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I. Introduction

Most of the authors who have written on the subject of choice of law have regarded the area as very complicated and turbulent.[1] This article deals with choice of law in the context of loan agreements used in international project financing, attempts to explain the scope and effects of governing-law clauses and addresses the question of which law should be chosen to govern loan agreements in international project financing. In emphasizing practical aspects, it concentrates on governing-law clauses in a loan agreement designed to finance a project between a lender or a syndicate of lenders in a developed country and a borrower in another country, often a less-developed country (LDC). The projects carried out in LDC's are often large undertakings aimed at exploiting the country's natural resources or enhancing its industrialization or economic development.

The definition of project financing adopted here is a broad one. It includes "pure" project financing, where the borrower typically is a legal entity

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1. *See, e.g.*, P. WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE (1980), 1, where the author describes the subject of conflict of laws as "notoriously complicated," and McDougal, *Toward Application of the Best Rule of Law in Choice of Law Cases*, 35 MERCER L. REV. 483, 525 (1984), quoting *Forsyth v. Cessna Aircraft Co.*, 520 F.2d 608, 609 (9th Cir. 1975), which referred to the "judicial nightmare known as Conflict of Laws."

established for the sole purpose of carrying out the project (such an entity, frequently a joint venture corporation formed by the project's sponsors, is hereinafter referred to as the "project company"), where the lenders rely on the projected cash flows and earnings of the project as their primary "security." Project financing also encompasses lending to an already established borrower (*i.e.*, a government or an agency thereof, or a corporation already operating in the country of the project) which has substantial operations in addition to the project, where the lenders rely not only on the general viability of the project but also on the general financial soundness of the borrower.[2]

Many banks see advantages in lending to specific projects rather than granting general "budget loans" to governments. The principal advantages include a knowledge of the exact purpose for which the funds are used and the fact that a study regarding the feasibility of the project will already exist. Although the rescheduling of sovereign debt has made many banks cut back on their lending to LDCs, many development projects continue to be financed on the basis of their projected viability.[3]

Since the relationship between the lender and the borrower after the disbursement of the loan is characterized by the borrower's obligation to repay the loan, interest and any fees, one of the principal objectives of the loan agreement must be to ensure that such amounts are paid in accordance with the terms of the agreement. Therefore, discussions in this article on particular governing-law-clauses are from the lender's perspective unless otherwise indicated. Since most international loan agreements contain governing-law-clauses, the issue of governing law in the absence of an express choice will not be discussed.[4]

2. Although "project financing," as the term is used by international bankers and financial lawyers, often means only "pure" project financing (which is also sometimes called "non-recourse" or "limited recourse" financing), most of the issues relating to governing law are not uniquely related to only one of these "types" of project financing. *See generally* Rendell & Niehuss, *International Project Finance*, in INTERNATIONAL FINANCIAL LAW, LENDING, CAPITAL TRANSFERS AND INSTITUTIONS, 31–47 (R. Rendell 2d ed. 1983) [hereinafter cited as RENDELL]; WOOD, *supra* note 1, at 313–25. For a discussion of the innovative aspects of "pure" project financing, *see* Rauner, *Project Finance: A Risk Spreading Approach to the Commercial Financing of Economic Development*, 24 HARV. INT'L L.J. 145 (1983).

3. *See, e.g., How to Finance a Pipeline Across the Pampas*, which is a part of the cover story, Curtin, *The Risk Explosion in Energy Financing*, EUROMONEY, Jan. 1982, at 30. This article explains how financing was arranged for a $875 million construction of a gas pipeline across central Argentina without any guarantees from the government of Argentina. For a more recent example of a project, *see also Rafferty, Papua New Guinea's "pot of gold,"* INSTITUTIONAL INVESTOR, Aug. 1984, at 129–32, which describes the interest of banks, despite the risks related to the uncertainty of future copper prices, in financing the Ok Tedi gold and copper mine project, where the local government has limited its own financial exposure.

4. Although there are numerous theories aimed at offering the best approach to the problem of determining applicable law in the absence of an express choice, many jurisdictions have adopted a "center of gravity" or a "most significant contacts" approach. In New York, *Auten v. Auten*, 308 N.Y. 155, 124 N.E.2d 99 (1954), adopted the "center of gravity" or "grouping of

II. Salient Legal Problems in Project Financing

It is necessary to identify some of the principal legal problems arising in the context of project financing before turning to the issue of what is or should be the governing law in the lender-borrower relationship. Three categories of important issues require a solution in each project financing: the terms of the concession,[5] problems relating to security for lenders, and undertakings given by third parties. The concession agreement forms the core of the structure of most natural resource projects. Although the lender is not a party to the concession agreement, the terms of the agreement often form the basis for assessing the risks involved in financing the project.

One of the principal issues to be resolved under the concession agreement is the extent and length of the rights granted. If, for instance, the project company's exclusive rights to the project are limited, or if the period of the concession ends before the final maturity of the debt, the project company's ability to repay the loan may be questionable. The project's foreign exchange regime is also very often set out in the concession. Lenders are interested to know that foreign exchange can be freely transmitted abroad to make all payments under the loan agreement. In addition, the arrangement often forming part of a project financing, under which proceeds from the project's output are deposited in a trust account with a foreign bank, typically located in London or New York, must be authorized in the concession agreement.

The concession agreement may contain clauses which are helpful in assessing the possibility of government expropriation and even contain provisions for payment of compensation in the event of an expropriation. If the government has agreed to settlement of disputes in a third country, *e.g.*,

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contacts" theory of the contract conflict of laws. According to this theory, the law which has the most significant contacts with the matter in dispute will be applied. Under Sec. 188 of the Restatement (Second) of Conflict of Laws [hereinafter cited as Restatement (Second)], where no effective choice is made by the parties, the law of the state having the most significant relationship to the issue will be applied, *see* RESTATEMENT (SECOND) § 188 (1971). *See also* R. LEFLAR, AMERICAN CONFLICTS LAW at 306–09 (3d ed. 1977). In England, unless the parties have expressly or tacitly agreed on a governing law, courts apply the law with which the agreement has its closest and most real connection. *See* WOOD, *supra* note 1, at 12. According to art. 4 of the 1980 EC Convention on the Law Applicable to Contractual Obligations [hereinafter cited as the EC Convention], the law with which the contract is most closely connected will be applied in the absence of a choice of law. 23 O.J. EUR. COMM. (L266) 2–3 (1980).

5. Concession means the agreement between the host country and the sponsors of the project (typically, the concession agreement is concluded between the government and the project company). It is sometimes also called the work or service contract or the participation or production sharing agreement. Under the agreement, the host government grants the sponsors of the project the basic rights to explore and exploit the natural resources, to develop them, or to carry out production, as required by the project. The concession agreement also determines the forms and amounts of compensation to be made to the government in consideration of the rights granted (such as royalties, taxes and possible equity participation). *See generally* SMITH & WELLS, NEGOTIATING THIRD WORLD MINERAL AGREEMENTS 27–59 (1975).

under the rules of ICSID,[6] such a clause may have the effect of deterring action which would adversely affect the position of foreign investors. The concession agreement may also authorize the project company to enter into management and technical assistance agreements with the foreign sponsors. Since management and technological know-how essential to successful operations are often transferred to the project company under such agreements, it is often in the lenders' interest to require such agreements. The number of significant issues dealt with in the concession agreement illustrates the strong contacts a project has to the local jurisdiction.

A second area of concern to lenders relates to the security available to ensure prompt payment under the loan agreement. If the lenders rely on the trust arrangement, under which proceeds of production are channelled first to a trustee bank which then pays the various creditors in order of priority, the trust will in most cases be established in London under English law or New York under New York law.[7] In such a situation, it may not be in the lenders' interests to agree in the loan agreement on a governing law different from that under which the trust is established. For example, if an event of default were to occur under the loan agreement and the lender decides to accelerate repayment of the loan, the lender might rely on both the loan agreement and the trust deed to enforce its rights. The legal principles applicable to an already complex contractual arrangement might be very difficult to construe, where different legal systems apply to the interpretation of the loan agreement and the trust deed.

