

# Foreign Exchange Risk Mitigation Techniques

Structure and Documentation  
A Technical Guide  
for Microfinance Institutions





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A Technical Guide for Microfinance Institutions



Consultative Group to Assist the Poor  
Prepared for CGAP by Cleary, Gottlieb, Steen & Hamilton, LLP

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## *Acknowledgments*

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## *Minimizing Foreign Exchange Risk*

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Hard currency loans constitute an important source of financing for the loan capital needs of microfinance institutions (MFIs). Although such loans may, in certain circumstances, appear to be a relatively cost-effective and easy source of funding, they also have the significant disadvantage of creating foreign exchange risk for those MFIs whose principal assets are microloans denominated in the local currency of the MFI's country of operation. Despite this, recent surveys indicate that few MFIs exposed to foreign exchange risk take effective steps to reduce that risk.

Foreign exchange risk largely arises in microfinance when an MFI incurs debt in a foreign currency, usually U.S. dollars or euros, and then lends those funds in domestic currency. The MFI can suffer substantial losses if the value of the domestic currency depreciates (or loses value) in relation to the foreign currency, meaning that the value of the MFI's assets drops relative to its liabilities. This is known as devaluation, or depreciation, risk.

Like any other institution that has a cross-border obligation denominated in hard currency, MFIs also can be affected by convertibility and transfer risks. In both cases, the MFI may have the financial capacity to make its hard currency payments, but cannot do so because of national government restrictions or prohibitions on making foreign currency available for sale or transferring hard currency outside the country. These risks are known respectively as convertibility risk and as transfer (or remittance) risk.

A growing supply of hard currency financing means that MFIs are increasingly exposed to foreign exchange risk. A recent CGAP survey estimates that of a total of \$1.2 billion in foreign investment in MFIs, \$750 million is debt capital and at least 92 percent of this debt capital is in hard currency. Given the volatility of the currency in many of the markets where MFIs work, failure to protect against foreign exchange risk can have serious consequences. It can have a severe impact on an MFI's profitability and ultimately its ability to carry out its mission.

Organizations exposed to foreign exchange risk have three options. First, they can choose to do nothing about their exposure and accept the consequences of variations in currency values or the possibility that their government may impose restrictions on the availability or transfer of foreign currency. This is not a recommended path. Second, they can “hedge” against their exposure. For example, they can purchase a financial instrument that will protect the organization against the consequences of those adverse movements in foreign exchange rates. Finally, they can partially hedge against the risks, or limit their hard currency exposure to set levels.

Given that the first option is not recommended, this Technical Guide addresses an MFI’s hedging options. A variety of conventional capital market instruments can be used to hedge against foreign exchange risk:

- forward contracts and futures (agreements made to exchange or sell foreign currency at a certain price in the future)
- swaps (agreements to simultaneously exchange or sell an amount of foreign currency now and resell or repurchase that currency in the future)
- options (instruments that provide the option, but not the obligation, to buy or sell foreign currency in the future once the value of that currency reaches a certain, previously agreed, price)

These conventional instruments may be the most appealing and efficient way to hedge against foreign exchange risk. However, many of the capital markets in the countries in which MFIs operate do not support these instruments, and the costs to MFIs of using these instruments may be prohibitive. Furthermore, creditworthiness issues may make it difficult for MFIs to purchase these derivative instruments.

Homegrown hedging mechanisms have emerged to fill the gap left by underdeveloped capital markets. Currently, the most common effective ways for MFIs to hedge against foreign exchange risk are back-to-back loans and letters of credit. This Technical Guide supplements the recent CGAP publication “Foreign Exchange Risk in Microfinance: What Is It and How Can It Be Managed?” (CGAP 2005) by examining these two foreign exchange risk mitigation structures. The following overview and accompanying documentation are intended to help MFIs judge the pros and cons of these instruments for their use. They provide technical guidance to help MFIs (1) understand the principal legal and documentation features of back-to-back loans and letters of credit, (2) evaluate the

relative appropriateness of these two structures in light of the MFI's particular circumstances, and (3) negotiate the documentation relating to these structures with commercial counterparties.

### Back-to-Back Loan

#### *Structure*

In a back-to-back loan structure, the MFI typically enters into a hard currency loan with a foreign bank, deposits the hard currency proceeds into an interest bearing deposit account at a bank, and pledges the hard currency account as collateral to support a local currency loan.<sup>1</sup> The account may be maintained at the local bank providing the local currency financing or at a separate deposit bank (which is typically located in the same jurisdiction as the local bank). See Figure 1, for an illustration of the first structure.

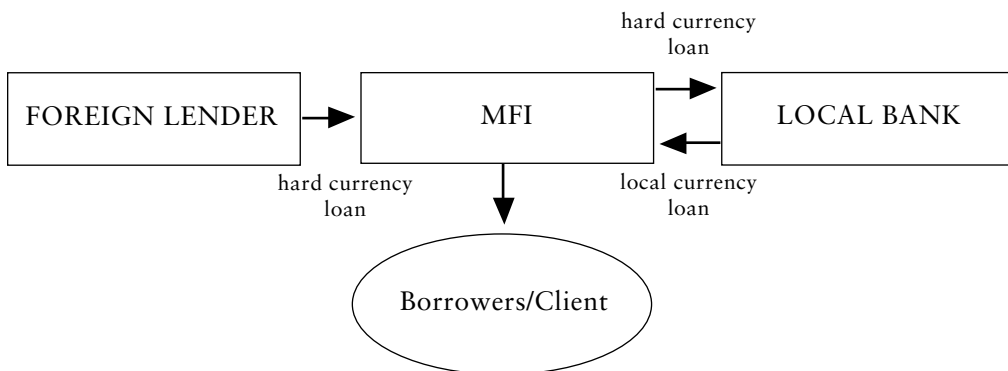


Figure 1. Back-to-Back Loan Structure (account maintained at local bank)

#### *Economic Considerations*

Certain features of this structure contribute to mitigate the risks the MFI would face by simply converting the hard currency loan to local currency to fund its local lending activities. First, a back-to-back loan structure avoids *convertibility risk*. If the MFI were to convert the hard currency loan into local currency and the local government subsequently

<sup>1</sup> The term “back-to-back loan” is also used to describe an arrangement whereby two borrowers located in different countries borrow equivalent amounts from each other (denominated in two different currencies) to offset the foreign exchange risk they are facing as a result of their operations. This once-common structure eventually evolved into the modern currency swap.

imposed restrictions on converting local currency into hard currency, the MFI may be incapable of converting the local currency back to hard currency to repay the hard currency loan. By retaining the hard currency in an account at the deposit bank, the MFI sidesteps this regulatory risk.

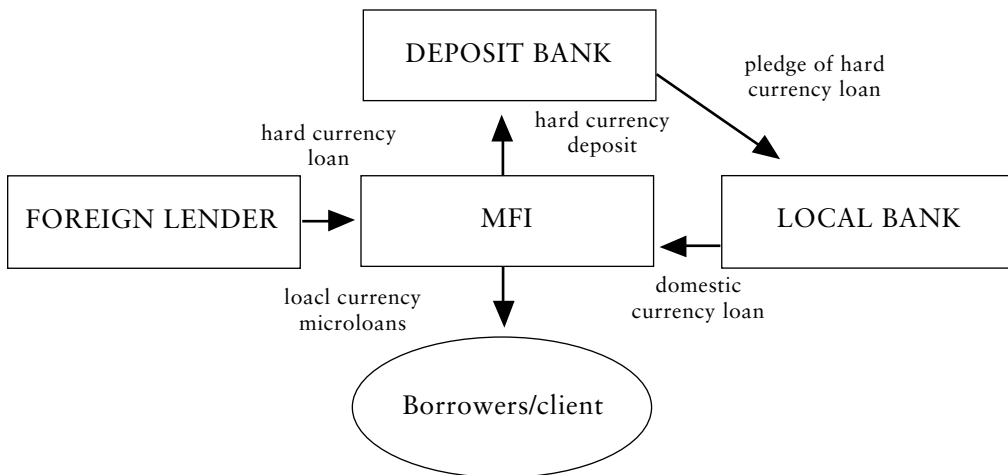
More important, retaining a hard currency deposit mitigates *depreciation and devaluation risk*. As long as the MFI does not default on the local currency loan, the hard currency deposit will be available at maturity to repay the principal of the hard currency loan. Even if the local currency loses value relative to the hard currency (either through depreciation or devaluation before maturity, this loss in value will not affect the MFI's ability to repay the hard currency loan because the hard currency amount on deposit at the deposit bank will be sufficient to cover the repayment. Such a depreciation or devaluation also will not affect the cost to the MFI of repaying the local currency loan because the MFI's income from its lending activities is also denominated in local currency.

