

The National Agricultural
Law Center



University of Arkansas · School of Law · Division of Agriculture
NatAgLaw@uark.edu · (479) 575-7646

An Agricultural Law Research Article

The Problems Posed by Negative Pledge Covenants in International Loan Agreements

by

Michael Bradfield & Nancy R. Jacklin

Originally published in COLUMBIA JOURNAL OF TRANSNATIONAL LAW
23 COLUM. J. TRANSNAT'L L.. 131 (1984)

www.NationalAgLawCenter.org

The Problems Posed by Negative Pledge Covenants in International Loan Agreements

MICHAEL BRADFIELD*
& NANCY R. JACKLIN**

In the summer and fall of 1982, many events seriously and adversely threatened to affect the recovery of the United States and the world economy. The heavy indebtedness of a significant number of developing countries and the related exposure of the commercial banking system of the industrialized world had placed strains on the international financial system. These strains could be traced in part to the two massive oil price increases of 1973-74 and 1979-80 which increased substantially the current account deficits of many oil-importing countries. Moreover, current account deficits of many developing countries, including oil-exporters, increased sizeably during this period as a result of the pursuit of policies of rapid domestic economic growth. As commercial banks increasingly served as intermediaries in the balance of payments financing process, these deficits were financed largely by expanding international bank lending. During the 1970's, however, rising world inflation and low, or even negative, "real" interest rates made these increasing debt burdens appear to many to be manageable.¹

Unfortunately, the second large increase in oil prices, the slowdown in the world economy, and the rise in interest rates in the late 1970's and early 1980's all contributed to high levels of borrowing by a number of countries and made expansionary economic policies unsustainable. While there have been occasions in the recent past when the financial strains of particular countries have been so se-

* General Counsel, Board of Governors of the Federal Reserve System.

** Assistant General Counsel, Board of Governors of the Federal Reserve System. The views expressed in this article are those of the authors and should not be taken to represent the views of the Board of Governors of the Federal Reserve System.

1. *International Financial Markets and Related Problems: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess. 41 (1983) (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System) [hereinafter cited as *Hearings*] and *International Debt: Hearings Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 240 (1983) (statement of Paul A. Volcker).

vere as to necessitate restructuring of their debt and adoption of comprehensive economic adjustment programs, the situation that emerged in 1982 was unique in its scope and potential effects. The individual economic and financial difficulties of several major debtor countries occurred at the same time, and threatened to spread to others.²

The potential for cascading liquidity pressures, undermining the stability of the international financial systems, was of particular concern to the U.S. Federal Reserve and to other governmental monetary and financial authorities. As stated by Chairman Paul A. Volcker in February 1983:

The international financial system is not separate from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, . . . [w]e are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.³

In the summer and fall of 1982, the U.S. government developed a comprehensive program to manage and diffuse these serious strains to the international financial system. The plan involved actions by governments, private lenders and international institutions. Each phase of the program was integral to the whole, involving the following cooperative measures.

First, central banks and monetary authorities should provide short-term bridge financing until other sources of financing could be arranged for the countries experiencing serious difficulties with their balance of payments. In each case, this bridge financing would be provided to encourage development by the country of an economic adjustment program with the International Monetary Fund (IMF) to deal with the country's fundamental balance of payments problems.

Second, once short-term bridge financing has been provided, the debtor country should adopt an IMF or other adjustment program.

Third, private banks should then restructure the debts of sovereign and private borrowers in the country while providing the needed financing.

2. *Hearings, supra* note 1, at 41. The diversity of the particular economic problems of the individual countries, and the corresponding need to manage the "debt problem" on a pragmatic case-by-case approach, is discussed in *Problems of the International Debt: Hearings Before the House Comm. on Foreign Affairs*, 98th Cong., 2d Sess. (Aug. 8, 1984) (statement of Paul A. Volcker).

3. *Hearings, supra* note 1, at 66 (testimony of Paul A. Volcker).

Fourth, the United States and other foreign governments should initiate a major replenishment of IMF resources by increasing IMF quotas and levels of the IMF's General Arrangements to Borrow.

Finally, creditor countries such as the United States should initiate a program for strengthening domestic supervision of international lending and for more effectively coordinating that supervision internationally.⁴

The first, critical stage in this program called for government monetary authorities to provide emergency short-term financing to borrowing countries with major debt burdens while other sources of financing and economic adjustment policies could be put into place. In 1982 and 1983, short-term bridge financing was arranged by central banks and monetary authorities for four major borrowing countries — Mexico, Argentina, Brazil and Yugoslavia — in amounts upwards of \$5 billion.⁵ The provision of this essential bridge financing almost was precluded, however, because of the widespread use of negative pledge covenants in both official and private international loan agreements with sovereign borrowers. The needed central bank funding was forthcoming only with some innovation and considerable international cooperation.

