made to finance a specific investment project, applicable only to countries where income producing public assets constituted a predominant share of the total assets and where a program of structural change had been implemented. In addition, the borrower had to be a special-purpose entity with a separate juridical personality, the external lender could not have alternative recourse for repayment and had to be private in character, and the World Bank could not be a co-finance of the investment project concerned. Thus, while the World Bank did show some flexibility in its Negative Pledge Clause policy, that flexibility was quite restricted and very much tied to a particular time and set of circumstances. The World Bank did not grant a waiver to most states that requested it.

Perhaps recognizing that the waiver policy of the early 1990s was not well-tailored to addressing the circumstances of most developing countries and the fears of the World Bank, another proposal was set forth in 2000, intended to “present[] Management's attempt to meet a real and serious need of certain member countries while avoiding the emergence of real and serious risks to the Bank.” Intended to apply on a country-by-country basis rather than a case-by-case basis, the 2000 waiver policy would “obviate[] the need for the further and probably impractical process of reviewing every application for a waiver.” However, in erecting new safeguards to ensure that waivers would be granted only where (a) such

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80 See Preston, supra note 5, § I(1); see also SHIHATA, supra note 3, at 315.
81 SHIHATA, supra note 3, at 315.
82 See Preston, supra note 5, § III(9).
83 See id.
84 See id.
85 See SHIHATA, supra note 3, at 311 (“There have been very few cases in the practice of the Bank where a request for a waiver of the NPC actually led to the granting of such a waiver.”).
86 See id. at 312.
87 See id. at 314.
waiver did not exceed the exigencies and real needs that justify it and (b) such waiver would not result in significant risks to the World Bank, the proposal may have further limited the ability of developing states to successfully seek a waiver for particular projects.

The World Bank’s current waiver policy remains restrictive and harkens back to early 1990s practices. According to the World Bank Operational Manual, OP 7.20, Section 7:

In exceptional cases, upon request, IBRD may grant a waiver in respect of the negative pledge clause. A proposed waiver must be recommended by the country director, through the Regional vice president (in consultation with the Vice President and General Counsel and the Director, Credit Risk Department), to the Managing Director (MD) concerned. The proposed waiver is then submitted to the Board for approval. In exceptional circumstances in which the assets subject to the security are considered to have no material effect on the country’s ability to service IBRD debt, the MD’s approval is sufficient.87

The only footnote to this section references the Board Paper published in 1990.88 Clearly, despite the changing of the times, world economies, and development philosophies, the World Bank has not updated its Negative Pledge waiver policy to reflect the current needs of a new era.

Why has World Bank policy regarding Negative Pledge Clause waivers (and Negative Pledge Clause policy in general) stagnated? In stark contradiction to the flurry of attention the Negative Pledge Clause received in the early 1990s, there has been a paucity of commentary and concern regarding this issue for the past decade in both the official World Bank treatment of the subject and analysis from legal scholars and practitioners. One easy explanation is that the restrictions placed on developing countries by the Negative Pledge Clause did not cause much hardship to the countries affected during the flush years of the late 1990s and early 2000s, when investors with ready cash and eagerness flocked to developing economies. With the markets favoring investment in the developing world, the commercial lenders of the developing world may have played a larger role in the development of new projects. Those public institutions that were involved in structured financings were better placed to command their own terms, given the plethora of investors knocking on their doors.89

88 See id. n.3 (citing Conable, supra note 6).
Moreover, “the huge amount of international project finance liquidity in 2002–07 meant that international lenders had space in their balance sheets for the occasional riskier loan in emerging markets.”\(^9\)

Unfortunately, since the financial crisis of 2008 and the emerging Euro crises, times have changed. FDI over the last few years slipped as a reflection of diminishing confidence in the market. In 2007, for example, at the peak of investor confidence, developing and transition economies welcomed roughly USD \$ 2,000 billion into their markets.\(^9\) In 2010, that number had dropped to less than USD \$ 1,200 billion.\(^9\) In short, the financial crises ensured that “[t]he balance of negotiating power in the markets has shifted back from borrowers to lenders.”\(^9\)