However, a back-to-back loan structure is not a perfect hedge against foreign exchange risk. The MFI is still assuming foreign exchange risk with respect to interest payments on the hard currency loan. If the local currency depreciates, such interest payments—to the extent they are not completely offset by interest earned by the MFI on its hard currency deposit—may increase the MFI's cost of funding. Although the increased funding cost with respect to the interest payments would not be of the same magnitude as the increased cost of repaying the hard currency principal at maturity without a foreign exchange risk mitigation structure, it may nevertheless be significant. Furthermore, if the local currency *appreciates*, the value of the hard currency principal will decrease and leave the local bank undersecured, which may lead the local bank to request additional collateral.

The structure also imposes significant financial and time management costs on the MFI. The MFI using this structure must enter into two loans and pay two sets of interest payments (in addition to the transaction fees involved in negotiating and documenting the structure). However, the MFI should also earn interest on the hard currency principal in the account. Therefore, the MFI's "net cost of funding" will be the *sum* of interest paid on the local currency loan and interest paid on the hard currency loan *minus* any interest earned on the account.

This structure has certain disadvantages not associated with a letter-of-credit structure (discussed below). Historically, MFIs that have used back-to-back loans have typically maintained the hard currency deposit at the local bank extending the local currency loan. As a result, the MFI may be exposed to the greater credit risk, because they have the risk of the

local bank, than if the hard currency were kept in a foreign bank of a higher credit quality. The MFI is also exposed to *transfer risk*: if the local government imposes a freeze on withdrawing hard currency assets or transferring them offshore, the MFI may not be able to access the hard currency principal to pay off the hard currency loan. In this respect, local banks typically maintain business relationships with correspondent banks in money centers that may be willing to maintain the hard currency deposit pursuant to a tri-party deposit account “control” agreement under which the offshore account is pledged to the local bank to secure the local currency loan. MFIs may find it worthwhile to explore this possibility with their local bank, because it would allow the MFI to reduce its credit and remittance risk associated with the back-to-back loan structure, possibly at lower cost than obtaining a letter of credit. See Figure 2 for an illustration of this structure.



**Figure 2.** Back-to-Back Loan Structure (account maintained at separate deposit bank)

### *Documentation*

Exhibit A provides an introduction to the legal steps required to create a back-to-back loan structure and the attendant risks. Aside from documenting and negotiating the loans themselves, the MFI should take care to properly document the pledge of the deposit account. One threshold issue to consider is whether it is customary in the local jurisdiction to pledge deposit accounts and/or cash collateral. In some jurisdictions, particularly where such pledges are not customary, lenders are instead given a contractual “right of set off” in the loan agreement. (See Box 1 for a brief discussion of pledge of property and set off.)

**Box 1. Overview: Pledge of Property and Set Off**

Very generally, a pledge of property transfers to a creditor the rights in such property that will, if the procedures required by law to make the pledge enforceable against third parties are followed, allow the creditor to satisfy the debtor's obligation by selling the property and retaining the proceeds. The debtor and its other creditors will not be entitled to the proceeds of sale of the pledged property unless the creditor has been fully paid.

By contrast, set off describes the right of a creditor to apply any amount the creditor owes to the debtor to reduce (or offset) the debtor's obligation to the creditor. For example, in many jurisdictions, if Debtor A deposits money in an account at Bank B, the resulting legal relationship is that Bank B owes Debtor A the principal amount of the deposit, plus interest. If Debtor A separately borrows money from Bank B and fails to repay the loan when required, Bank B may refuse to return the money deposited by Debtor A and instead apply all or part of the deposit to repay the loan owed by Debtor A.

The practical differences between a pledge and a right of set off depend on the law in force in the relevant jurisdiction. These differences, however, may be significant. For instance, in some jurisdictions, the law requires a creditor exercising remedies against pledged property to follow certain procedures designed to protect the debtor's interest and to realize the full value of the property. Such restrictions often do not apply to the exercise of the right of set off. On the other hand, pledges relating to accounts and cash collateral are relatively recent legal developments and remain unavailable in many jurisdictions.

Upon a payment default by the MFI under the local loan, such a right of set off would give the local bank the right to set off and apply property of the MFI in its possession (i.e., the deposit account) against the MFI's obligations to the local bank under the local loan. Where the collateral is pledged, the local bank's policies and procedures and the nature of local law relating to pledges of collateral will determine the agreements used to document such a pledge. The documentation required will also vary based on where the account will be maintained.

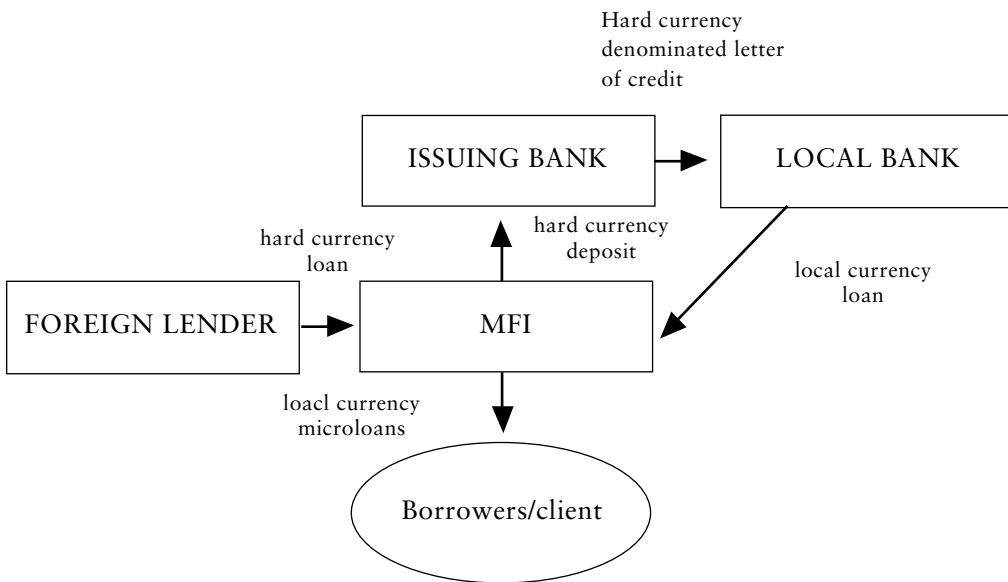
An MFI should consider several issues when documenting the pledge of a deposit account. These include whether other property of the MFI will be pledged under any security agree-

ment; whether and how the MFI must provide additional collateral if the hard currency principal loses value relative to the local currency; the creditworthiness and location of the bank where the deposit account is to be maintained; the nature of “control” the local bank may exercise over the deposit account, particularly if the remedy and event of default provisions of the local currency loan have been triggered; and the extent to which the term of the deposit account will match the maturities of the local currency loan and the hard currency loan.

**Letters of Credit**

*Structure*

In a letter-of-credit structure, the MFI enters into a hard currency loan with a foreign lender and deposits the hard currency proceeds of this loan in an account maintained at a bank as collateral to secure the issuance by such bank of a letter of credit to a local bank located in the MFI’s jurisdiction. To achieve the full benefits of this structure, the bank issuing the letter of credit (the “issuing bank”) typically is not located in the MFI’s jurisdiction. The local bank, in turn, agrees to extend a local currency loan to the MFI to finance its lending activities. See Figure 3 for an illustration.



**Figure 3.** Letter-of-Credit Structure

The letter of credit is an irrevocable obligation of the issuing bank to pay the local bank a certain amount in hard currency (normally up to the amount of the hard currency deposit placed by the MFI with the issuing bank) if the local bank presents a document to the issuing bank stating that the conditions specified in the letter of credit have been met. In the MFI context, the most common condition that can trigger presentation of the letter of credit for payment is that the MFI has defaulted on the local currency loan. Therefore, if the MFI defaults on the local currency loan, the local bank will be entitled to present a statement to that effect to the issuing bank and to be repaid by the issuing bank the hard currency equivalent of the local currency owed by the MFI.<sup>2</sup> Assuming that the MFI does not default on the local currency loan and repays the principal on the local loan when due, the letter of credit will expire without any payment being made by the issuing bank. At that point, the issuing bank should release the hard currency deposit to the MFI, which will use the deposit to repay the principal amount of the MFI's hard currency loan.