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.

I. THE NATURE AND SCOPE OF NEGATIVE PLEDGE COVENANTS

Customarily, international loan documents provide that the borrower shall not create liens or charges on its assets or revenues in favor of other creditors. If such a security interest is provided to one creditor, the second creditor shall share equally in the security.⁶ Violation by the borrower, like a breach of any other major covenant, typically is considered an event of default under the loan agreement. These "negative pledge" or "pari passu" clauses are a common fea-

4. See *supra* note 1.

5. For a discussion of several of these financing arrangements, see *Hearings, supra* note 1, at 80-83 (testimony of Paul A. Volcker).

6. For a discussion of negative pledge clauses in international loan agreements, as well as sample clauses, see generally G. DELAUME, *LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING* 251 (1967). For a discussion of negative pledge covenants in the domestic context, see generally McDaniel, *Are Negative Pledge Clauses in Public Debt Issues Obsolete?*, 38 *BUS. LAW.* 867 (1983).

ture in certain domestic financings,⁷ and are a long-standing feature of international loan agreements.⁸

Developments in the use of these covenants in the last decade largely contributed to the problems now faced by central banks in arranging short-term financing packages for developing country borrowers. Virtually *all* developing country borrowers are now affected because these clauses are standard in all World Bank loans⁹ and are contained in private jumbo syndicated loans, which are an increasingly prevalent form of financing sovereign debt.¹⁰ Further, the breadth of these restrictive covenants has increased so that essentially all the assets and revenues of the sovereign borrower and its agencies and instrumentalities are affected, virtually any arrangement giving another creditor a preferred status is restricted, and few, if any, exemptions from application of the negative pledge clause are provided by contract.¹¹

A typical negative pledge clause of the broadest scope found in these syndicated loan agreements reads as follows:

The Borrower will not enter into any arrangements with respect to any External Indebtedness or other obligations currently outstanding or hereafter incurred which arrangements would have the effect of placing any creditor in a position of preference (by means of any Encumbrance or any preferred arrangement of any kind) over the Lender with respect to the availability of any of the assets of the Borrower for the satisfaction of its indebtedness to the

7. See McDaniel, *supra* note 6, at 867; AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 349 (1971); AMERICAN BAR ASSOCIATION, TERM LOAN HANDBOOK 155 (J. McCann ed. 1983).

8. For example, negative pledge covenants are contained in: the General Bond of the German Government International 5½% Loan of 1930 (the Young Loan); the World Bank Twenty Year Bonds of 1962, issued in the United States; and the Compagnie Francaise des Petroles, Paris 4½% Loan of 1963, issued in Switzerland. G. DELAUME, *supra* note 6, at 251.

9. For information on the large number of developing countries in which World Bank loans are currently outstanding, see WORLD BANK ANNUAL REPORT 1983 (1984) (and prior years).

10. For a discussion of the increased use of syndicated loans, see, for example, Bee, *Syndication*, in OFFSHORE LENDING BY U.S. COMMERCIAL BANKS 151 (F. Mathis ed. 1975). For data on the increase in 1973-82 of developing country debt to foreign banks, see *Hearings*, *supra* note 1, at 69. For a discussion of increased loan syndications, see generally BANK FOR INTERNATIONAL SETTLEMENTS, ANNUAL REPORT, for years 1974-82, particularly chapters relating to the international credit and capital markets.

11. The World Bank typically has two types of exemptions from the application of its negative pledge covenants: purchase money mortgages and liens arising in the ordinary course of business and securing short-term debts. Delaume, *supra* note 6, at 255. While the former exemption is used on occasion by private creditors in international loan agreements, the latter exemption is not common.

Lender hereunder except that the Borrower may create, without being required to extend the benefits of the same to the Lender, any Encumbrance over any assets acquired by the Borrower after the date of this Agreement to secure the payment of the whole or any part of the purchase price of such asset or financing obtained for the payment of the purchase price of such asset. For purposes hereof "External Indebtedness" shall mean indebtedness which is payable in a currency other than [local currency] or is payable to any person, firm, corporation or other entity resident or having its head office or chief place of business outside the [country of the borrower].