The good news, however, is that FDI appears to have made a comeback since 2011.\(^9\) Yet, while this is reassuring for developing economies in general, a closer look shows that this swell can largely be attributed to increased amounts of M&A deals.\(^9\) Greenfield investment projects (i.e. newly-developed projects), the very sort of large infrastructure works that might most benefit a developing country, have continued to decline in value, dropping from a peak of USD \$ 450 billion in the third quarter of 2008 to USD \$ 150 billion for the fourth quarter of 2011.\(^9\) It is also worth noting that “[a]s these projects are registered on an announcement basis, their performance largely coincides with investor sentiment during a given period. Thus, their tumble in value terms beginning in the second quarter of [2011] was strongly linked with rising concerns about the direction of the global economy and events in Europe.”\(^9\) With investor confidence crumbling due to recent European fiscal troubles, it seems unlikely that project financings in the developing world will rebound soon. Indeed, over the past few years, such projects have seen “greater delays in financial closure, more cancellations, and higher financing costs.”\(^9\)

Given the recent slowdown in project financings and low investor confidence, the developing world needs to make their investments attractive again. Low-income countries can no longer count on liquidity-flush investors’ willingness to scheme around perilous Negative Pledge Clause concerns in their rush to invest. The Negative Pledge Clause, with

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\(^9\) Leigland & Russell, supra note 88, at 3.
\(^9\) Id. at 4–5.
\(^9\) Id. at 5.
\(^9\) Id.
\(^9\) Leigland & Russell, supra note 88, at 1.
all of its attendant uncertainties and risks, stands as an obstacle to public-private projects, and should be modified to make investment in the developing world as worry-free as possible for skittish investors. The time is ripe for the World Bank to reform the Negative Pledge Clause to boost the developing world’s development.

V. SUGGESTIONS FOR REFORM

In contemplating reform of the Negative Pledge Clause, it is crucial to preserve the Negative Pledge Clause’s fundamental function of protecting the World Bank as a creditor of last resort. However, this goal must be placed within the context of the World Bank’s overarching mission to promote fiscal stability and encourage development. A loan agreement that protects the World Bank’s position to the overall detriment of third world development betrays the World Bank’s very purpose. Therefore, a balance between a broad and narrow interpretation of the Negative Pledge Clause should be struck, with errors made on the side of promoting development instead of overprotecting the World Bank’s position. That the World Bank should err on the side of promoting development becomes an increasingly compelling argument when considered in light of the current global economic climate and struggle for fiscal stability. This article proposes two simple ways in which the World Bank could reform its Negative Pledge Clause to preserve the balance between protection of the World Bank and promotion of development.

First, the World Bank could clarify the ambiguities in the language and scope of the Negative Pledge Clause. Pinning down the interpretation of “ownership” and “control” would go a long way in letting creditors know what transactions the Negative Pledge Clause would govern. Such certainty would cut down on the additional costs and inefficiencies connected to the quasi-security structures that creditors erect in an attempt to shield their investments from the ambiguous strictures of the Negative Pledge Clause.

In choosing definite interpretations for “ownership” and “control,” the World Bank has a plethora of options to choose from. Given the current need to promote liquidity and foreign investment in developing countries, the wisest course would be to choose the narrow interpretations which would free entities lurking in that gray area of potential state control or ownership from the constraints of the Negative Pledge Clause. Ownership should be determined based on the dilution calculation instead of the majority ownership calculation. Under this method, where a state’s equity stake in the company in question is calculated as the product of the state’s direct equity stake in a parent SOE multiplied by that parent SOE’s equity stake in the subsidiary, see discussion supra Part II.A.
which is in turn 75% owned by the state, would not be deemed to be “owned” by the state for the purposes of the Negative Pledge Clause.