As an additional security, lenders often require mortgages or charges over the borrower's real property, facilities and inventory. Such security interests are established under local law, which also provides the legal framework for enforcing the security interest, regardless of the governing law of the loan agreement. In addition to relying on the concession, the establishment of a "project security" and other security interests described above, undertak-

6. *See* Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, 17 U.S.T. 1270, T.I.A.S. No. 6090, 575 U.N.T.S. 159, entered into force on Oct. 14, 1965, under which the International Centre for the Settlement of Investment Disputes (ICSID) was established under the auspices of the World Bank.

7. Typically, the borrower assigns to the trustee the right to receive the proceeds of the sale of the output of the project. Ideally, the entire output is sold to purchasers under long-term sales contracts, which ensures payments to the trustee regardless of the general demand in the markets. The trustee must make payments of principal, interest and fees to the lenders, as well as payments to equipment suppliers and other contractors, and build an adequate reserve to meet future debt service requirements before anything can be paid from the trust account to the project company (*i.e.*, the borrower). For a more detailed description of this type of a security arrangement, *see* RENDELL, *supra* note 2, at 42–45, where it is also advised that in order to perfect the lenders' security interest created in the receivables, it should be recorded in various jurisdictions. The authors further indicate that such jurisdictions should include the host country, the countries of residence of the long-term purchasers and the country in which the trust account is located. *Id.*

ings by third parties to the lenders are typically used as building blocks in project financing.[8] The sponsors, the government or another third party, such as an export credit institution, may be required to guarantee the loan. The sponsors may be required to give guarantees concerning the amount of equity they will contribute to the project company. Also, the sponsors may be required to give the lenders completion guarantees under which they agree to complete the project in accordance with the original time schedule.[9] In addition, the sponsors often are obligated to provide funds to meet unexpected cost overruns in the project, either by contributing equity or giving subordinated loans to the project company.

The long-term sales agreements discussed above can also be viewed as forms of "indirect" guarantees to the lenders.[10] One form of a long-term sales agreement is the "take-or-pay contract." Under a take-or-pay contract, the purchaser of the output of the project agrees to make payments under the agreement regardless of whether the product is actually delivered,[11] and these payments, often channelled to a trustee in accordance with a scheme described above, should be sufficient to service the debt to the lenders.[12]

Since the lenders often grant their loans to finance the project directly to the project company, which is formed and capitalized specifically to carry out the project, lenders frequently require at least a "comfort letter" or a "keep-well" agreement from the principal shareholders of the project company.[13] The purpose of such commitments is to create shareholder obligations to keep the project company adequately capitalized and in good financial condition. However, since these obligation clauses are usually very broadly worded, the enforceability of these commitments is often questionable under any legal system.

As illustrated above, the effect of such third party undertakings is to shift many of the project risks from the lenders to other parties. It is in the lenders' interests to require as conditions precedent to any disbursements of the loan that agreements be executed providing for a solution acceptable to

8. *See* RENDELL, *supra* note 2, at 34, 39–40. *See also* Rauner, *supra* note 2, at 165–79 (discussing various types of third party undertakings and their uses in spreading project risks).

9. *See* EUROMONEY, *supra* note 3, at 31, where it is put forward that the trend in financing energy projects has been towards banks assuming more risks and granting loans without demanding a completion guarantee.

10. Rauner, *supra* note 2, at 171.

11. *Id.* at 172.

12. *See* EUROMONEY, *supra* note 3, at 47–48, which explains how the take-or-pay contract is dying out as a form of financing coal and gas projects, where such contracts used to be common, and are now being replaced by long-term purchase contracts without the "take-or-pay" provisions.

13. *See* Rauner, *supra* note 2, at 175.

the lenders concerning the concession, the security arrangements, and third party undertakings.[14]

As the brief overview above shows, a typical project carried out in an LDC, involving foreign lenders requires a complex net of agreements with contacts to many jurisdictions. To reduce exposure to the borrower's jurisdiction and adverse changes in local legislation, lenders often seek a position isolated from the local jurisdiction, which in most cases leads to selection in the loan agreement of a governing law other than that of the borrower's country.

III. Relevance of the Governing Law

A. Aspects Subject to the Stipulated Governing Law

1. *The Problem of* "Renvoi"

When a court is confronted with an agreement containing a governing-law clause, the first issue to resolve is whether the parties have intended to refer to the whole law as the governing law, or whether the choice is deemed to refer only to substantive law.[15] Whole law in this context means both the substantive law and the conflicts rules of law. In the event that the choice is deemed to cover the whole law, the conflicts of law rules of the chosen law will also be applied, which in turn may lead to the application of another substantive law. This approach is known as "*renvoi*" and is generally undesirable in the interpretation of international commercial agreements. Many legal systems do not accept *renvoi.*[16]

14. In addition, the loan agreement usually sets forth many other important conditions precedent, such as obtaining legal opinions regarding the validity and enforceability of all essential undertakings of the borrower.

15. The clause itself is often very brief and typically states only: "This agreement shall be governed by and construed and interpreted in accordance with the laws of X." The clause does not commonly address the question of whether or not this refers to the whole law of X or only to its substantive law. Examples of clauses attempting to limit the scope of the agreed choice of law to substantive law only are: (i) "This Agreement shall be governed by the internal laws of X" and (ii) "This Agreement shall be governed by the laws of X (other than the law of X governing choice of law)."

16. A New York court will probably apply only the substantive law of the jurisdiction chosen by the parties. *See* Gruson, *Governing-Law Clauses in International and Interstate Loan Agreements—New York's Approach*, 1982 U. Ill. L. Rev. 207, 222 (1982). Under Art. 15 of the EC Convention, the applicable law consists of all other legal norms except for the conflicts of law rules of the chosen jurisdiction. *See also* Restatement (Second) § 187(3) (1971), according to which, if no contrary intention has been indicated, the parties are deemed to have referred to the substantive law. *But see* Trautman, *Some Notes on the Theory of Choice of Law Clauses*, 35 Mercer L. Rev. 535, 539 (1984), where it is pointed out that there can be no definite answer to the question of whether the parties' reference is to the substantive law or to the whole law, since ultimately the question is one of interpretation. However, Trautman also seems to accept the notion that, in most cases, application of only the substantive law corresponds best to the intentions of the parties.

2. *Issues Governed by the Chosen Law*

Despite the express stipulation of the governing law, the entire relationship between the parties is not always governed by that law only. The scope of the governing law (the *lex causae*) can be limited because different laws are applied to different issues in the agreement under a doctrine frequently referred to as "*depecage*," or because the ability of the parties to stipulate the governing law is limited.

Turning first to the question of *depecage*, the essence of the problem is whether one substantive law governs the entire relationship between the parties, or whether the agreement can be "split" by applying one law to some aspects and another law to the remaining part of the agreement. Optimally, the lawyer drafting the governing-law clause could choose a particular law with the knowledge that a court interpreting the clause would favor the unitary view, according to which the *lex causae* should govern as many aspects of the transaction as possible.[17] Nevertheless, the general approach to the choice of law cases in the U.S. is that the choice of applicable law should depend on the issue involved.[18] A famous judicial precedent adopting this approach was *Babcock v. Jackson*.[19] This case involved a conflict of laws decision in a tort case, and the court stated that "justice, fairness and the best practical result . . . may best be achieved by giving 'controlling effect' to the law of the jurisdiction which . . . has the greatest concern with the specific issue raised in the litigation." The Restatement (Second) of the Conflict of Laws (Restatement (Second)) also expresses the position that the governing law may shift as required by the particular issue being considered. The Restatement (Second) sets forth the following rule regarding the situation where the parties have not agreed on an applicable law:

> Section 188(1): The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in section 6.[20]

This issue-specific approach is also apparent in sec. 187, dealing with the law chosen by the parties. It provides in part:

> Section 187(1): The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties

17. According to Wood, many significant commercial legal systems favor the unitary view, under which questions of essential validity, interpretation, effect and discharge of the agreement are determined by the same "proper law," *i.e.*, the substantive law applicable to the agreement. However, Wood also lists many significant exceptions to the principle of unitary control by the proper law. *See* Wood, *supra* note 1, at 28–31.