#### *Economic Considerations*

The letter-of-credit structure shares many of the same economic characteristics as the back-to-back loan structure. Like the back-to-back loan structure, the MFI is not exposed to *convertibility risk* because the MFI need not convert the hard currency into local currency. Similarly, the primary advantage of the letter-of-credit structure is that the MFI is not exposed to the risk that a depreciation or devaluation of the local currency would increase its funding costs with respect to the hard currency principal. Rather than converting the hard currency principal into local currency, the MFI uses the hard currency principal to obtain a letter of credit to support its local currency financing. The structure also has similar disadvantages. The MFI is still assuming foreign exchange risk with respect to interest payments on the hard currency loan. Furthermore, if the local currency were to *appreciate* against the hard currency, the value of the hard currency letter of credit would decrease, and the local bank might require additional collateral from the MFI, depending on the terms of the local currency loan.

However, the letter-of-credit structure has certain unique advantages. Unlike a back-to-back loan structure in which the hard currency proceeds are deposited in an account

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<sup>2</sup> The procedure for determining the hard currency equivalent of the local currency owed by the MFI, and in particular the time at which such determination is to be made, should be clearly specified in the local loan agreement.



in the MFI's jurisdiction, in a letter-of-credit structure the hard currency deposit is maintained in the jurisdiction of the foreign lender. As a result, the MFI is not exposed to *transfer risk*. Even if the MFI's home jurisdiction were to impose restrictions on cross-border capital flows or withdrawals of hard currency from local banks, the MFI would be able to repay the hard currency loan with the hard currency held outside its home jurisdiction.

The letter-of-credit structure also has certain drawbacks. First, it imposes significant costs on the MFI. As in a back-to-back loan structure, the MFI must pay interest on both the hard currency loan and the local currency loan (and the transaction fees involved in negotiating and documenting the structure). In addition, the MFI must pay the fee charged by the issuing bank to maintain the letter of credit.<sup>3</sup> Such costs may be offset, to some extent, by the interest paid by the issuing bank to the MFI on the hard currency deposit. The interest rate charged by the local bank on the local currency loan also may be lower than it would be without the letter of credit. Because letters of credit are a well-established and internationally recognized means of collateralizing international financial transactions, if the issuing bank is reputable and has a solid credit history, the local bank may be willing to lend at a lower interest rate than it would normally charge the MFI for an uncollateralized local currency loan. In short, to the extent that the local bank is substituting the creditworthiness of the issuing bank for that of the borrowing MFI, the pricing of the local loan should reflect that lesser risk to the local bank. It is likely, however, that these factors will not completely offset the additional costs imposed by the structure.

Therefore, the MFI's "net cost of funding" will be the *sum* of interest paid on the local currency loan, interest paid on the hard currency loan, and the letter-of-credit fee charged by the issuing bank *minus* interest earned on the deposit. As a practical matter, the incremental cost relative to a simple hard currency loan should be regarded as the cost of mitigating the foreign exchange risk that would be faced by the MFI if it were simply funding its local lending activities with such a loan, and the financial viability of the structure should be evaluated accordingly. For an illustration of the cash flows under the letter-of-credit structure, see Figure 4.

A letter-of-credit structure is very similar to a back-to-back loan structure. Therefore, in determining the relative costs and benefits of the two structures the MFI should consider whether the fees associated with obtaining a letter of credit materially increase the

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<sup>3</sup> The precise fee charged by the issuing bank depends on various factors, including the size of the letter of credit, whether it is fully collateralized, and the existing business relationships between the MFI and the issuing bank. We understand that the typical fee for a fully collateralized letter of credit is about 0.5% per annum.

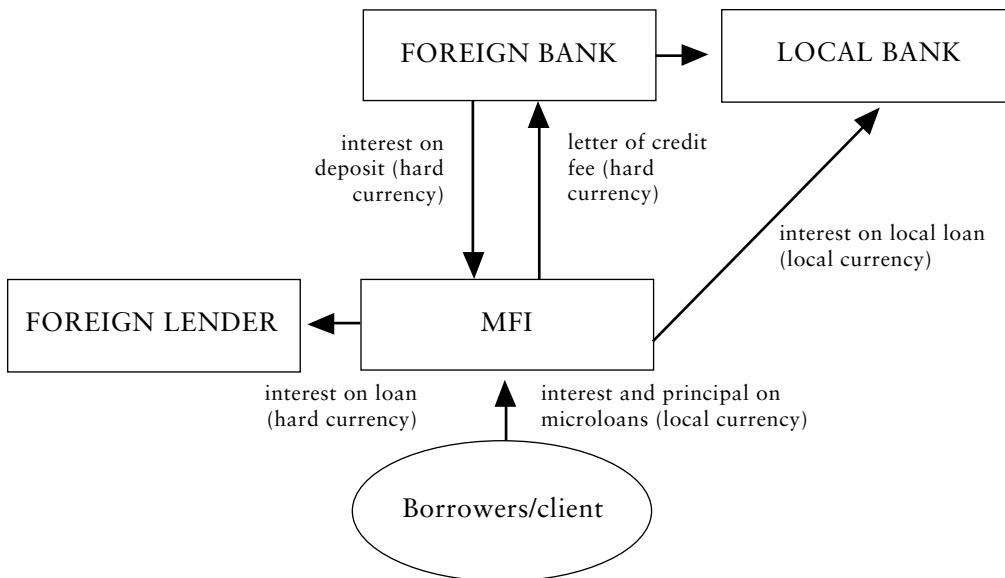


Figure 4. Nonprincipal Cash Flows under the Letter-of-Credit Structure

funding cost of a letter-of-credit structure; whether there is a material transfer risk in the local economy, in which case a letter-of-credit structure may be preferable; whether there is a material risk of losing the hard currency collateral if it is deposited at the local bank pursuant to a back-to-back structure; and the local bank's preference for one of the structures.<sup>4</sup>

#### *Documentation*

Although the documentation required to implement the letter-of-credit structure is fairly standardized, it is also relatively complex and needs to be carefully reviewed and negotiated to ensure the provisions proposed by the issuing bank and/or the local bank do not reduce or negate some of the benefits sought by the MFI.

As a general matter, the letter-of-credit documentation is drafted and negotiated by reference to a substantial body of law and market practice applicable to letters of credit. Exhibit B-1 provides an introduction to the fundamental principles of letter-of-credit law and of its application to this structure. This exhibit also summarizes the most important

<sup>4</sup> Some local banks, particularly those with experience in international trade finance, may prefer a letter-of-credit structure over other third-party credit enhancements, such as guarantees.

points the MFI should consider to protect its interests in the course of negotiating the documentation relating to the letter-of-credit structure.

Exhibit B-2 is an annotated sample letter of credit. This is the principal document the MFI will need to negotiate with the foreign issuing bank and (to a lesser extent) the local bank. Among other important provisions, the letter of credit specifies the circumstances in which the local bank may request payment by the issuing bank under the letter of credit. Because any such payment will result in the issuing bank's retaining the hard currency deposit, thus depriving the MFI of the hard currency needed to repay the hard currency loan at maturity, the relevant circumstances should be carefully circumscribed and should be consistent with the provisions of the local currency loan agreement.

Exhibit B-3 is an annotated sample reimbursement agreement. This is the agreement between the MFI and the issuing bank that governs the MFI's obligation to reimburse the issuing bank for amounts paid by the issuing bank to the local bank under the letter of credit. The reimbursement agreement also governs the issuing bank's rights over the hard currency deposit by the MFI and, in particular, the foreign bank's right to retain the deposit to satisfy the MFI's reimbursement obligation. Because the MFI needs the hard currency deposit to be returned at maturity to be able to repay the hard currency loan, it is crucial that the relevant provisions of the reimbursement agreement be carefully negotiated. The annotation in Exhibit B-3 includes the symbols ☺, ☹, and ☹, which provide visual cues to MFIs regarding how favorable various options are to them.



## *Exhibit A*

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### Documentation Risks Associated with Back-to-Back Loans

The term “back-to-back loan” is commonly used to describe an arrangement whereby an MFI uses the proceeds of a hard currency loan deposited in a deposit account as collateral to support a local currency loan from a local bank. This exhibit discusses the documentation required to create a back-to-back loan structure and the legal issues to be considered in connection with the lender’s rights to act against the deposit account.