Moreover, a typical broad definition of the assets of a sovereign borrower includes:

assets of the Borrower or any of its political subdivisions or of any agency of the Borrower or of any such political subdivision, including the [name of central bank] or any institution performing the functions of a central bank.

Application of these clauses precludes the central bank of a debtor country from entering into any arrangements by which foreign monetary authorities are given a legal preference over other creditors, even when the debtor country is seeking short-term emergency financing.

II. EFFECT ON CENTRAL BANK FINANCING

As indicated earlier, central bank financing was arranged for a number of developing countries in late 1982 and in 1983. This type of financing has been provided for well over fifty years by U.S. monetary authorities, through the Federal Reserve and the U.S. Treasury Exchange Stabilization Fund, for foreign central banks and foreign monetary authorities. Usually the financing takes the form of currency swaps, but it also may take the form of other central banking transactions of a monetary character. Typically, the purpose is to provide short-term balance of payments support for the foreign central bank. The basic features of the enabling statutes of most central banks and monetary authorities, including the United States' authorities, are that the purpose for financing must be directly related to a stable system of currency and credit, and that the assets acquired by the "creditor" institution must be essentially monetary in character. Other central banks as well as the Bank for International Settlements (BIS) follow the same lending arrange-

ments either as a matter of law or of policy.¹²

The context in which the central bank balance of payments financing was provided in late 1982 and early 1983 made particularly important the provision of collateral or some tangible form of assurance by the borrowing country that it indeed would have resources with which to repay the central bank financing in the short-term. Consequently, the negative pledge covenants in loan agreements contracted by the parent foreign governments of the central bank borrowers posed a major obstacle to provision of these central bank credits.

In view of these negative pledge covenants, the prospective central bank creditors had a choice of three options to assure the successful collection of their bridge loans:

1. Ignore the negative pledge covenants and insist on the provision of collateral in support of the credits;
2. Require the borrower to obtain waivers of the negative pledge covenants and provide collateral in support of the credits; or
3. Enter into some alternative arrangements with the borrower, consistent with the applicable negative pledge covenants, that enhance sufficiently the liquidity of the central banks' claims.

The first alternative clearly was not acceptable. From a purely legal standpoint, whatever security interest the central banks obtain by contract either might be set aside or might be diluted by the other creditors of the foreign government taking legal action to enforce the negative pledge or *pari passu* clauses in their own loan agreements with the foreign government. While no court in the United

12. The statutory authority for use of the U.S. Treasury Exchange Stabilization Fund (ESF) appears at 31 U.S.C. § 5302 (1982). The statute specifies that the ESF cannot be used to make loans to foreign governments that remain outstanding for more than six months in any twelve-month period, absent unique or exigent circumstances.

The Federal Reserve can enter into currency swaps and similar arrangements based on Section 14(e) of the Federal Reserve Act, 12 U.S.C. § 358, which gives the Federal Reserve banks the authority to open and maintain deposits in foreign countries. The scope of the Federal Reserve's authority is discussed in *Hearings on H.R. 10162 Before the House Comm. on Banking and Currency*, 87th Cong., 2d Sess. 142 (1962). Consistent with this authority, the Federal Open Market Committee (FOMC) authorization for foreign currency swaps with designated foreign central banks provides that drawings by either party must be liquidated within twelve months unless, because of exceptional circumstances, the FOMC specifically authorizes a delay. 69TH ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM at 82-83 (1982). See also 69 FED. RESERVE BULLETIN 426 (1983).

For the enabling legislation of foreign central banks, for example, see the central banking laws of the Federal Republic of Germany, France and the United Kingdom in IMF, CENTRAL BANKING LEGISLATION (Vol. I, 1961; Vol. II, 1967) as well as the CONSTITUENT CHARTER OF THE BANK FOR INTERNATIONAL SETTLEMENTS AND STATUTES OF THE BANK FOR INTERNATIONAL SETTLEMENTS (Jan. 20, 1930, amended 1975).

States has enjoined a borrower's pledge of assets to a subsequent creditor as a violation of a negative pledge clause, or ordered a proportionate sharing in the security, the U.S. law in this area is far from clear.¹³ In addition, a suit might be brought by other creditors of the sovereign borrower against the central bank creditors themselves for damages based on tortious interference with the loan agreements containing the negative pledge clauses.¹⁴ Again, the likely outcome in U.S. courts is difficult to predict.¹⁵ This uncertainty as to whether other creditors would have a legal remedy against the central banks is compounded because syndicated loan agreements containing negative pledge clauses involve banks from numerous nations and are governed by the laws of a variety of different countries.