18. *See* Reese, *Depecage: A Common Phenomenon in Choice of Law*, 73 Colum. L. Rev. 58 (1973); R. Leflar, *supra* note 4, at 221–22; Trautman, *supra* note 16, at 544–47.

19. 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963).

20. Restatement (Second) § 188(1) (1971).

could have resolved by an explicit provision in their agreement directed to that issue.

(2): The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of Section 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.[21]

Art. 7 of the European Communities Convention on the Law Applicable to Contractual Obligations (EC Convention) authorizes the court to deviate from the applicable law in favor of another jurisdiction's mandatory rules regarding a particular situation with a close connection to that jurisdiction. It has been suggested that art. 7 may be a European surrogate for the American issue-specific approach and that the European approach and the method of proceeding issue-by-issue set out in the Restatement (Second) serve the same purpose.[22]

Whereas an earlier form of implementing the doctrine of *depecage* applied different laws for the interpretation and the performance of the agreement,[23] a principal area of its modern application consists of cases where the fundamental policy, the public policy or the mandatory rules of a particular jurisdiction override the provisions of the applicable law of the contract. As noted above, sec. 187(2)(b) of the Restatement (Second) authorizes a deviation from the chosen law in a particular issue, when required by a fundamental policy of a state having a materially greater interest than the chosen state. It is important to note that sec. 187(2)(b) allows the fundamental policy of another jurisdiction, not necessarily the forum, to override the law chosen by the parties. The EC Convention does not go quite as far as the Restatement (Second) in this respect. Art. 16

21. RESTATEMENT (SECOND) § 187(1), (2) (1971).

22. *See* Trautman, *supra* note 16, at 548–50. Art. 7 of the EC Convention provides: "1. When applying under this Convention the law of a country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and in so far as, under the law of the latter country, those rules must be applied whatever the law applicable to the contract. In considering whether to give effect to these mandatory rules, regard shall be had to their nature and purpose and to the consequences of their application or non-application.

2. Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract."

23 O.J. EUR. COMM (L 266) 3–4 (1980).

23. *See* McCartney, *The Use of Choice-of-Law Clauses in International Commercial Contracts* 6 WAYNE L. REV. 340, 368–69 (1960). *See also* WOOD, *supra* note 1, at 23.

contains an "*ordre public*" clause, giving the court the possibility of omitting application of the applicable law if the result of such application would be contrary to the public policy of the forum. In addition, under art. 7(2) the court is specifically authorized to apply the mandatory rules of the forum irrespective of the law otherwise applicable to the contract. However, art. 7(1) is markedly similar to sec. 187(2)(b) of the Restatement (Second), as it allows the court to give effect to the mandatory rules of a third country having a close connection with the situation.[24] The principal difference between art. 7(1) of the EC Convention and sec. 187(2)(b) appears to be that the scope of applying art. 7(1) is limited to mandatory rules of a third country, while sec. 187(2)(b) covers situations where state's fundamental policy is violated.

Determining the governing law issue-by-issue has wide scope of applicability in the context of international loan agreements. "You don't choose regulatory laws, they choose you"[25] is increasingly true in today's commercial environment. For an international lender, it is not possible to think of a loan to a foreign borrower without considering the foreign exchange regulations in the borrower's country, the possible central bank approval required before the borrower can validly enter into the agreement, or provisions of law on withholding tax on interest income in the borrower's country. These are matters governed by the law and regulations of the borrower's country. Similarly, constitutional matters as well as the law regarding the status of a corporate borrower are typical matters where local law governs exclusively. On the other hand, there are also regulatory laws applicable in the lender's country. For example, if the lender is a U.S. bank, statutory limits on lending to foreign borrowers apply.[26]

If the parties to the transaction are from member countries of the International Monetary Fund (IMF), a court can, on the basis of art. VIII 2(b) of the Articles of Agreement of IMF, refuse to apply an agreement, regardless of the law chosen by the parties, if the agreement is an "exchange contract" contrary to the exchange control regulations of a member country and involving its currency. Art. VIII 2(b) of the IMF's Articles of Agreement provides:

> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either

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24. *See supra* note 22. Under art. 3(3) of the EC Convention, "mandatory rules" are defined as being rules of law of a particular country which cannot be derogated from by contract.

25. Carroll, *The Biggest Fallacy in the Euromarkets*, EUROMONEY (June 1981), at 259.

26. *See generally*, C. Corse and B. Nichols, *United States Government Regulations of International Lending by American Banks*, in RENDELL, *supra* note 2, at 155–65.

member more effective, provided that such measures and regulations are consistent with this Agreement.[27]

Since regulatory laws apply regardless of the choice of the parties, the governing-law clause rarely contains any reference to them. An example of a clause, where such laws are not mentioned, but their existence is nevertheless accepted, is provided by the general conditions of World Bank loans. They contain a clause according to which the rights and obligations of the parties are governed under the terms of the agreement notwithstanding the law of any state.[28] Since these loan agreements are between the World Bank, which is deemed to be a subject of international law, and states which also are such subjects, it has authoritatively been suggested that the law governing such agreements is international law.[29] However, *depecage* (or an issue-by-issue approach) is accepted in World Bank loans, since at least constitutional requirements (of the borrowing state), manner of payment and formalities are subject to municipal law.[30] In addition to the unavoidable *depecage* described above, the parties can in principle divide the various rights and obligations arising out of the loan agreement into two (or more) categories and stipulate that a different law shall govern matters belonging to each category.[31]

3. *Party Autonomy and Its Limitations*

The doctrine of party autonomy in the choice of law governing a contractual relationship and the various exceptions to the autonomy rule form another group of issues in the context of the validity of a governing-law clause. The autonomy of the parties to choose the law governing their agreement is, consistently with the principle of freedom of contract,

27. ARTICLES OF AGREEMENT, INTERNATIONAL MONETARY FUND (Reprinted, May 1982).

28. Sec. 10.01 of these conditions provides, in part: "Sec. 10.01. *Enforceability*. The rights and obligations of the Bank, the Borrower and the Guarantor under the Loan Agreement and the Guarantee Agreement shall be valid and enforceable in accordance with their terms notwithstanding the law of any State or political subdivision thereof, to the contrary." GENERAL CONDITIONS APPLICABLE TO LOAN AND GUARANTEE AGREEMENTS, INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (1980).

29. *See* Broches, *International Legal Aspects of the Operations of the World Bank*, III Recueil des Cours, Academie de droit international 339 (1959).

30. *See* G. DELAUME, TRANSNATIONAL CONTRACTS, APPLICABLE LAW AND SETTLEMENT OF DISPUTES 37–38 (Booklet 2, 1980).

31. According to art. 3(1) of the EC Convention, the parties can agree on a governing law so that it is made to apply only to a certain part of the agreement. *See* EC Convention, *supra* note 4, at art. 3(1). It is necessary to agree on two different governing laws at least if the loan is secured by collateral which is held by a trustee, or otherwise located, in a jurisdiction other than that the laws of which govern the loan transaction in general. In such a case, matters relating to perfection and validity of the lender's security interest in the collateral should be made subject to the laws of the jurisdiction where the trust holding the collateral is established and/or where the collateral is located.

accepted as the basic rule in almost all jurisdictions.[32] However, there are differences in the limitations which various jurisdictions impose on party autonomy.[33] The contents of the autonomy rule has been stated by an author[34] as follows: "When a conflict arises regarding a contract that contains a choice-of-law clause, the designated law will be applied unless it bears no substantial relationship to the contract, or unless some fundamental policy of a more interested state would be thwarted."[35] The Restatement (Second) recognizes the importance of party autonomy,[36] but also contains a "no substantial relationship" and a "fundamental policy" limitation.[37] The reasonable relation standard is also used in sec. 1–105 of the Uniform Commercial Code:

> Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this Act applies to transactions bearing an appropriate relation to this state.[38]

The Uniform Commercial Code, while not applicable to loan agreements, carries great weight as a statutory expression of the principles of conflict of laws.[39]

Since New York is a major financial center and has a policy of maintaining such a status,[40] the current law on party autonomy in New York is relevant. *Haag v. Barnes*,[41] held that when determining the governing law of an agreement which contains a governing-law clause, a court will not regard the parties' intent as conclusive but will instead lay emphasis upon the law of the

32. *See, e.g.*, WOOD, *supra* note 1, at 7 for a brief overview of the acceptance of the rule in various jurisdictions.