#### **Documentation Required**

To set up an effective back-to-back loan structure, the MFI must do the following:

1. Enter into a loan agreement (the “Hard Currency Loan”) with a foreign lender (the “Foreign Lender”) for a principal amount of \$X (the “Hard Currency Principal”)<sup>1</sup>
2. Enter into a loan agreement (the “Local Loan”) with a local bank (the “Local Bank”) for a principal amount equivalent to \$X in the local currency
3. Set up a deposit account (the “Account”) at a bank that takes hard currency deposits (the “Deposit Bank”) (this bank may or may not be the Local Bank) and deposit the Hard Currency Principal into the Account
4. Pledge the Account as collateral to support the MFI’s obligations to repay the Local Loan pursuant to a security agreement (or an equivalent arrangement in the local jurisdiction)
5. (if applicable in the local jurisdiction and if the Deposit Bank is not the Local Bank) Enter into a deposit account control agreement with the Local Bank and the Deposit Bank whereby the Local Bank is given control over the Account

The legal and documentation issues that generally arise in negotiating loan agreements (steps 1 and 2) are beyond the scope of this exhibit.<sup>2</sup> This exhibit instead focuses on the

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<sup>1</sup> WARNING: A back-to-back loan structure cannot be employed if the Hard Currency Loan includes any negative covenants or “use of proceeds” clauses that prevent the MFI from pledging the proceeds of the Hard Currency Principal as collateral for a local currency loan.

<sup>2</sup> For further guidance with respect to documenting hard currency loans, see Foundation for International Community Assistance, *Microfinance Institutions Commercial Loan Documentation: Form of Annotated Loan Agreement* (2004). For further guidance with respect to documenting local loans, see “Commercial Loan Agreements: A Borrowing Guidebook for Microfinance Institutions” (CGAP 2006) (the “Local Loan Guidebook”).

following salient issues to be considered in connection with the pledge of the Account (steps 3 through 5):

- Are accounts customarily pledged under local law? Alternatively, or in addition to such a pledge, do local banks typically receive a contractual or implied right of set off? If so, what is the scope of such a set-off right?
- What are the documentary requirements for a pledge of an Account under local law? Must the Local Bank have control over the Account? If so, what is the nature of the control required? If a security agreement is required, will the pledge provisions cover collateral other than the Account? Will the events of default described in the security agreement create business or legal risks for the MFI?
- Do the event of default and remedy provisions under the Local Loan give the Local Bank undue discretion to declare an event of default?
- Should the Local Bank or a separate bank act as the Deposit Bank?
- Is it feasible to match the maturities of the Local Loan, the Account, and the Hard Currency Loan? If the Hard Currency Loan amortizes, is it feasible to match the payment schedules of the Local Loan and the Hard Currency Loan?
- What is the MFI's exposure to the credit risk of the Deposit Bank?

### **Contractual and Statutory Rights of Set Off**

A threshold issue to consider is whether, under local law, the MFI may pledge cash collateral and/or the Account to support its obligations under the Local Loan. Even where pledges of cash collateral or deposit accounts are contemplated under local law, such pledges may not be customary. In some jurisdictions, the Local Bank is instead given a contractual "right of set off" under the Local Loan pursuant to which the Local Bank may set off and apply property of the MFI in its possession (i.e., the Account) and the Local Bank's obligations to the MFI against the MFI's obligations to the Local Bank under the Local Loan. Even if the Account is in fact being pledged, the Local Bank may nonetheless include a set-off provision in the Local Loan as a form of additional protection. A set-off provision may read as follows:

In addition to any rights now or hereafter granted under applicable law and not by way of limitation of any such rights, upon the occurrence and during the continuance of any event of default, the Lender is hereby authorized by the Borrower at any time and from time to time, without notice to the Borrower, to set off and

apply all property of the Borrower held by the Lender and any other amount payable by the Lender to the Borrower against any amount payable by the Borrower to the Lender under this Loan Agreement.

Where the Local Bank is given an express right of set off, the MFI should carefully review the scope of the set-off right and consider the following factors:

- The right of set off should not arise until the occurrence or continuance of a payment default by the MFI under the Local Loan and the expiration of all applicable delays and cure periods.
- The right of set off often applies to all property of the MFI in the Local Bank's possession. Therefore, the MFI may want to limit the amount of other property it maintains at the Local Bank. If additional property of the MFI will nonetheless be held at the Local Bank, the MFI should consider segregating the Account from other accounts the MFI holds at the Local Bank. In addition, the MFI may seek to limit, by contract, the scope of the set-off right so that the Local Bank's set-off rights are limited to the Account.<sup>3</sup>
- The Local Bank should be required to provide the MFI contemporaneous notice of its exercise of the right of set off.
- The MFI should consider whether the set-off provision gives the Local Bank the right to set off against obligations of the MFI to the Local Bank other than obligations under the Local Loan. Similarly, the MFI should consider whether the right of set off (i) would allow affiliates of the Local Bank to set off against obligations of the MFI to such affiliates or (ii) would allow the Local Bank or its affiliates to set off against obligations of affiliates of the MFI to such parties. The MFI should be wary of such provisions because the Local Bank or its affiliates would be given the right to set off and apply the Hard Currency Principal to satisfy obligations not relating to the Local Loan (including obligations arising after the Local Loan is disbursed). Local counsel should be able to advise the MFI on the extent to which local law would permit such an expansive set-off right.

The MFI also should bear in mind that, in many jurisdictions, there may be an implied right of set off arising through statute or case law even where there is no express

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<sup>3</sup> WARNING: The MFI should consult with local counsel as to whether local law gives the Local Bank a right of set off that could extend the reach of the Local Bank to other property of the MFI maintained with the Local Bank. Local counsel also should advise whether a contractual limitation on the scope of such a right would be enforceable under local law.

contractual grant of this right. The MFI should consult with local counsel to determine if there is a statutory or case law right of set off under local law and, if so, its possible application to the MFI.

### **The Pledge of the Account**

When a borrower “pledges” collateral to support its obligations under a loan, it is agreeing to give the lender the right to exercise remedies against (i.e., seize) the collateral if the borrower fails to fulfill its payment obligations under the loan. Upon such a failure, the lender may seize and liquidate that portion of the collateral required to satisfy those unfulfilled obligations. Therefore, the collateral “secures” the lender’s right to receive certain payments from the borrower under the loan. This is why, in many jurisdictions, a lender is said to have a “security interest” in the collateral.<sup>4</sup>

In a back-to-back loan structure, the MFI pledges the Account to the Local Bank to secure its obligation to repay the Local Loan. This means that upon a payment default under the Local Loan, the Local Bank may exercise remedies against the Hard Currency Principal in the Account to satisfy unpaid amounts under the Local Loan.

The documentation and arrangements required to give the Local Bank these rights and powers vary from jurisdiction to jurisdiction. Because collateral comes in many different forms and any system designed to protect the rights of lenders and borrowers requires complex rules and recording systems, jurisdictions typically adopt statutes setting forth how a borrower can effectively pledge different types of collateral to a lender. The MFI should consult with local counsel to determine (a) the local statutory regime relating to secured transactions, (b) the relevant provisions applying to the pledge of collateral in the form of a deposit account, and (c) the documentation and arrangements required to effect such a pledge. In New York and most other U.S. states, a lending bank would typically require the borrower to enter into a security agreement (pursuant to which the borrower pledges the Account to the lending bank) and a deposit account control agreement (pursuant to which the borrower gives the lending bank control over disposition of the funds in the Account). (See Box A.1.)

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<sup>4</sup> It should be noted that the words “pledge”, “collateral”, “secure”, and “security interest” are terms of art whose meaning may vary in different jurisdictions. Furthermore, some jurisdictions (in particular, those jurisdictions whose legal system is based on civil law) may use entirely different terminology to describe the same general arrangement.



**Box A.1. The Uniform Commercial Code**

New York and most other U.S. states have adopted the Uniform Commercial Code (“UCC”). Under UCC, a pledge of collateral to support a borrower’s obligations under a loan is enforceable by a lender only where the lender’s security interest has “attached” to the collateral. A security interest will attach where the borrower has given value to the lender, the borrower has rights in the collateral, and the borrower has authenticated a security agreement that provides a description of the collateral. Therefore, a New York bank acting as a lender (“NY Bank”) would require the borrower to enter into a security agreement (sometimes referred to as a pledge agreement) under which the borrower would grant the NY Bank a security interest in the Account.

Furthermore, in a UCC jurisdiction, the lender’s security interest in the collateral takes priority over the claims of other creditors of the borrower only where the lender has “perfected” its security interest. One method by which a lender can perfect its security interest is by gaining “control” over the collateral. Therefore, the NY Bank would also likely require such control over the Account. Control can be accomplished by (a) maintaining the Account at the NY Bank itself (where the NY Bank is the Deposit Bank), (b) maintaining the Account at another financial institution (where the NY Bank is *not* the Deposit Bank) and setting up the Account in the name of the NY Bank on behalf of the MFI, or (c) entering into a deposit account control agreement. A deposit account control agreement is a three-party agreement whereby the MFI directs the Deposit Bank to comply with instructions originated by the NY Bank directing disposition of the funds in the Account without further consent by the MFI.