The definition of “control” should likewise be limited and restricted only to instances of (a) ownership or (b) where the state possesses the ability to direct major decisions of the entity (whether by contractual arrangements, use of board seats, or weighted voting arrangements). The mere ability to veto actions (for example, as might be the case where unanimous board consent is required and the state controls only one of many board seats) or to direct the day-to-day functions of the company but not major decisions should not be considered “control.” It is worth noting, however, that while the narrowest interpretation of “ownership” and “control” would be the interpretation best suited to fulfill the World Bank’s mission in the current economic context, solidifying any interpretation of these terms would go a long way in encouraging investor confidence when dealing with partial SOEs. Potential lenders are much more likely to play the game if they know the rules, even if those rules are not as favorable as they could be.

Second, it would also be helpful to reduce creditor and developing-state uncertainty regarding the consequences of a potential breach if the World Bank loan agreements included a governing law clause (to the extent that certain World Bank loan agreements do not already include such a clause). With greater certainty as to the law that would be applied, developing countries could then choose whether to efficiently breach the World Bank loan agreements, and creditors could have a better sense of the consequences for their partnership in this breach. Again, even if consequences for a breach under whichever governing law is chosen are severe enough to prevent an otherwise profitable project, the gains in certainty can help contractual partners make smart decisions.

Third, the World Bank could amend its General Conditions to incorporate an exception for project financings into the Negative Pledge Clause. This exception would be similar in concept to the existing “purchase money mortgage” exception in Section 6.02(c)(i) of the General Conditions. As explained in a memorandum to the Executive Directors of the World Bank, the purpose of the purchase money mortgage is:

to permit a borrower to finance new assets which will remain with the borrower after payment of the related financing and which can be expected to contribute to the borrower’s wealth. The assumption here is that because the assets of the borrower are available to pay all the borrower’s creditors increase with the

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100 The relevant portion of this section states: “The provisions of paragraphs (a) and (b) of this Section shall not apply to: (i) any Lien created on property, at the time of purchase of such property, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property.” General Conditions, supra note 1, § 6.02(c)(i).
purchase of such assets, the Bank is not disadvantaged. Although the secured creditor who financed the asset is senior to the Bank and other unsecured creditors as to that asset, over time as the borrower repays that creditor, the borrower’s “equity” in the asset will build up and consequently the assets available to pay the Bank and other unsecured creditors will increase.\footnote{Conable, supra note 6, ¶ 12; see also Asiedu-Akrofi, supra note 6, at 420 (noting that the purchase money mortgage exemption “is acceptable because it facilitates the financing of new assets and allows a net gain to the asset base, which in turn increases the ability of the borrower to repay the lender”).}

This reasoning, acceptable to the World Bank for asset purchases, likewise applies to project financings which expand a developing state’s pool of assets and income from revenue. It is a simple calculation—allowing project financings to be secured by a lien on the project and its related revenue streams would increase the amount of funds available for the creation of these new works. If the project financing is successful, the creditors will be paid off according to plan and the developing state gains a valuable asset, thus increasing its financial stability and base to repay the World Bank loan. If the project financing is unsuccessful, the creditors can foreclose on an asset and revenue stream that might not have otherwise existed without the creditor’s investment. Presumably, the World Bank is not hurt by the foreclosure on such an asset. Moreover, incorporating such an exception directly into the text of the General Conditions instead of relying on a broader waiver policy would prevent the World Bank from acting as the gatekeeper for every private investor lending money to a particular SOE.\footnote{A similar benefit was discussed by the World Bank in having a broader waiver policy apply to countries instead of individual projects. See Preston, supra note 5, § II(12) (“[A] case-by-case approach would put the Bank in the position of foreign investment gatekeeper and umpire, requiring the Bank to second-guess and evaluate the decision of every private investor wishing to invest in a country.”).}