33. *Id.* An interesting comparison of the breadth of party autonomy in choosing the governing law in England, Germany, France and New York is contained in Lowe, *Choice of Law Clauses in International Contracts: A Practical Approach*, 12 HARV. INT'L L.J. 1 (1971).

34. Bauerfeld, *Effectiveness of Choice-of-Law Clauses in Contract Conflicts of Law: Party Autonomy or Objective Determination?* 82 COLUM. L. REV. 1659 (1982).

35. *Id.* at 1675.

36. *See* RESTATEMENT (SECOND) 187(1), (2) (1971); Bauerfeld, *supra* note 34, at 1659; WOOD, *supra* note 1, at 8.

37. *See* RESTATEMENT (SECOND) § 187(1), (2) (1971).

38. U.C.C. § 1–105(1) (1977).

39. Gruson, *supra* note 16, at 213. According to Gruson, the reasonable relationship standard of the UCC and the common law choice of law rule relating to governing-law clauses are substantially the same.

40. *See, e.g.*, Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985) (dicta), *cert. dismissed*, 54 U.S.L.W. 3178 (U.S. Sept. 23, 1985) (No. 85–146); Ehrlich-Bober & Co. v. University of Houston, 49 N.Y.2d 574, 427 N.Y.S.2d 604, 404 N.E.2d 726 (1980); J. Zeevi and Sons, Ltd. v. Grindlays Bank (Uganda), 37 N.Y.2d 220, 371 N.Y.S.2d 892, 333 N.E.2d 168, *cert. denied*, 423 U.S. 866 (1975).

41. 9 N.Y.2d 554, 216 N.Y.S.2d 65, 175 N.E.2d 441 (1961). *Haag v. Barnes* involved a child support agreement between a resident of Illinois and a resident of New York, and the agreement provided that Illinois law would be applicable.

place which has the most significant contacts with the matter in dispute. Authors on the subject have proposed either that *Haag v. Barnes* be adopted more widely in New York or that the reasonable relationship requirement be interpreted more liberally, and there have even been conflicting views on the actual state of the law in New York.[42]

Consistent with its policy of encouraging international commercial and banking transactions within its territory,[43] however, New York passed a law on July 19, 1984, clarifying the situation. According to the new law, parties to any transaction covering in the aggregate not less than $250,000, including transactions otherwise covered by sec. 1–105(1) of the Uniform Commercial Code, may agree that the law of the state of New York shall govern their rights and duties in whole or in part, whether or not such contract, agreement or undertaking bears a reasonable relationship to New York. The new statute provides:

> Choice of law. 1. The parties to any contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate not less than two hundred fifty thousand dollars, including a transaction otherwise covered by subsection one of sec. 1–105 of the Uniform Commercial Code, may agree that the law of this state shall govern their rights and duties in whole or in part, whether or not such contract, agreement of undertaking bears a reasonable relation to this state. This section shall not apply to any contract, agreement or undertaking (a) for labor or personal services, (b) relating to any transaction for personal, family or household services, or (c) to the extent provided to the contrary in subsection two of section 1–105 of the Uniform Commercial Code.
> 2. Nothing contained in this section shall be construed to limit or deny the enforcement of any provision respecting choice of law in any other contract, agreement or undertaking.[44]

The statute also contains provisions regarding choice of forum, dealt with later in this article. The new law was a result of a legislative effort begun in 1982 whose supporters included the Committee on Foreign and Comparative Law of the Association of the Bar of the City of New York.[45] One effect of the 1984 law is to encourage a lender and borrower outside New York to

42. *See* Gruson, *supra* note 16, at 211, where the author says that "except in the case of *Haag v. Barnes*, New York courts have always held that the intention of the parties is controlling as to governing law," and Bauerfeld, *supra* note 34, at 1670, where the author, referring to *Haag v. Barnes* and subsequent federal court cases, says that "the courts' reluctance to give determinative weight to a choice-of-law clause is especially apparent in New York, where the courts do not even purport to follow the autonomy rule."

43. *See supra* note 40 and text preceding it.

44. *See* N.Y. GEN. OBLIG. LAW § 5–1401 (McKinney Supp. 1984–1985). *See also* Becker, *New New York Choice of Law Law*, 19 INT'L LAW. 371 (1985). The transactions which are covered by Section 1–105(2) referred to in § 5–1401(1)(c) relate to creditors' rights in fraudulently-sold goods, the liability of banks for mishandling money instruments, the bulk transfer of goods, the liability of issuers of securities, and the perfection of security interests. *Id.*

45. *See* Becker, *supra* note 44, at 372.

choose New York law as the governing law for their loan agreements where lack of a reasonable connection to New York may earlier have made them favor, *e.g.*, English law.[46] The new law makes it clear that the grouping of contacts theory relied on in *Haag v. Barnes* will not be applied in connection with agreements covered by the new law.

Of the two exceptions to the autonomy rule,[47] the "fundamental" or "public policy" exception is in practice applied more often and is also the exception that has created the most uncertainty regarding the validity of the choice of governing law.[48] The policy issue creating controversy between various authors is whether to give more weight to the principle of freedom of contract or to the interests of the jurisdiction most concerned with an issue in enforcing its fundamental policy or mandatory rules of law. It would be in the interests of those involved in commercial transactions, including lenders in international loan agreements, to have clear rules regarding the scope of party autonomy and the exceptions to the party autonomy. The current state of the law in many jurisdictions does not enhance such predictability.

What are the fundamental or public policies which might be evaded by a particular choice of law in an international loan agreement? It has been suggested that "usury[49] laws, money-lending statutes, laws relating to boycotts or economic sanctions and loans to finance prohibited transactions" are areas where such evasion might occur.[50] In many cases, gold clauses have been struck out by courts on the grounds of public policy. The Restatement (Second) says the "fundamental policy of a state which has a materially greater interest . . . ,"[51] which does not limit the application of the exception only to regulatory laws. The language of the EC Convention, while referring both to "public policy" and to "mandatory rules,"[52] does not

46. English courts have recognized an express choice of law by the parties to a loan transaction even if the jurisdiction had no connection with the contract. *See* Cates and Isern-Feliu, *Governing Law and Jurisdiction Clauses in Euroloan Agreements*, INT'L FIN. L. REV. 28 (July 1983).

47. *See supra* note 35 and the preceding text.

48. *See* Bauerfeld, *supra* note 34, at 1676–77, 1690.

49. The RESTATEMENT (SECOND) has adopted the approach of "most lenient law" in cases where usury is alleged. Sec. 203 provides: The validity of a contract will be sustained against the charge of usury if it provides for a rate of interest that is permissible in a state to which the contract has a substantial relationship and is not greatly in excess of the rate permitted by the general usury law of the state of the otherwise applicable law under the rule of sec. 188. RESTATEMENT (SECOND) § 203. *See, e.g.*, R. LEFLAR, *supra* note 4, at 312–14. New York follows a "rule of validation" in usury cases, assuming that the parties intended to enter into a valid agreement, and following the RESTATEMENT (SECOND), except that in some cases a lesser standard than "substantial relationship" between the contract and the state whose usury law is applied. *See* Gruson, *supra* note 16, at 217–18.