The description above is for illustrative purposes only and is based on New York law. Although the documentation required in the local jurisdiction may be very similar to a security agreement and a deposit account control agreement documented under New York law, the MFI should not rely on the approach used in New York to structure a pledge of an Account under local law.

In any event, the MFI should keep certain things in mind while documenting the pledge of the Account:

***Security Agreement Pledge Provisions.*** The MFI should consult with local counsel to consider the scope of any local law equivalent of the security agreement. In particular, the MFI should consider:

- whether the pledge of collateral under the security agreement extends beyond a pledge of the Account. Frequently, lenders will draft overly broad granting clauses in security agreements. The pledge may include a pledge of all other accounts maintained at the Local Bank. This may not be necessary where the value of the Hard Currency Principal is equal to or greater than the hard currency equivalent of the Local Loan principal.
- whether there are provisions requiring the MFI to pledge additional hard currency collateral or other forms of collateral if an appreciation of the local currency will leave the Local Bank under-collateralized. In this situation, the MFI should be mindful that the source used to determine the exchange rate for these purposes is an objective, reliable, and widely used source that will not give the Local Bank arbitrary discretion. Local custom should determine the source used. Perhaps more important, the MFI should consider whether and how it will obtain additional hard currency collateral in such circumstances.

***Choice of the Deposit Bank.*** The MFI should carefully consider whether, under local law, the Local Bank must be the Deposit Bank. If there is no such requirement, the MFI may want to maintain the Account at a separate Deposit Bank to ensure the Local Bank cannot arbitrarily prevent the MFI from accessing Hard Currency Principal in the Account and to limit the Local Bank's statutory set-off rights. Where the Account is maintained with a separate Deposit Bank, the MFI and the Deposit Bank need to enter into the local law equivalent of a deposit account control agreement, if any such local law equivalent exists.

The MFI may consider designating an offshore bank as the Deposit Bank. During an economic crisis, the local government may impose a freeze on withdrawing hard currency denominated assets and/or transferring such assets abroad. If the MFI uses a domestic bank, the imposition of such a freeze could prevent it from withdrawing the Hard Currency Principal and/or transferring the Hard Currency Principal abroad for purposes of repaying the Hard Currency Loan. As a result, the MFI might default on the Hard Currency Loan. By contrast, the local government cannot restrict withdrawals from an Account at an offshore Deposit Bank. For example, the Account could be maintained at

a correspondent bank of the Local Bank located in New York. The MFI could then enter into a control agreement with the Local Bank and the New York Deposit Bank. If the MFI uses this approach, it should retain counsel from the offshore jurisdiction to review the deposit account control agreement.

Even where local law allows for a separate Deposit Bank, Local Banks may be unwilling to enter into these arrangements and insist on performing the functions of both the lending bank and the Deposit Bank. Where this is the case, the MFI should consider whether a back-to-back loan structure is worth the attendant risks.

***Nature of Control Granted.*** If the MFI designates the Local Bank as the Deposit Bank or grants it some other form of control over the Account, the MFI should consider the nature of the control provisions and the rules governing control under local law. Under New York law, for example, a lender will have control over the Account as long as it may direct disposition of funds in the Account without the consent of the borrower. Even if the borrower remains free to withdraw and deposit funds in the Account, the lender still will be deemed to have control over the Account if it has the right to dispose of funds in the Account without the borrower's consent. Other jurisdictions may have a different standard for what constitutes control. For example, local law may require the Local Bank to have "exclusive" control over the Account. Even without such a requirement, the Local Bank may include such a requirement in its form of control agreement or, where it is the Deposit Bank, in other documentation. If this is the case, the MFI should take care to ensure the control granted will not limit its ability to withdraw the Hard Currency Principal (a) upon the maturity of the Hard Currency Loan, (b) upon the potential insolvency of the Local Bank, or (c) upon the Local Bank's breach of certain representations, warranties, covenants, or other duties to the MFI. Where such exclusive control is not open to negotiation, the MFI should take the resulting risks into account in deciding whether to employ a back-to-back loan structure.

***Scope of Events of Default and Remedies.*** Where the Local Bank is given control over the Account, the MFI should consider the scope of the event of default and remedies provisions given to the Local Bank under the Local Loan. Hard currency collateral can be particularly valuable to the Local Bank, especially if foreign exchange is in short supply (as can occur during a foreign exchange crisis). If the event of default provisions are overly broad, the Local Bank may be tempted to declare an event of default in bad faith and use its control to seize the Hard Currency Principal. If this occurs during a foreign exchange crisis, the MFI may find itself without hard currency to pay off the Hard

Currency Loan at a time when its local currency denominated assets are losing relative value due to depreciation or devaluation. In particular, the MFI should review those event of default provisions that will be automatically triggered upon the occurrence of an event (such as default provisions that are triggered if the MFI falls below a certain credit rating, or cross-default provisions that are triggered if the MFI defaults under another agreement) or that are subject to interpretation by the Local Bank.

With respect to remedies, the MFI should consider whether there are acceleration provisions under the Local Loan. An acceleration provision can exacerbate the risks associated with overly broad event of default provisions. For a more in-depth discussion of event of default and remedy provisions under Local Loans, see the *Local Loan Guidebook* (CGAP 2006).

*Matching the Maturities/Payment Schedules of the Loans and the Account.* The MFI should attempt to match the maturities of each of the loans and the Account. Although this seems obvious, it is frequently difficult to accomplish in practice. The Deposit Bank may require the Hard Currency Principal to be deposited in the Account for a fixed term. The MFI also may choose to deposit the Hard Currency Principal in a fixed-term Account to earn a higher rate of interest. However, Deposit Banks frequently offer Accounts only for certain specified terms. If the MFI chooses to hold the Account at a Deposit Bank other than the Local Bank, it may not be able to match the term of the Account with the term of the Local Loan. This will likely not be an issue where the Local Bank also functions as the Deposit Bank.

MFIs cannot employ effective back-to-back loan structures where the term of the Account and/or the term of the Local Loan is longer than the term of the Hard Currency Loan because, on the maturity of the Hard Currency Loan, the MFI will not be allowed to withdraw the Hard Currency Principal. The back-to-back structure can be employed where the terms of the Account and Local Loan are shorter than the term of the Hard Currency Loan. However, this situation is not optimal because the MFI will not be earning interest on the Account for the period from the end of the term of the Account to the maturity of the Hard Currency Loan. The MFI's net cost of funding will increase for this end period.

If the Hard Currency Loan amortizes (has several principal payment dates rather than one principal payment on maturity), the MFI probably will not be able to employ a back-to-back loan structure. The structure can be employed only if the Local Currency Loan also amortizes at the same time and in the same amounts as the Hard Currency Loan and

funds deposited in the Account are liquid enough to be withdrawn as each principal payment under the Hard Currency Loan becomes due. Even if the MFI can manage to match these payment schedules, the back-to-back loan structure cannot be effectively employed if there are significant time lags in moving funds from one jurisdiction to another (as can often be the case in some developing countries where MFIs operate).

*Exposure to Credit of Deposit Bank.* The MFI will be subject to the credit risk of the Deposit Bank and could lose the Hard Currency Principal upon the insolvency of the Deposit Bank. Before entering into any back-to-back structure, the MFI should conduct its own due diligence as to the creditworthiness of the Deposit Bank. This is particularly important here because, unlike most bank deposits, the MFI's deposit of Hard Currency Principal is likely to be "locked into" the Deposit Bank for an extended period of time (the term of the Local Loan). The MFI should also consider whether the Hard Currency Principal in the Account is insured by any applicable local deposit insurance laws. Because the deposit is not a deposit of local currency, such local deposit insurance laws may not apply.

### Conclusion

Any MFI considering employing a back-to-back loan structure should carefully consider the issues relating to the pledge of the Account before entering into such a structure to determine whether the structure is feasible and does not expose the MFI to excessive risk. The MFI should consider alternatives to a back-to-back structure in the following situations:

- If the Local Bank insists on unlimited control over the Account
- If the event of default and remedy provisions under the Local Loan are overly broad and give undue discretion to the Local Bank
- If the maturities or repayment schedules of the Local Loan and the Hard Currency Loan cannot be matched or if there are significant time lags in moving funds across jurisdictions
- If the MFI is seriously concerned with the creditworthiness of the Deposit Bank

The MFI also should not lose sight of the fact that the back-to-back loan structure is essentially a structure consisting of two underlying loans. Therefore, in addition to considering the issues associated with the pledge of the Account, the MFI should consult with foreign and local counsel to ensure the Hard Currency Loan and the Local Loan are properly negotiated and documented.