A further significant factor making the first alternative undesirable from a legal standpoint was that breach of a negative pledge covenant typically is considered an event of default under the inter-

13. In *Kelley v. Central Hanover Bank & Trust Co.*, 11 F. Supp. 497 (S.D.N.Y. 1935), *rev'd*, 85 F.2d 61 (2d Cir. 1936), a company had pledged the stock of its operating companies as collateral against short-term notes. When less than one year later the company went into receivership, a debentureholder brought suit to have the pledged stock returned to the company or to have the debentureholders share equally and ratably in the security. The suit was based on a negative pledge covenant. The covenant contained an exception for property to secure loans "contracted in the usual course of business for periods not exceeding one year." The court held there had been no violation of the negative pledge clause, and even if there had been and the new creditors knew about it, the negative pledge covenant did not create an equitable lien on the company's assets.

On appeal, the Second Circuit reversed and remanded, instructing the trial court to determine whether the new secured loans had been "in the ordinary course of business" and whether the lenders knew about the restrictive covenants. *Kelley v. Central Hanover Bank & Trust Co.*, 85 F.2d 61 (2d Cir. 1936). The suit ultimately was settled out of court.

The ruling in *Kelley* follows the traditional line of cases holding that an equitable lien arises only when the intent of the parties to create a lien is clear but where, for instance, that intent was frustrated for a technical reason. See *Fisher v. Safe Harbor Realty Co.*, 150 A.2d 617, 620 (Del. 1959) (citing 4 POMEROY, EQUITY JURISPRUDENCE §§ 1235, 1237). For a further discussion of *Kelley*, see Ryan, *Defaults and Remedies under International Bank Loan Agreements with Foreign Sovereign Borrowers — A New York Lawyer's Perspective*, 1982 U. ILL. L. REV. 89, 105-06.

The mere existence of a negative pledge clause may not itself create an inference that the parties intended to create a lien. See, e.g., *Kuppenderheimer & Co. v. Mornin*, 78 F.2d 261 (8th Cir. 1935). *Contra* *Coast Bank v. Minderhout*, 61 Cal. 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

14. Such a claim was filed in a suit by Citibank, N.A. against the Export-Import Bank of the United States and Manufacturers Hanover Trust Company based upon a negative pledge covenant in a Citibank loan agreement with Zaire. *Citibank, N.A. v. Export-Import Bank*, 76 Civ. 3514 (S.D.N.Y., filed August 13, 1976).

15. The action in note 10, *supra*, also was settled out of court. Courts are likely to look closely at all the facts and circumstances in such a case. Relevant factors include: the actor's conduct and motive, the interest interfered with, the interest advanced by the actor, society's interests, the proximity of the actor's conduct to the interference, and the parties' relations. RESTATEMENT (SECOND) TORTS § 767 (1963).

national loan agreements in question.¹⁶ If a default is called on one loan because of the breach, then the application of cross-default clauses in other agreements¹⁷ could result in widespread default. This would jeopardize the entire program of controlling the debt problem of the borrower both in the short-term and on a more sustainable long-term basis.

Finally, the first alternative was undesirable because central banks, whose aim is to protect the integrity of the international credit system, did not want to contravene the provisions of valid loan agreements.

The second option — requiring the government of the central bank borrower first to obtain waivers of all relevant negative pledge covenants before the new central bank bridge financing is provided and for which collateral or similar security is given — was practicable only in a limited instance and even then long delays were encountered. The option was *not* available where the government of the central bank borrower had a large number of outstanding syndicated loan agreements, containing negative pledge clauses for which waivers from hundreds of banks throughout the world would be needed, thus providing leverage for individual banks or groups of banks to use the required waivers to obtain unrelated concessions in loan negotiations. Emergency funding did not allow for the process of obtaining waivers in such circumstances.