Historically, project financing exceptions to negative pledge clauses are not uncommon in commercial bank loan agreements with states because:

\textit{[t]his exception does not present a serious threat to the Lenders—the unexploited assets, such as minerals, would not produce foreign currency income. The assets on which foreclosure would be permitted are also restricted to those directly involved in the project, so the borrower cannot pledge other assets owned or income derived from other sources. Furthermore, the risk of foreclosure is outweighed by the potential benefits derived from exploitation of an income-generating asset. If successful, the project will generate additional foreign exchange for repayment of the Loan and other foreign indebtedness.}\footnote{Hurlock, supra note 6, at 354 (discussing exceptions common to commercial bank negative}
Even other development banks have allowed for project financing exceptions. For example, the European Bank for Reconstruction and Development (EBRD), with its focus on promoting the development of private enterprise, has “adopted a policy under which the waiver applies generally to liens securing external debt incurred in project financings, provided that there is a reasonable expectation that the debt can be serviced from the revenues generated by the project.” Indeed, the EBRD’s more liberal waiver policy appears to have influenced the World Bank’s amendment of its waiver policy to include a similar project financing exception, though, as discussed above, the World Bank’s waiver policy is still highly restrictive. In not allowing a systematic exception for project financings, the World Bank is out of touch with market practice regarding permitted exemptions to the Negative Pledge Clause.

The argument for allowing a project finance exception for greenfield projects, which seek liens to secure financing for new properties and assets, is clear. However, the picture is somewhat more complicated for brownfield project financings (i.e. projects that construct upon an existing work), which seek to improve upon an existing state-owned asset or for project financings further secured by liens on existing government assets. If a cautious World Bank wishes to ensure that a newly created lien cannot threaten the developing state’s existing asset base, such a project finance exception could be carefully drafted to allow liens only on newly created assets and revenue streams. A smarter path, however, would be an exception to encourage the exemption of such projects which require use of existing assets as collateral security, provided that the World Bank is notified in advance of its construction and gives affirmative consent (which it would do, presumably, if it judges the project financing to be sound, and likely to increase the state’s ability to repay its World Bank loan obligations). This, of course, is similar to a waiver policy in that affirmative World Bank consent of the lien would be required. However, building the procedure for obtaining such consent directly into the text of pledge clauses through an analysis of the Bank Credit Agreement with the Central Bank of the Republic of Turkey, dated July 13, 1979); see also Andre Newburg, The First Three Years of the European Bank for Reconstruction and Development: Legal Issues and Solutions, in CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS, 45, 58–59 (Robert C. Effros ed., Int’l Monetary Fund, 4th ed. 1997) (“The modern trend in international financial practice has been to relax the application of negative pledge restrictions, so as to permit the incurrence of secured debt to finance productive projects.”).

See Newburg, supra note 103, at 59; see also Hurlock, supra note 6, at 381 (noting the European Bank for Reconstruction and Development created a waiver policy which applies “exclusively to liens ‘securing external debt incurred in connection with the financing of the acquisition, construction or development of any properties in connection with a project (a ‘project financing’)’” (quoting Limited Waiver of Bank’s Negative Pledge Clause, at 1–2, BDS93-140/Rev 2 (Nov. 17, 1993)).

See Hurlock, supra note 6, at 384 (“The World Bank decided to modify its negative pledge waiver policy to confirm more closely with that of the EBRD . . . the World Bank adopted the EBRD’s ‘project financing concept’ in place of its own requirement that the borrower be a special purpose vehicle, an arrangement more in line with commercial practice.”).
the Negative Pledge Clause would validate the approval of such a waiver. For the state and potential creditors, having to obtain World Bank consent for such projects could be a cumbersome process, but providing for that possibility is a better option than the difficulties imposed on such projects by the current World Bank waiver policy.