## Exhibit B-1

### Letter-of-Credit Foreign Exchange Risk Mitigation Structure

The purpose of these model letter-of-credit provisions is to introduce MFIs to the principal provisions of the standard documentation relating to standby letters of credit, as they may be obtained from commercial banks in the United States<sup>1</sup> to help the MFI mitigate foreign exchange risk.

Letters of credit are an important building block of many domestic and international transactions and may be put to many different uses. At its most basic level, a letter of credit is a promise by the issuer of the letter of credit, typically a bank, to pay a specified amount to the recipient of the letter of credit (referred to as the “Beneficiary”) upon the Beneficiary’s presentation of certain documents. A letter of credit typically is issued at the request of a party (referred to as the “Applicant”) to secure the obligations of the Applicant to the Beneficiary pursuant to an underlying transaction, for example, a loan or a sale of goods by the Beneficiary to the Applicant. (See Figure 1.) Thus, in practical terms, a letter of credit is a mechanism that substitutes the creditworthiness of the issuer for that of the Applicant. As a result, the Beneficiary is assured that it will receive prompt payment of amounts it is owed under

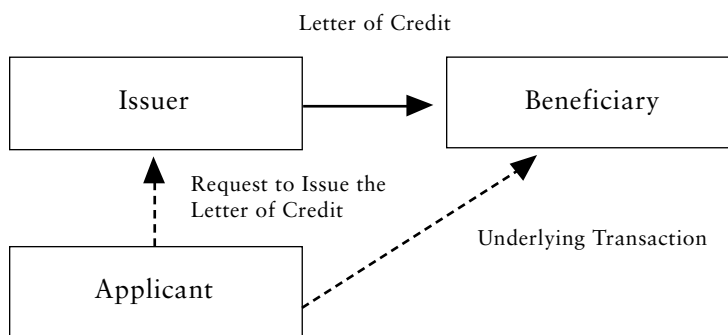


Figure 1.

<sup>1</sup> This document’s coverage is limited to the United States because of the extensive descriptions of the Uniform Commercial Code. Standby letters of credit are available from banks in other jurisdictions, but the legal regime and documentation may differ considerably.

the underlying transaction, even if the Applicant encounters financial difficulties (assuming that the issuer remains creditworthy). A demand by the Beneficiary for payment by the issuer is referred to as a “drawing” or a “draw.”

This discussion does not purport to provide an exhaustive description of the contents of such documentation. The standard forms of letter of credit and related agreements vary depending on the issuing bank and the requirements of the recipient of the letter of credit. In addition, the annotations to these model provisions were elaborated based on the MFI’s perspective on the letter-of-credit transaction, in an attempt to clarify the principal issues and provisions that would normally be relevant to the MFI’s interests. Accordingly, the annotations do not exhaustively describe all applicable letter-of-credit law and practice. In light of these considerations, these provisions should be seen as general guidance.

In addition, because the purpose of these model letter-of-credit provisions is to explain a variety of common clauses found in letter-of-credit documentation, it includes clauses that do not favor borrowers/applicants, such as MFIs, as well as clauses that issuers may omit in their initial draft documentation. Accordingly, borrowers should not copy or propose to issuers and lenders any clause in these model provisions without, in each case, carefully considering the specific provision and its consequences.

### **Letter-of-Credit Structure**

Under a letter-of-credit-based foreign exchange risk mitigation structure, the MFI first obtains a hard currency loan from a foreign lender. Second, the MFI obtains a standby letter of credit (the “Letter of Credit”) from a bank (the “Issuing Bank”), which typically will be located in the same jurisdiction as the foreign lender. To do so, the MFI sets up a deposit account at the Issuing Bank and deposits the proceeds of the hard currency loan into that account. As a condition of obtaining the Letter of Credit, the MFI must enter into a reimbursement agreement (the “Reimbursement Agreement”) with the Issuing Bank pursuant to which the deposit account will serve as collateral to support the MFI’s obligation to reimburse the Issuing Bank for any amounts drawn under the Letter of Credit. The Letter of Credit is normally denominated in hard currency and likely will be in the same hard currency as the cash collateral deposited with the Issuing Bank. The MFI concurrently arranges the issuance by the Issuing Bank to a local bank (the “Local Bank”) of the Letter of Credit, which supports the MFI’s obli-



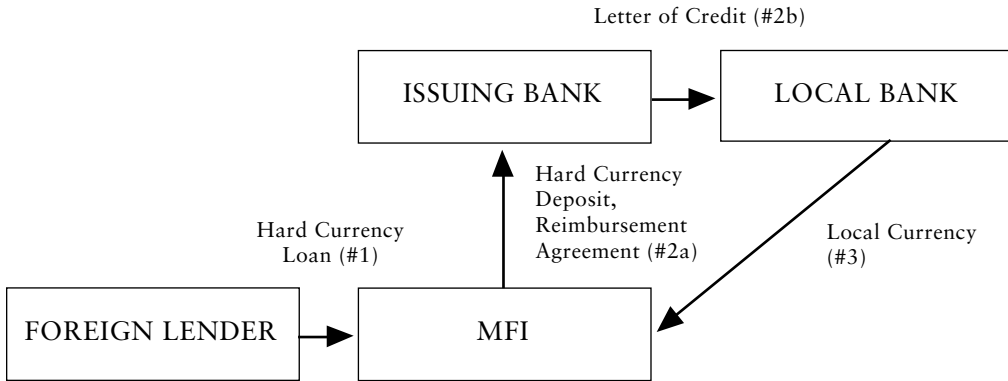


Figure 2.

gations to repay a local currency loan by the Local Bank to the MFI. Third, the MFI enters into the local currency loan with the Local Bank, supported by the Letter of Credit. See Figure 2.

As a practical matter, these three transactions will normally be negotiated simultaneously, because the Local Bank will want to incorporate specific requirements relating to the form and content of the Letter of Credit in the agreement governing the local currency loan (the “Local Loan Agreement”). Before finalizing such requirements between the MFI and the Local Bank and executing the Local Loan Agreement, it is crucial that the MFI ensure the Issuing Bank will be willing to issue a Letter of Credit that complies with the proposed requirements of the Local Loan Agreement.

**Fundamental Legal Features**

There are two types of letters of credit: commercial letters of credit and standby letters of credit. The Letter of Credit in the MFI transaction described above is a standby letter of credit. A standby letter of credit is normally irrevocable and is often used as credit support for a loan or other underlying transaction between the beneficiary and the applicant. It becomes payable upon the applicant’s default on the underlying transaction. Under normal circumstances, the parties do not expect the standby letter of credit to ever be drawn upon. Rather, the parties expect the applicant to fulfill its obligations to the beneficiary under the underlying transaction, and the standby letter of credit to expire without ever being drawn upon.

By contrast, commercial letters of credit operate as a means of payment under a commercial contract, typically a contract for the sale and shipment of goods. In a typical commercial letter of credit, the Applicant is the buyer of goods and the Beneficiary is the seller. The Letter of Credit provides for payment by the issuer upon presentation by the seller–beneficiary of certain documents evidencing that the goods have been shipped and transferring ownership of the goods in transit (e.g., bill of lading, insurance and inspection certificates). The Letter of Credit provides the seller with certainty that it will be paid when the goods are duly shipped, rather than having to ship the goods first and rely on the buyer for payment.

The issuer of a Letter of Credit is entitled to be reimbursed by the Applicant for the amount of any drawing made by the Beneficiary on the Letter of Credit. Although this right is codified in applicable law and practice, the issuer will normally require that the Applicant enter into an agreement (in this case, the Reimbursement Agreement) that specifies the Applicant’s reimbursement obligation in more detail and provides for additional rights of the issuer against the Applicant (for instance, reimbursement of certain expenses incurred by the issuer in connection with the Letter of Credit). See Figure 3.