Accordingly, the third alternative was pursued in a number of cases. A solution relied upon in these cases by the central banks is one familiar to U.S. banking institutions: the central banks utilized the statutory preference afforded by New York law (or similar laws of other jurisdictions) to creditors of a right of set off. Historically,

16. Negative pledge covenants typically were contained in the syndicated loan agreements to which each public sector borrower was signatory (such as government-owned utilities, oil companies and airlines) as well as those in which the foreign government itself was guarantor. Thus, negative pledge covenants in numerous loan agreements were at issue. The "event of default" provisions in the loan agreements typically would state that if the borrower or guarantor "shall fail to perform or observe any term, covenant or agreement" contained in the loan agreement, "and any such failure shall remain unremedied for 10 days after written notice thereof" has been given by any bank in the syndicate, then the majority banks in the syndicate may declare that obligations to make advances under the agreement are terminated, and that the entire unpaid principal and accrued interest is immediately due and payable. "Majority banks" are customarily defined as banks having made at least two-thirds percent of the aggregate principal amount of the loan outstanding, or if no amounts are outstanding, banks having at least two-thirds percent of the loan commitments.

17. A typical cross-default clause defines a default to be one of three events: (1) a default in payment of other debt, (2) a default in performing or observing a covenant or other term, or the occurrence of another event, permitting the maturity of other debt to be accelerated, or (3) the actual acceleration of the maturity. Ryan, *supra* note 13, at 95-96.

banks have had broad rights to set off claims from assets held at the bank. Set off is permissible so long as there are "mutual demands and debts" between the parties and the debt owed the bank is matured and liquidated.¹⁸ In addition, New York state law provides:

Every debtor shall have the right upon . . . the issuance of any execution against any of the property of; . . . or the issuance of a warrant of attachment against any of the property of; a creditor, to set off and apply against any indebtedness, whether *matured or unmatured*, of such creditor to such debtor, any amount owing from such debtor to such creditor, at or at any time after, the happening of any of the above mentioned events, and the aforesaid right of set off may be exercised by such debtor against such creditor . . . notwithstanding the fact that such right of set off shall not have been exercised by such debtor prior to the making, filing or issuance or service upon such debtor of, or of notice of . . . issuance of execution . . . or order or warrant.¹⁹

Thus, where assets of the borrowing central bank are on deposit with the creditor central bank at the time the debt matures, the creditor may, without need for recourse to the courts, and despite a court order of attachment on behalf of another creditor, set off against those assets the amount of its claim on the borrower. Because the common law and statutory right of set off creates a preference for a specific creditor by operation of law and not by virtue of an agreement of the borrower and the lender, the position reasonably can be taken that the existence of and reliance upon such a right is not inconsistent with obligations contained in negative pledge covenants. This conclusion indeed is reinforced by the terms of numerous loan agreements that contain at the same time the broadest of negative pledge clauses and also an unqualified right of the creditor to set off against any and all assets of the borrower to the full extent permissible by operation of law.

For example, one such clause states:

The Borrower (a government agency) and the Guarantor (a government) hereby grant to each Bank the right, to the extent permitted by applicable law, at any time and from time to time, without notice to the Borrower or the Guar-

18. For a discussion of the right of set off under New York law, see Ryan, *supra* note 13, at 106; Mayer & Odorizzi, *Foreign Government Deposits: Attachment and Set-Off*, 1982 U. ILL. L. REV. 289.

19. N.Y. Debt. & Cred. Law § 151 (McKinney 1981)(emphasis added).

antor (any such notice being expressly waived by the Borrower and the Guarantor), to set off and apply any and all deposits (general or special, time or demand, provisional or final) at any time held and other indebtedness at any time owing by such Bank to or for the credit or the account of the Borrower or the Guarantor, at any branch or office or in any currency, against any and all of the obligations of the Borrower or the Guarantor now or hereafter existing under this Agreement and the Notes held by such Bank and the Guaranty, when the same shall become due and payable, whether at maturity, upon the acceleration of the maturity thereof or otherwise and irrespective of whether or not such Bank shall have made any demand under this Agreement or such Notes or the Guaranty and although such obligations may be unmatured.

While the needed emergency central bank bridge financing of 1982-83 did proceed, unnecessary and undesirable delays occurred in finalizing the agreements due to the uncertainty about what option to take in dealing with the negative pledge covenants. In the end, some central banking authorities would have preferred different financing arrangements than those ultimately adopted.