50. WOOD, *supra* note 1, at 9.

51. *See* RESTATEMENT (SECOND) § 187(1), (2) (1971).

52. *See* EC Convention, *supra* note 4, at 3–5.

either preclude the possibility that such rules might consist of both regulatory laws and "private law" (the European term for nonregulatory law).

Another area in the application of mandatory rules, which is not entirely clear, is the question of whose mandatory rules should be considered.[53] The language of Restatement (Second) has been interpreted to mean that the mandatory rule to be examined is that of the jurisdiction most concerned with the particular issue.[54] In order to first identify the issue involved, the court has to apply the doctrine of *depecage*.[55] The EC Convention, where the "issue-by-issue" approach has also been adopted, authorizes a deviation from the otherwise governing law to give effect to "mandatory rules of the law of another country with which the situation has a close connection."

The fact that mandatory rules of any law having a sufficient contact with an issue may override the choice of governing law, creates more uncertainty to the contractual relationship than a situation where just the mandatory rules of the forum could have such an overriding effect. The issue of whether a governing-law-clause can be overridden by mandatory rules or on the grounds of a "fundamental policy" is frequently litigated, because it provides an escape from the governing law.[56]

Since project financing often involves lending from a developed country to an LDC, it is important to note—in addition to the criticism of the autonomy rule in the context of advancing the principles of federalism in the U.S.—[57]the argument that complete party autonomy is not in the best interest of developing nations due to their weaker bargaining position.[58] Considering the general scarcity of capital in the LDCs, such an argument is probably well-grounded as regards the imbalance in the respective bargaining powers of LDC-borrowers and lenders from developed countries. However, it can also be said that the nature of a loan agreement is characterized by the borrower's obligation to repay, and therefore the likely result of the lender's superior bargaining power, *i.e.*, application of the law of the lender's country is not unjustified to the borrower. In addition, "pure" party autonomy is not recognized by courts, as has been discussed above. Provided there were sufficient contacts to the borrower's jurisdiction, and such jurisdiction contains mandatory rules or a fundamental policy conflicting with the chosen governing law on a particular issue, the court could, if its conflicts rules were similar to the Restatement (Second) or the EC Conven-

53. *See* Trautman, *supra* note 16, at 543–50.
54. *Id.* at 544.
55. *Id.*
56. *See* Bauerfeld, *supra* note 34, at 1676, 1690.
57. *Id.* at 1664.
58. *See* Vickers, *The Choice of Law Clause in Contracts Between Parties of Developing and Developed Nations*, 11 GA. J. INT'L & COMP. L. 617, 620 (1981).

tion, apply the doctrine of *depecage* and the "evasion of mandatory rules" exception from party autonomy to utilize the law of the borrower's country to such issue.[59] However, the exception would apply only if the contacts to the borrower's jurisdiction were significant enough, and loan agreements frequently provide that repayment of the loan must take place outside the borrower's country, thus shifting the weight of significant contacts away from the borrower's jurisdiction.[60]

4. *The Act of State Doctrine*

The choice of governing law made by the parties may not have the effect of protecting the lender as desired if the defendant raises the defense of "act of state." Generally, the doctrine holds that a court in one country will not examine the validity of an act of a foreign state, when the act gives effect to the public interests of that state.[61] The U.S. Supreme Court recently, quoting its decision in *Underhill v. Hernandez*,[62] restated the classic definition of this doctrine as follows:

> Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgement on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.[63]

Regarding the rationale of the doctrine, the Supreme Court stated that the act of state doctrine operates to confer presumptive validity on certain acts of foreign sovereigns by rendering nonjustifiable claims that challenge such acts.[64] The cases where the act of state doctrine is applied are an additional illustration of instances where effect is given to public policy (of a state other than the forum) in a particular issue. A recent New York case where the doctrine was applied is *Perez v. Chase Manhattan Bank*.[65] This case involved certificates of deposit purchased in 1958 in a Cuban branch of Chase Manhattan Bank, payable in Cuba. As a result of Cuban government confiscation of the assets of the owner of the certificates and the subsequent surrender in Cuba, by the bank, of funds representing the certificates, a suit was

59. *Cf.* RESTATEMENT (SECOND) § 187(2) (1971); EC Convention, *supra* note 22, at art. 7.1.

60. Lenders from New York customarily require the place of repayment to be New York City, since such a choice is, under New York law, considered a very important contact for determining the governing law. *See* Gruson, *Legal Aspects of International Lending*, in HANDBOOK OF INTERNATIONAL BUSINESS, 27.12 (I. Walter & T. Murray, 1982).

61. *See* Brower, *International Legal Protection of United States Investment Abroad*, in A LAWYER'S GUIDE TO INTERNATIONAL BUSINESS TRANSACTIONS, pt. III (Folio 6) 6.4(b) (iii) (2) (W. Surrey & D. Wallace ed., 2d ed. 1977).

62. 168 U.S. 250, 252, (1897).

63. *See* Allied Bank International v. Banco Credito de Agricola de Cartago, *supra* note 40.

64. *Id.*

65. 61 N.Y.2d 460, 463 N.E.2d 5 (1984).

brought in New York against the bank for payment under the certificates. The certificates were not presented for payment in New York until 1974. The court held that the act of state doctrine precluded inquiry by the court into the propriety of the confiscation directed at the assets of the owner of the certificates in Cuba, and that the bank was not liable to pay on the certificates a second time.

Critical to the court's decision in *Perez v. Chase Manhattan Bank* is the fact that the debt was situated in the confiscating state. The court, citing its earlier decisions on this issue, said that "a debt is located within a foreign state when that state has the power to enforce or collect it." In many cases, the act of state doctrine has been held inapplicable because the situs of the debt is outside the state whose act is at issue. Two recent cases involved the application of the situs of the debt argument. The cases of *Libra Bank v. Banco Nacional de Costa Rica*[66] and *Allied Bank International v. Banco Credito Agricola de Cartago*[67] both arose as a result of a resolution issued by the Central Bank of Costa Rica, under which external debt payments were essentially suspended. In *Libra*, the plaintiff banks were participants of an international loan made to a bank wholly-owned by the Costa Rican Government. The court held that the act of state doctrine did not apply because debt was sited in New York. Additionally, the court stated that the Costa Rican regulations were inconsistent with United States policy. The defendants relied on art. VIII 2(b) of the IMF Articles of Agreement, but the court rejected this argument because the loan agreement was not an exchange contract.

In *Allied*, the suit was brought by a syndicate of banks against borrowers, who were three Costa Rican banks wholly-owned by Costa Rica and subject to direct control of the Central Bank of Costa Rica. The Court of Appeals of New York first held for the defendants, rejecting the applicability of the act of state doctrine (which had been the grounds for a decision in the district court in favor of the defendants), but giving its holding on the grounds that comity required the court to recognize the validity of the Costa Rican government action. However, the case was reheard with the Executive Branch of the United States joining as *amicus curiae*. The Justice Department explained that the Costa Rican action was inconsistent with both the debt restructuring procedures of the IMF and United States policy. The earlier decision was reversed mainly on two grounds: the situs of the debt was outside Costa Rica (because payments under the loan had to be made to *Allied* in New York) and the government action was contrary to the interests of the United States.[68] While the governing law of the loan agreement was

66. 570 F. Supp. 870 (S.D.N.Y. 1983).
67. *See supra* note 40.
68. For more background of the case, *see* Cashel, *Allied Bank Case Reversed on Rehearing*,

not the central legal issue in the *Libra* and *Allied* cases, they nevertheless illustrate the overriding effects governmental policy can have on the contractual relationship. Application of the doctrine, as in *Perez*, gives an overriding effect to the policy of the defendant's country, while *Libra* and *Allied* clearly demonstrate the overriding effect of the forum's public policy.