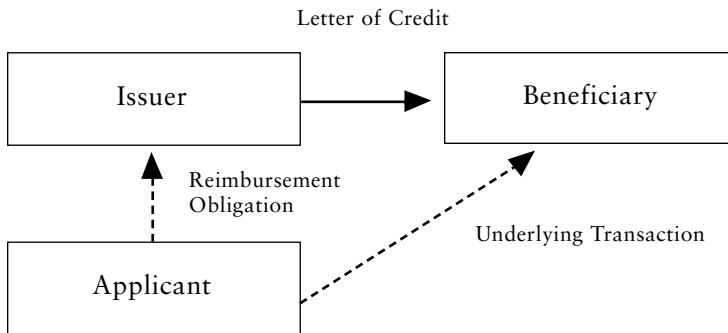


Figure 3.

Often the issuer will also require that the Applicant provide collateral to cover this potential reimbursement obligation. The issuer will retain that collateral until the Letter of Credit is drawn on (in which case the issuer will appropriate the collateral to satisfy the Applicant’s reimbursement obligation) or until the Letter of Credit expires without being drawn (in which case the issuer will return the collateral to the Applicant).

From a legal perspective, several characteristics of letters of credit distinguish them

from ordinary contracts as well as from other types of credit support (such as third-party guarantees). The most important legal features of letters of credit are as follows:

- ***Letters of credit are purely documentary.*** The issuer of a Letter of Credit must honor a demand for payment presented to it under the terms of the Letter of Credit as long as the required documents are presented and the terms and conditions of the Letter of Credit have been complied with. In particular, the issuer must disregard any nondocumentary conditions to payment in the Letter of Credit, which means that the issuer's obligations are limited to verifying that the relevant documents presented by the Beneficiary appear on their face to comply with the requirements of the Letter of Credit. The issuer does not have to verify that the documents are accurate and true. For instance, if the Letter of Credit requires a statement from the Beneficiary that it is drawing on the Letter of Credit because the Applicant has defaulted on the underlying transaction (in this case, the local currency loan from the Beneficiary [the Local Bank] to the Applicant [the MFI]), the issuer is not required to investigate whether the Applicant actually has defaulted. As long as the Beneficiary presents the required statement and complies with any other requirements under the Letter of Credit, the issuer is required to pay.
- ***The issuer of a Letter of Credit is entitled to be reimbursed by the Applicant for any drawing.*** As explained, as long as the Beneficiary has complied with the terms and conditions of the Letter of Credit, the issuer is required to pay the Beneficiary, and the issuer is entitled to be reimbursed later by the Applicant for this payment. Even if the demand for payment by the Beneficiary is fraudulent, the issuer has no obligation to withhold payment as long as it acts in good faith. Because the issuer will be liable for any damages to the Beneficiary if the issuer's refusal to honor a demand for payment turns out to have been wrongful, the issuer will normally choose to pay if it may do so in good faith, and then the issuer will be entitled to reimbursement by the Applicant. Under very limited circumstances, the Applicant may prevent the issuer from paying the Beneficiary on a fraudulent demand, but this would likely require timely court intervention.
- ***Letters of credit are independent of the underlying transaction.*** The Letter of Credit is entirely independent of and separate from the underlying contract. Disputes between the Applicant and the Beneficiary over the underlying contract

(for instance, disputes about whether the Applicant has in fact defaulted under the underlying contract) are irrelevant as a matter of law to the duty of an issuer to honor the Letter of Credit when conforming documents are presented to it. In theory, such disputes are to be addressed following payment. In other words, disputes over whether the Beneficiary was in fact entitled to draw on the Letter of Credit need to be resolved between the Beneficiary and the Applicant and cannot be used by the Applicant as a defense against the issuer's right to immediate reimbursement.<sup>2</sup>

Finally, an important aspect of the legal framework governing letter of credit is the relationship between applicable law, on the one hand, and relevant customs and practice of international trade, on the other. Specifically, in New York (as in all other U.S. states), letters of credit are primarily governed by Article 5 of the Uniform Commercial Code ("UCC"). However, the UCC expressly allows the parties to a letter of credit to vary Article 5's nonmandatory provisions and to select the law or rules applicable to a particular letter of credit. It is common for letter-of-credit issuers to include provisions specifying that the Letter of Credit will be governed by one of the following codes of international customs and practice:

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<sup>2</sup> Another consequence of this independence principle is that the presence of a letter of credit as a credit support mechanism does not absolve the applicant of its obligations under the underlying transaction. For instance, in this case, if the MFI were to default on the local currency loan and, for some reason (including insolvency of the Issuing Bank), the Issuing Bank did not repay the Local Bank under the Letter of Credit, the Local Bank would be entitled to exercise the legal recourse it may have against the MFI in the MFI's jurisdiction, potentially including seizure of the MFI's assets. The MFI could therefore have to repay the loan and attempt to recover the hard currency deposit from the Issuing Bank. As a result, by entering into this foreign exchange risk mitigation structure, the MFI is exposed to the Issuing Bank's credit (which may be mitigated to some extent by any deposit insurance regime in force in the Issuing Bank's jurisdiction).

<sup>3</sup> Given the importance of commercial letters of credit in the international market as a means of payment for international sales and shipment of goods, a substantial body of customs and practices developed over time has been compiled and published by the International Chamber of Commerce as the Uniform Customs and Practice for Documentary Credits, known as the "UCP" or the "UCP 500." The UCP was last revised in 1993. Article 5 of the UCC was revised in 1995 with the UCP in mind, and Article 5 of both the UCC and the UCP addresses many of the same subjects. Where Article 5 of the UCC is relatively short and succinct, however, the UCP is much longer and detailed, addressing some issues (such as the form and nature of the documents to be presented to the issuer) at a level of detail not found in Article 5. By its terms, the UCP applies to all letters of credit, both commercial and standby, where the parties agree to incorporate or otherwise make the UCP applicable. Although the UCP does not have the force of law, it is binding on the parties to a letter of credit to which it is made applicable and generally will be followed by a court hearing a dispute involving that letter of credit.

- The Uniform Customs and Practice for Documentary Credits, 1993 Revision, International Chamber of Commerce Publication No. 500 (“UCP”)<sup>3</sup> or
- The International Standby Practices, 1998, International Chamber of Commerce Publication No. 590 (“ISP98”)<sup>4</sup>

When parties specify that the rules embodied in the UCP or the ISP98 apply to their letter of credit, those rules take precedence over the nonmandatory provisions of the UCC. Absent such a specification, neither the UCP nor the ISP98 will apply to a letter of credit. In most cases, the issuer will have a policy governing the use of UCP or ISP98 in its standby letters of credit, and it will be difficult for an applicant, such as an MFI, to argue for an exception from such policy. Although most differences between the UCP and the ISP98 concern technical matters that are primarily of relevance to the issuer and the beneficiary, the annotations to the Annotated Sample Letter of Credit and the Annotated Sample Reimbursement Agreement in Exhibits B-2 and B-3 will note some relevant differences.

The description above is intended only to provide an overview of the main legal features of standby letters of credit. In addition, such description is necessarily limited to selected provisions of New York State law, as well as the UCP and ISP98. Questions relating to any specific transaction should be directed to legal counsel in the appropriate jurisdiction.

### Documentation

As mentioned above, in letter-of-credit law, the party who requests the issuance of a letter of credit is referred to as the “Applicant,”<sup>5</sup> the party who issues the Letter of Credit is referred to as the “Issuer,” and the party to whom the Letter of Credit is issued is referred to as the “Beneficiary.” In the case of the transaction described above, the MFI is the Applicant, the Issuing Bank is the Issuer, and the Local Bank is the Beneficiary. The local currency loan is the underlying transaction.

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<sup>4</sup> Although the UCP applies to all letters of credit, it was developed primarily for use in connection with *commercial* letters of credit, and many in the marketplace thought it was not completely appropriate for use with *standby* letters of credit. To address these concerns and the increased importance of standbys as financial instruments, in 1998 the Institute of International Banking Law and Practice, in connection with the International Chamber of Commerce, published the International Standby Practices, known as the “ISP98.” The ISP98 is intended to apply only to standby letters of credit. Although similar in many respects to the UCP, in light of the differing market context that standby letters of credit occupy, the ISP98 was drafted not only with bankers in mind but also for a larger audience, including corporate credit managers, rating agencies, and government regulators. As a result, the ISP98 is in some respects more detailed than the UCP. Like the UCP, the ISP98 will apply where the parties to the standby letter of credit agree to incorporate it.