To codify this exemption, Section 6.02(c) of the current General Conditions could be amended to include a new (ii) which would set forth the permitted project financing exception:

The provisions of paragraphs (a) and (b) of this Section shall not apply to: (i) any Lien created on property, at the time of purchase of such property, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; (ii) any Lien created to support any Project Financing, provided that, for any Project Financing involving both newly financed assets and existing Public Assets where the person or persons providing such financing do not expressly agree to limit their recourse to the newly financed assets and the revenues to be generated by the operation of, or loss of or damage to, such assets as the principal source of repayment for the moneys advanced, the Bank gives prior written consent that the provisions of (a) and (b) of this Section shall not apply to such Lien; or (iii) any Lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.

In addition, the following definition would be added in as Section 80 to the Appendix (Definitions):

“Project Financing” means any financing (but not a refinancing) of the acquisition, construction or development of any asset in connection with a project if the person or persons providing such financing have been provided with a feasibility study prepared by competent independent experts on the basis of which it was reasonable to conclude that such project would generate sufficient foreign currency income to repay substantially all of the principal of and interest on External Debt incurred in connection with such project.

This suggested wording in amended Section 6.02(c) builds in the exemption for project financings, but requires World Bank approval for projects where the principal source of repayment is not the project itself. Moreover, by including the requirement for a feasibility study prepared by an independent engineer in the definition of “Project Financing,” the
proposed language also adds some comfort that any project which could fall under the project financing exception would be unlikely to hinder the state’s repayment of its World Bank loans. Ultimately, incorporation of this language into the General Conditions could encourage the type of project financings currently stifled by the Negative Pledge Clause’s broad ban on third-party liens.

V. CONCLUSION

When it comes to promoting development-friendly projects, the World Bank and developing nations should share a similar goal: infrastructure projects that might enrich a poor nation should be encouraged, making such nation more likely to repay its prior debt obligations and lessen its future dependence on developing-bank funds. The hope is for the developing nation to take its place amidst the ranks of fiscally stable members of the world economy. However, in order for a developing nation to become a full member of the world economy, it must be able to act and grant security like other commercial borrowers. Unfortunately, the current Negative Pledge Clause, while established for some important and legitimate reasons, has worked to stifle such development.

Granted, reform of the Negative Pledge Clause should not throw the baby out with the bathwater—the protections offered by the Negative Pledge Clause to both the World Bank and the developing nation itself are crucial to allowing the World Bank to remain a lender of last resort. After all, developing nations are not pure commercial actors who can be allowed to fail, but do from time to time require the help that development banks offer in stabilizing faulty economies with well-timed loans, help which a development bank can only offer if it maintains a low credit rating and has some hope of timely repayment. The benefits that the Negative Pledge Clause offers to the World Bank and the developing nations should be maintained, while carving away its most negative externalities.

Clarification of “ownership,” “control,” and the governing law while also providing an exemption for liens securing project financings strengthen the integrity of the World Bank loan agreements; these reforms would provide certainty of the reach and consequences of the Negative Pledge Clause and encourage the financing of works that enrich the developing nation. The counter-argument—that overly broad interpretations of key terms or exemptions could prevent the World Bank from effectively enforcing the Negative Pledge Clause to safeguard its loan repayments—weaken when one considers that the World Bank rarely calls an event of default under its loan agreement based on breach of the current Negative Pledge Clause. The current Negative Pledge Clause is not protecting the World Bank against the kinds of third-party financings and security interests that would threaten the World Bank’s ability to be repaid. On one hand, the current Negative Pledge Clause heightens the uncertainty and transaction costs of intrepid investors willing to risk their investment
on an asset already encumbered by the Negative Pledge Clause. On the other hand, the Negative Pledge Clause dissuades certain other investors from lending funds to attractive projects. The proposed reforms would tailor the Negative Pledge Clause to better fit the mission of the World Bank and the development needs of the borrower country, thus leading to successful fiscal interventions and, ultimately, more prosperous nations.