5. *Changes in Governing Law*

Generally, the governing law of an agreement is deemed to be the law as it exists from time to time.[69] Therefore, changes in the governing law occurring after the conclusion of the agreement may affect the contractual obligations. In the well-known English case of *Re Helbert Wagg & Co.*, an English company made a loan in sterling to a German company. The loan agreement stipulated the governing law of Germany and required repayment of the loan in London. Due to a German moratorium law 1933, the borrower made the payments under the loan agreement in marks to a German government agency. The English court held that German law, including the moratorium law, was applicable and, since the borrower had complied with the requirements of the moratorium law, it was discharged from further liability.[70]

In order to obtain insulation from adverse changes in local laws, lenders sometimes insert a provision in the loan agreement attempting to "freeze" the governing law to what it was at the time of conclusion of the loan agreement.[71] A loan agreement where the governing law is so "frozen," usually also provides that any governmental interference with or modification of the governing law entitles the lender to accelerate the loan, provided the borrower's ability to perform its obligations is affected by such an interference or modification.[72] There are two reasons why "freezing" clauses probably will not be upheld by a court and which makes their use unadvisable. First, if such a clause is deemed to be a choice of governing law, subsequent legislation may modify the contractual provisions. Second, if it is interpreted as a clause incorporating the law at the time of concluding the agreement, it will not be deemed an effective choice of law at all, and therefore subsequent legislation, such as moratorium laws, may still apply to the agreement.[73] Such "freezing" clauses have also been criticized because they show distrust of the ability of the country whose laws are "frozen,"

INT'L FIN. L. REV. Apr., 1985, at 7. On the "situs of debt" argument and the act of state doctrine, *see also Weston Banking Corp. v. Turkiye Garanti Bankasi, A.S.*, 86 A.D. 2d 544, 446 N.Y.S.2d 67, 69, *aff'd*, 57 N.Y.2d 315, 442 N.E.2d 1195, 456 N.Y.S.2d 684 (1982); J. Zeevi and Sons, Ltd. v. Grindlays Bank (Uganda), *supra* note 40.

69. *See, e.g.*, WOOD, *supra* note 1, at 5.

70. *See* Re Helbert Wagg & Co. (1956) Ch. 323, *summarized in* WOOD, *supra* note 1, at 5–6.

71. *Id.* at 24.

72. *See, e.g.*, Cates and Isern-Feliu, *supra* note 46, at 31.

73. *Id.*

usually an LDC, to protect the interests of the foreign party, and the use of such clauses is contrary to the principles of the New International Economic Order.[74]

B. The Interplay between the Governing Law and the Forum

An express choice of forum where disputes between the parties will be settled is commonly inserted in an international loan agreement.[75] To a great extent, the choice of governing law made by the parties may be affected by the choice of forum. First, the procedural rules are determined by the law of the forum (*lex fori*).[76] As part of the procedure, the forum determines the law governing the agreement (*lex causae*) in accordance with its choice-of-law rules.[77] As has been discussed above, the extent of accepting party autonomy in the choice of governing law may vary depending on the jurisdiction. Significantly, although the modern approach to party autonomy makes it possible in principle for a particular issue to deviate from *lex causae* in favor of the "mandatory rules" or "fundamental policy" of any state with sufficient relationship with that particular issue,[78] a court is most familiar with the rules and policy of its own law and, therefore, may in practice more often override the *lex causae* by *lex fori* than by another law.[79]

Generally, a court considers the contents of foreign law a question of fact which must be proved by the litigant relying on it. Two important consequences arise from this. First, the court takes no judicial notice of foreign law, and it requires proof by expert witnesses. Second, in cases where appeal is permissible only on questions of law, no appeal is possible on questions of foreign law, since it is treated as fact, not law.[80] To provide such proof

74. *See* Adede, *Legal Trends in International Lending*, II Recueil des Cours, Academie de Droit International 27, 154–55 (1983 II).

75. *See, e.g.*, Gruson, *supra* note 60, at 27.19; Cates and Isern-Feliu, *supra* note 46, at 31.

76. *See, e.g.*, R. Leflar, *supra* note 4, at 221; Gruson, *supra* note 60, at 27.18; Cates and Isern-Feliu, *supra* note 46, at 30.

77. *See, e.g.*, Gruson, *supra* note 60, at 27.18.

78. *See* text at notes 16–21 *supra*.

79. *See, e.g.*, Wood, *supra* note 1, at 10, where the author states: "The ineluctable fact that courts must apply the mandatory laws of their own country is a matter of great practical significance—much more so than the somewhat peripheral doctrines limiting freedom of choice of law."; Graveson, *The Inequality of the Applicable Law*, Brit. Y. Int'l L. 231, 236 (1980), where the author notes that widely different views are held, depending on the jurisdiction, regarding the application of the public policy of the forum, and that in England the exclusion of foreign law on the basis of public policy of the forum is generally regarded as an exceptional and undesirable limitation on the normal operation of the choice-of-law rules.

80. *See, e.g.*, Graveson, *supra* note 79, at 236–37, where it is noted that the approach of treating foreign law as a fact is especially characteristic to common law systems. For New York law regarding judicial notice of foreign law, *see* N.Y. Civ. Prac. R., Rule 4511 (McKinney 1963).

usually involves retaining lawyers from the foreign country, and thus increases inconvenience and litigation costs. Furthermore, courts often have a preference for applying their own law instead of foreign law.[81] As a consequence, it is generally advisable to have the forum coincide with the choice of governing law of the agreement.

Since a judgment is useless unless it can be effectively enforced, lenders frequently seek a forum where the borrower has assets, or attempt to find a forum whose judgment is enforceable in a jurisdiction where the borrower has assets.[82] Often, the jurisdiction clause is nonexclusive, leaving a possibility of bringing suit in more than one forum.[83] An exclusive forum clause, where the parties agree on only one forum to settle disputes, may have the effect of ousting the jurisdiction of other courts. A leading U.S. Supreme Court case concerning "ouster" of jurisdiction is *The Bremen v. Zapata Off-Shore Co.*[84] This case involved a maritime towage contract between American and German corporations providing for settlement of all disputes in London. Litigation was commenced in a U.S. district court over an accident that occurred on the high seas. The Supreme Court, in upholding the choice of forum clause, relied on the fact that the choice of forum was unaffected by fraud, undue influence or overweening bargaining power.

Focusing only on the issue of enforcement, selecting arbitration as the method of dispute settlement would generally appear to offer a good solution, since international conventions, of which the 1958 New York Convention is most important, should ensure enforcement of a foreign arbitral award in the borrower's country if it is a party to the convention. In the area of recognition and enforcement of foreign court judgments, there are few treaties which are generally bilateral.

The use of arbitration is limited because lenders in many cases are reluctant to accept it. This reluctance is due to a common conception that arbitrators are likely to found their award on elements of reasonableness or compromise instead of strictly applying the governing law.[85] Lenders generally recognize the usefulness of arbitration in areas such as international construction, engineering or equipment supply agreements, which may involve large documentation in specialized areas. A principal advantage of

81. *See* Graveson, *supra* note 79, at 237. According to Graveson, the main reason for preference of *lex fori* is the immature state of the entire system of conflict of laws. For a general discussion regarding the policy involved in preference of *lex fori*, *see*, *e.g.*, Weinberg, *On Departing From Forum Law*, 35 MERCER L. REV. 595 (1984). According to LEFLAR, mere forum preference by itself is not a valid reason for any choice-of-law result. R. LEFLAR, *supra* note 4, at 182.

82. *See*, *e.g.*, Gruson, *supra* note 60, at 27.19.

83. *See* Cates and Isern-Feliu, *supra* note 46, at 33.

84. 407 U.S. 1 (1972).