III. CONCLUSION

Questions can be raised as to the practical purpose served by negative pledge clauses in international loan agreements with sovereign borrowers. Certainly they do not assure that sufficient assets exist to satisfy all general creditors. Negative pledge covenants do not prevent a borrower from selling its assets, only from pledging them. Moreover, these clauses do not prevent another general creditor from obtaining a legal preference through operation of a common law or statutory right of set off. Finally, as has been amply demonstrated in the last several years, they do not serve as any meaningful inhibition on a sovereign's aggregate borrowing.²⁰

Recent experience demonstrates that widespread use of negative pledge covenants in loan agreements with sovereign borrowers can be inimical to the interests of both the lender and the sovereign borrower since emergency short-term central bank funding effectively can be precluded. Such short-term funding often plays a pivotal role in resolving the financial problems of the borrower by

20. For data on the growth of developing country debt 1973-82, see *Hearings, supra* note 1, at 69.

providing temporary funds while maximizing the likelihood that the borrower will take the difficult economic steps needed to correct its underlying economic difficulties. Such funding also provides confidence to private lenders to play their essential role in the adjustment process. As such, in the end the central bank financing serves to make the borrower more creditworthy. As one writer has stated so vividly regarding a domestic corporate rescue effort: "If the negative pledge clause blocks a rescue effort . . . it will be small satisfaction to the . . . [creditors] that they will share 'equally and ratably' in the ashes."²¹

Thus, there is no question that if negative pledge covenants are retained in loan agreements with sovereign borrowers, they should contain a routine exemption for credit provided by central banks or governmental monetary authorities.²² Failure to provide such ex-

21. McDaniel, *supra* note 6, at 881. The author explains the problems with obtaining government-guaranteed loans for Chrysler because of negative pledge clauses in two outstanding Chrysler debenture issues.

22. A court has held that a negative pledge clause, containing an exception for pledges that secure notes with maturities of not more than a year, nonetheless is applicable to notes that have a stated maturity of less than a year but were rolled over and so did not in fact mature within a year. *Kaplan v. Chase Nat'l Bank*, 156 Misc. 471, 281 N.Y.S. 825 (N.Y. Sup. Ct., 1934). Thus, an exception for central bank financing maturing in one year or less may not be sufficiently broad in the event that the maturity of a short-term credit is extended.

23. Like the negative pledge covenants in international loan agreements of sovereign borrowers, a restrictive covenant in debt instruments of a bank holding company recently has posed similar obstacles to governmental efforts to contribute to the orderly and equitable resolution of financial difficulties. In July 1984, an assistance program for Continental Illinois Bank was arranged. A major element of this program was a capital infusion to the bank by the Federal Deposit Insurance Corporation (FDIC). In analogous situations in the past, the FDIC would make such an infusion by a direct capital investment in the affected bank. By providing assistance in this form, in the event the rescue were not successful, the FDIC's resources would be protected to the maximum extent possible in liquidation. In the case of the Continental Illinois assistance package, a restrictive covenant in the indenture agreements governing Continental Illinois Corporation's (CIC) long-term debt necessitated a different approach.

The covenant at issue requires that the holding company, CIC, hold at least 80% of the capital stock of Continental Illinois Bank. A breach of the covenant constitutes an event of default. This or a similar covenant is contained in a number of CIC's debt instruments. The presence of standard cross-default clauses in CIC's debt instruments more generally hampered the FDIC in following the approach of directly acquiring capital stock of the bank. Instead, the approach adopted to provide a capital infusion consistent with the restrictive covenant involved investment by the FDIC in preferred stock of the holding company, providing rights to 80% of the common stock. This solution had the disadvantage that, under the hypothetical circumstance where the bank closed, CIC noteholders would be more senior claimants than the FDIC, which would be a preferred stockholder. On balance, however, it was considered that, in view of the restrictive covenants, this form of capital infusion was the best way of meeting a number of objectives: maximizing the possibilities for a successful rehabilitation of the bank, minimizing the cost to the FDIC and maintaining general market confidence.

emptions, particularly in large syndicated loan agreements where timely waivers of restrictive covenants are impracticable, merely will frustrate governmental efforts to contribute to the orderly resolution of international financial difficulties in the future, to the detriment of creditors and borrowers alike and, ultimately, to the detriment of the financial systems more broadly.²³

The Federal Reserve has stated its concern about bank holding company debt covenants, such as those of CIC, which circumscribe the FDIC's ability to make a direct capital investment in a bank which the FDIC deems appropriate in the exercise of its statutory responsibilities. If such covenants are now or were to become widespread, regulatory action to limit their scope may be appropriate. *See* Letter from Paul A. Volcker to Jake Garn, Chairman, Senate Comm. on Banking, Housing and Urban Affairs (Aug. 8, 1984). As with negative pledge covenants in international loan agreements, interests of all parties, and the financial system as a whole, would be served best by drafting the covenant so as not to limit assistance by official lenders.