85. *See*, *e.g.*, Cates and Isern-Feliu, *supra* note 46, at 34–35.

arbitration in such cases is the possibility of appointing, as arbitrators, persons who are knowledgeable and experienced in such types of agreements. However, if a borrower defaults on its loan, the existence of such a default is generally established without difficulty, and the obligation to make the payments required under the loan agreement is usually clear and does not involve issues of construction. When the borrower is a sovereign, arbitration is sometimes a solution both parties can agree to. Brazil has been one of the countries that accepts arbitration clauses in its loan agreements.[86]

A factor possibly having an effect on both the governing law and choice of forum of the loan is whether the lender wishes to obtain promissory notes from the borrower, in addition to the loan agreement. In many jurisdictions, most notably in many civil law countries including South America, the lender can use promissory notes to obtain summary remedies against the borrower. U.S. lenders customarily require such notes from borrowers. In England, however, notes are generally not required.[87] The use of notes is a purposeless exercise if the law of the forum does not offer any additional protection of remedies to the note holder.[88]

The use of promissory notes may even complicate issues relating to the governing law of the loan agreement. In many countries, the law contains provisions regarding the law applicable to promissory notes. In some countries the rule points to the law of the country where the note is made, and in others, the law of the place of payment of the note is decisive. Therefore, it is important to investigate possible conflicts in the governing law of the notes and the loan agreement. To ensure that lenders do not lose any rights under the loan agreement, the loan agreement sometimes contains a provision to the effect that all payments, whether under the notes or under the loan agreement, must be made in accordance with the terms of the loan agreement.

The doctrine of *forum non conveniens* should be taken into consideration, particularly where both the lender and borrower are foreign entities who agreed on a forum in one of the U.S. states. This doctrine has been restated as follows: "A state will not exercise jurisdiction if it is a seriously inconvenient forum for the trial of the action provided that a more appropriate forum is available to the plaintiff."[89] This doctrine is applied also in New York, where the statute has been formulated as follows:

86. *Id.*

87. *See generally* de Elizalde, *The Use of Promissory Notes in International Loans: A Latin American View*, 4 INT'L BUS. LAW. 214 (1976), which contains articles on the use of promissory notes in international loan transactions in Latin America, Spain, the U.S., France and England; WOOD, *supra* note 1, at 244–50. *See also* Mendes, *Enforcement of Loans to Brazil Put At Risk*, INT'L FIN. L. REV. 14 (Jan. 1985).

88. It appears that *e.g.*, under English law the lender's position will not be enhanced in any significant way by use of promissory notes. *See Youard, Promissory Notes in International Loan Transactions: An English View, supra* note 87, at 259–70.

89. RESTATEMENT (SECOND) § 84 (1971).

Rule 327. Inconvenient forum. (a) When the court finds that in the interest of substantial justice the action should be heard in another forum, the court, on the motion of any party, may stay or dismiss the action in whole or in part on any conditions that may be just. The domicile or residence in this state of any party to the action shall not preclude the court from staying or dismissing the action.[90]

The *forum non conveniens* doctrine is also applied in England, and in cases where there exists no sufficient nexus between the action and the forum. A principal consequence of the application of the *forum non conveniens* doctrine is the dismissal of the action.

As regards *forum non conveniens* in New York, it is not entirely clear whether the doctrine is applied in cases where the agreement contains a New York forum selection clause.[91] In addition to applying the doctrine of *forum non conveniens*, New York law restricts actions by foreign corporations against other foreign corporations to five specific categories of cases. The restrictions are contained in sec. 1314(b) of the New York Business Corporation Law, which provides:

(b) Except as otherwise provided in this article, an action of special proceeding against a foreign corporation may be maintained by another foreign corporation of any type or kind or by a nonresident in the following cases only:
  (1) Where the action is brought to recover damages for the breach of a contract made or to be performed within this state, or relating to property situated within this state at the time of the making of the contract.
  (2) Where the subject matter of the litigation is situated within this state.
  (3) Where the cause of the action arose within this state, except where the object of the action or special proceeding is to affect the title of real property situated outside this state.
  (4) Where the action or special proceeding is based on a liability for acts done within this state by a foreign corporation.
  (5) Where the defendant is a foreign corporation doing business in this state.[92]

Simultaneously with the adoption of sec. 5–1401 concerning choice of law,[93] however, a new sec. 5–1402 was added to the New York General Obligations Law, which permits any person to sue a foreign corporation in an action arising out of a contract containing a New York choice of law clause and a New York choice of forum clause and involving a transaction of at least $1,000,000, notwithstanding any New York statute that otherwise would lead to dismissal of the action. The new law makes it possible for a foreign corporation to sue another foreign corporation in New York regardless of the restrictions set forth in sec. 1314(b) of the New York Business Corporation Law, provided the action otherwise falls under the category defined in the new law. This statute provides:

90. N.Y. Civ. Prac. R. 327, (McKinney Supp. 1984–1985).
91. *See* Becker, *supra* note 44, at 371.
92. N.Y. Bus. Corp. Law, § 1314(b) (McKinney Supp. 1984–1985).
93. *See* text at note 44 *supra*.

> Section 5–1402. Choice of forum. 1. Notwithstanding any act which limits or affects the right of a person to maintain an action or proceeding, including, but not limited to, paragraph (b) of section thirteen hundred fourteen of the business corporation law and subdivision two of section two hundred–b of the banking law, any person may maintain an action or proceeding against a foreign corporation, non-resident, or foreign state where the action or proceeding arises out of or relates to any contract, agreement or undertaking for which a choice of New York law has been made in whole or in part pursuant to section 5–1401 and which (a) is a contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate, not less than one million dollars, and (b) which contains a provision or provisions whereby such foreign corporation or non-resident agrees to submit to the jurisdiction of the courts of this state.
> 2. Nothing contained in this section shall be construed to affect the enforcement of any provision respecting choice of forum in any other contract, agreement or undertaking.[94]

The new New York statute also amended the civil practice law and rules so that *forum non conveniens* will not be applied to contracts defined in the new sec. 5–1402. The new statute provides:

> Notwithstanding the provisions of subdivision (a) of this rule, the court shall not stay or dismiss any action on the ground of inconvenient forum, where the action arises out of or relates to a contract, agreement or undertaking to which section 5–1402 of the general obligations law applies, and the parties to the contract have agreed that the law of this state shall govern their rights or duties in whole or in part.[95]

When the borrower is a sovereign state, the lender will also have to consider the consequences of immunity of the borrower from suit, execution or attachment on the basis of the doctrine of sovereign immunity.[96] Frequently, the borrower agrees to waive such immunity in the loan agreement.[97]

IV. Comments on the Choices Available for Governing Law

A. Public International Law

As noted above, an example of a "choice" (although not explicit) of public international law in loan agreements is provided by the loan agreements of the World Bank.[98] The fact that there has been no litigation

94. N.Y. Gen. Oblig. Law, Section 5–1402 (McKinney Supp. 1984–1985).
95. N.Y. Civ. Proc. R. 327(b)., (McKinney Supp. 1984–1985).
96. For the contents of the doctrine under U.S. law, *see* the Foreign Sovereign Immunities Act (1976), 28 U.S.C. 1602 *et seq.*
97. Because the doctrine relates to jurisdiction rather than to governing law, it will not be discussed further here.
98. *See* text at *supra* note 28.

involving World Bank loans makes it difficult to predict how the application of international law would in practice affect the rights of the parties. In principle, a private lender and a private borrower could also choose public international law to govern their loan agreement.[99] However, it seems that at least two major factors form obstacles to larger acceptance of public international law as the governing law of international loan agreements.

First, it has traditionally been thought that predictability of the outcome of litigation is one of, if not *the* most important value that should be advanced by conflict of laws in general.[100] Unfortunately, there exists almost a total lack of judicial precedents in the area of the application of international law to loan agreements.[101] In the context of international loan agreements, certainty of outcome as well as stability of the governing law are also advisable attributes of governing law.[102] Considering the nature of the business of banking as a regulated industry, where public interest requires that excessive risks are not taken, banks should probably not be the forerunners in experimenting with a body of law the contents of which is not adequately clarified by relevant precedent.

Second, the sources of public international law (*i.e.*, treaties, customary international law, general principles of law recognized by civilized nations, international judicial decisions and the views of prominent scholars) contain rules which already by their nature have to be quite general due to the fact that international law is common to all nations. For example, one of the sources of international law—general principles of law recognized by civilized nations—can by definition contain only principles which are common to both civil law and common law jurisdictions, as well as to other legal systems of civilized nations. Customary international law, on the other hand, leads to an investigation into the practices among sovereign states, a much larger and more difficult task. It is unlikely that even treaties and views of leading scholars could provide rules that would adequately and predictably cover the field of international financial transactions. Furthermore, a state entering into an agreement with a private party subject to international law may not assume the same kind of an international obligation towards its contracting party as it would under a treaty concluded with another state.[103]

In spite of the above-mentioned factors, the use of public international law in connection with local law may in some cases bring additional stability and foreseeability to the contractual relationship. Such a combination of the principles of public international law and local law may be a particularly

99. *See, e.g.*, Wood, *supra* note 1, at 19–22.
100. *See* Bauerfeld, *supra* note 34, at 1668.
101. *See* Wood, *supra* note 1, at 21.
102. *See, e.g.*, Cates and Isern-Feliu, *supra* note 46, at 28; *cf.* Adede, *supra* note 74.
103. *See* Adede, *supra* note 74, at 71.

advisable solution for a party attempting to reduce the risk of expropriation, and will be discussed later in this article.

B. An External Law

Private lenders frequently require that their loan agreements be governed by their own law or another "external" law. Frequent choices are the laws of New York or England, which in many cases are also the law of the lender's home state.[104] The choice of an external law is intended to offer insulation against adverse changes in local legislation, and, especially in the cases of New York or English law, provide a body of law with sufficiently developed jurisprudence to enable the parties to better predict the outcome of the litigation. However, as discussed above, it is usually advisable to link the governing law with the forum, and a lender seeking to protect its interest should also investigate the enforceability of a judgment given by the forum.

It is not self-evident that the law of the lender's country is always the "best" law, even though only lender's interests would be considered. If the possible availability of various third party undertakings[105] is not taken into consideration, and the borrower is the project company,[106] it is very likely that, at least prior to start-up of the project and for at least some period after the operations have commenced, the principal assets of the borrower will be located in the borrower's country, consisting mainly of the plant and equipment, licenses and possible inventory of the project company. In such a situation, the only efficient enforcement mechanism available to the lender might be bringing a suit in a forum in the borrower's country. In that case, the costs and complexity involved in proving the contents of foreign law in the local forum might be considerations making the choice of local law more appealing. In addition, as previously mentioned, there may be instances where either public policy or mandatory rules of the forum, or simply the court's preference of the *lex fori*, may lead to application of local law regardless of a choice of other governing law in the agreement. Moreover, resorting to remedies such as liquidation of a local security interest is in any event governed by local law.

If, on the other hand, the lender relies on a trust account type security for repayment of the loan,[107] the choice of forum, and the choice of governing law could be determined by the location of the trustee bank, which typically is New York, London or another international financial center. In this case, the judgment could be enforced against funds in the trust account. As

104. *See, e.g.*, Wood, *supra* note 1, at 25; Cates and Isern-Feliu, *supra* note 46, at 28.
105. *See supra* note 8.
106. For a definition of a project company for the purposes of this article, see *supra* note 2 and accompanying text.
107. *See supra* note 7.

previously discussed, it would be advisable in such a case to make the law of the loan agreement conform with the law of the trust deed.

Sometimes the loan agreement provides that the governing law is the law of a country, unrelated to the transaction or the parties. A clause where the parties agree on such a "neutral" law may be agreed upon as a compromise solution.[108] Often, choice of third country law is accompanied by a choice of forum in that same jurisdiction. Since neither the lender's nor the borrower's counsel can ordinarily be expected to be knowledgeable about the contents of the chosen, third country law, such a choice would require an investigation into the substantive provisions of its law as well as the remedies available there to be able to predict the outcome of a litigation. The parties would also have to take into consideration the additional costs involved in retaining counsel knowledgeable in the chosen law, and the expenses associated with litigating in the chosen third country forum. As previously discussed, except for cases litigated in New York covered by the new statute, the lack of a sufficient nexus to the jurisdiction may result in application of the doctrine of *forum non conveniens*.

C. Law of the Borrower's Country

The case of *Re Helbert Wagg & Co.* provided an example of the risks inherent in choosing the law of the borrower's country that every prudent lender attempts to avoid. Also, the recent *Libra* and *Allied Bank* cases offer a possibility of speculation if the agreement had provided for local law and local forum. However, as previously discussed, sometimes agreeing to local law would offer comparatively good protection to the lender.

In some cases the lender is given little or no choice, because legislation in the borrower's country may require choice of local law in loan agreements.[109] In some cases, the choice of local law can be combined with the principles of international law. Such a combination may provide protection against changes in local law under which the lender would not be treated in accordance with principles of international law. Such clauses were inserted in concession agreements between local subsidiaries of foreign oil companies and the Libyan government prior to the Libyan nationalization of its oil companies in 1971–74.[110] The governing-law clauses in the concession

108. *See* Wood, *supra* note 1, at 25.

109. *See* Ritch, *Legal Aspects of Lending to Mexican Borrowers*, 7 N.C.J. Int'l & Com. Reg. 315 (1982), where the author explains that in a loan agreement, despite a choice of foreign law in a contract, Mexican law will be applied if suit is brought in Mexico involving performance in Mexico.

110. For a full discussion concerning evolution of the wording of such clauses and the protection that the clauses offered in the arbitrations following the nationalizations, *see* von Mehren and Kourides, *International Arbitrations Between States and Foreign Private Parties: The Libyan Nationalization Cases*, 75 Am. J. Int'l L. 476 (1981).

agreements between the oil companies (which were subsidiaries of Texaco Inc., Standard Oil Company of California, Atlantic Richfield Company and British Petroleum Company Limited) and the Libyan government provided:

> This Concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals.[111]

The nationalizations, where the Libyan government eventually expropriated 100 percent of the foreign oil companies' interests and properties in Libya without offering any compensation, brought about parallel arbitration proceedings initiated by the companies. In those proceedings, the companies relied heavily on the governing-law clause, which limited the applicability of Libyan law only to instances where such law contains principles common with international law. In the absence of such common principles, general principles of law were to govern. The companies were to a large extent successful in the arbitration proceedings, relying mainly on the governing-law clause.[112] However, despite the advantages to investors offered by the type of governing-law clauses used in the Libyan concessions, such clauses may suit fewer situations in project financing, unless the lender has reason to be concerned about the eventuality that a sovereign borrower would expropriate funds deposited locally for the repayment of the loan.

V. Conclusion

As has been discussed in the foregoing, the parties to a loan agreement are far from being completely free to determine the law governing all aspects of their loan transaction. All jurisdictions impose at least a public policy-type limitation on the autonomy of the parties with respect to choice of law. Other factors weakening the intended effects of governing-law-clauses have also been discussed above. However, in an ideal case, the governing-law clause of the loan agreement facilitates predictability in many important matters, such as those relating to interpretation and enforceability of covenants as well as collateral for the loan. It may also influence the choice of law of other agreements relating to the project.

A practical factor affecting the choice of law is the availability of counsel in the jurisdiction of the chosen law to provide a legal opinion on the legality, validity and binding effect of the loan agreement and its enforceability against the borrower under the chosen governing law. A lender will

111. *Id.* at 481–82.
112. *Id.* at 497–500.

probably decline to agree on a governing law unknown to it unless it is furnished with such an opinion by counsel acceptable to it.

New York law, particularly after the passing of the 1984 statute, appears to be generally a prudent choice for a governing law from the lender's point of view. However, it may in some cases be advisable to choose the laws of one or more other jurisdictions to govern the aspects relating to the security arrangement for the loan, if not the entire loan transaction.[113]

113. Although this article concentrates on loan agreements, the comments made herein pertaining to a security arrangement of a loan apply also to other documents creating such security and forming a part of the loan transaction, such as guarantees, pledge and trust agreements.