The letter-of-credit structure for MFIs involves three principal legal relationships, each of which is normally documented by an agreement between the two relevant parties:

1. The Letter of Credit is issued by the Issuing Bank to the Local Bank at the MFI's request. As described above, the Issuing Bank has an independent legal obligation to pay the Local Bank upon satisfaction by the Local Bank of the documentary conditions specified in the Letter of Credit. Often, the relevant documentary condition for a letter of credit of this type is simply a certificate to the Issuing Bank, signed by a representative of the Local Bank, affirming that the Local Bank is entitled to draw on the Letter of Credit because the MFI has defaulted on the Local Loan Agreement. An Annotated Sample Letter of Credit is included in Exhibit B-2.
2. The Reimbursement Agreement is entered into between the MFI and the Issuing Bank. Under this agreement, the Issuing Bank agrees to issue the Letter of Credit requested by the MFI, and the MFI agrees to reimburse the Issuing Bank for any drawing by the Local Bank on the Letter of Credit. The Reimbursement Agreement also will contain provisions granting the Issuing Bank the right to apply the cash collateral deposit against the MFI's reimbursement obligation following a drawing on the Letter of Credit. An Annotated Sample Reimbursement Agreement is included in Exhibit B-3.
3. The Local Loan Agreement is entered into between the MFI and the Local Bank. It will contain provisions requiring the MFI to obtain the issuance of the Letter of Credit to support its obligation to repay the local currency loan. The Local Loan Agreement may specify the drawing conditions and other terms to be incorporated in the Letter of Credit and normally provides that the issuance of a complying letter of credit is a condition that must be fulfilled before disbursement of the local currency loan. In addition, the Local Loan Agreement contains all other terms pertaining to the local currency loan.<sup>6</sup>

In addition to these three agreements, the hard currency loan between the foreign lender and the MFI is documented by a separate loan agreement. This outline will discuss the relationship between the three components of letter-of-credit documentation and the hard currency loan agreement, where relevant.<sup>7</sup>

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<sup>5</sup> The applicant is occasionally referred to in letter-of-credit documentation as the "account party."

<sup>6</sup> Refer to *Commercial Loan Agreements: A Borrowing Guidebook for Microfinance Institutions* (CGAP 2006) for further information on local currency loan documentation.

<sup>7</sup> For further information on hard currency loan documentation, refer to *Foundation for International Community Assistance International, Microfinance Institutions' Commercial Loan Documentation: Form of Annotated Loan Agreement* (2004) (the "Model Loan Agreement").

### Principal Drafting and Negotiation Issues

The annotations to the Annotated Sample Letter of Credit and the Annotated Sample Reimbursement Agreement in Exhibits B-2 and B-3, respectively, explain many of the most common provisions found in standby letter-of-credit documentation, as well as possible variants and negotiation points. As a practical matter, however, the MFI's ability to negotiate each of these points may be limited, either by the Issuing Bank's lack of flexibility (particularly in the context of a relatively small transaction) or by time or other material constraints. To help MFIs prioritize among possible negotiation points, the following list describes the principal substantive issues that should be carefully reviewed and negotiated as part of this foreign exchange risk mitigation structure, and refers to the relevant provisions and annotations in Exhibits B-2 and B-3.

- ***Definition of, and limitations on, the Local Bank's right to draw on the Letter of Credit.*** As explained, any dispute concerning the Local Bank's right to draw on the Letter of Credit will be resolved by reference to the Local Loan Agreement and any related agreements between the MFI and the Local Bank. Accordingly, it is important that the circumstances under which a drawing is permitted be clearly agreed between the MFI and the Local Bank and that the statement to be provided by the Local Bank to draw on the Letter of Credit be carefully drafted to reflect such circumstances. In particular, the MFI should ensure that the Local Bank is not inadvertently permitted to draw on the Letter of Credit before all notice and grace periods under the Local Loan Agreement have expired and all other conditions to acceleration of the local currency loan have been satisfied. In addition, the Local Bank should not be permitted to draw an amount in excess of what is required to make it whole with respect to the default. The MFI should consider incorporating other requirements with respect to the Local Bank's potential exercise of its right to draw on the Letter of Credit, including a commercial reasonableness or similar standard with respect to the method and rate for conversion of the drawn amount from U.S. dollars to local currency. *See* Annotation 4 to the Annotated Sample Letter of Credit (Exhibit B-2). The MFI should insist that the Local Bank's right to draw under the Letter of Credit be nontransferable. *See* Annotation 6 to the Annotated Sample Letter of Credit.
- ***The Issuing Bank's rights in the collateral pledged by the MFI to support the Letter of Credit.*** In normal circumstances, the MFI will deposit the proceeds of the hard currency loan in a deposit account at the Issuing Bank to support the MFI's obligation to reimburse the Issuing Bank for drawings on the Letter of Credit. Such support

usually will be achieved either by a specific pledge of the deposit account to the Issuing Bank, or by the Issuing Bank's relying on its right to set off its obligation to return the deposit against the MFI's reimbursement obligation. In both cases, the MFI should carefully review the pledge and set-off provisions of the Reimbursement Agreement to ensure they are not over inclusive. In particular, many standard reimbursement agreements contain a very broad pledge of the applicant's assets and rights obtained in connection with the underlying transaction. Clauses of this nature are inappropriate in the context of a fully cash-collateralized letter of credit. The MFI should insist that the pledge be limited to the deposit account and proceeds thereof. Some reimbursement agreements also allow the Issuing Bank and its affiliates to set off any obligations owed by the MFI to any of them against the collateral account. In such cases, the MFI should carefully consider its other business relationships with the Issuing Bank to determine the circumstances under which the exercise by the Issuing Bank of such rights might interfere with the letter-of-credit structure and, in particular, with the MFI's ability to recover the hard currency deposit and repay the hard currency loan at maturity. *See* Annotations 91 and 92 to the Annotated Sample Reimbursement Agreement (Exhibit B-3). The MFI also should ensure that the timing of expiration of the Letter of Credit, the Local Loan Agreement, and the hard currency loan are carefully matched so that the MFI will be able to recover the hard currency deposit in time to repay the hard currency loan at maturity. *See* Annotations 2 and 9 to the Annotated Sample Letter of Credit (Exhibit B-2). Finally, the MFI must be conscious that, even though this structure rests on the expectation that the Issuing Bank will rely primarily on the hard currency deposited as collateral to satisfy the MFI's obligation, the Issuing Bank will nevertheless be able to exercise legal recourses against the MFI if the amount of collateral is for any reason insufficient to satisfy the MFI's obligations following a drawing on the Letter of Credit.

- ***Issuing Bank's right to request additional collateral.*** Many reimbursement agreements contain a clause allowing the issuer, at its discretion, to request additional collateral to be posted by the applicant. However, in this case, the full amount of the Letter of Credit normally will be collateralized by the initial deposit of the proceeds of the hard currency loan. In addition, the MFI is unlikely to be able to post additional hard currency collateral on short notice and such a request could therefore lead to a default under the Reimbursement Agreement. The MFI should therefore negotiate against the inclusion of any such clause or, if this is not possible, the MFI should insist that the



Issuing Bank's discretion be circumscribed, for instance by limiting the Issuing Bank's right to require additional collateral to certain well-defined circumstances (for instance, if the MFI commences an action against the Issuing Bank to prevent it from honoring a drawing on the Letter of Credit). *See* Annotations 53 and 54 to the Annotated Sample Reimbursement Agreement.

- ***Limitations on the Issuing Bank's obligations.*** A typical reimbursement agreement contains several provisions limiting the Issuing Bank's obligations under applicable law and practice, and providing that the MFI's obligation to reimburse the Issuing Bank for drawings under the Letter of Credit will survive notwithstanding various facts and circumstances (illustrated in Section 7 of the Annotated Sample Reimbursement Agreement) that could, under applicable law and practice, reduce or eliminate that obligation. The MFI should carefully consider such provisions to ensure that they do not excessively reduce the Issuing Bank's obligations or expose the MFI to excessive liability. In particular, provisions under which the MFI waives rights under applicable law and practice if not raised within a specified period of time (for instance, defenses to its reimbursement obligation) should be negotiated so as to provide sufficient time for the MFI to receive and review the relevant documents and communicate any objections to the Issuing Bank, taking into account the geographical distance, time difference, and language barriers between the Issuing Bank and the MFI. The MFI also should be cautious in agreeing to provisions allowing the Issuing Bank to waive vis-à-vis the Local Bank certain provisions of the applicable practice code or the Letter of Credit, such as deadlines. *See* Annotation 41 to the Annotated Sample Reimbursement Agreement (Exhibit B-3).
- ***Fees charged by the Issuing Bank.*** An important factor in determining the economic viability of the letter-of-credit structure will be the amount of the fees charged by the Issuing Bank for issuing and maintaining the Letter of Credit. Accordingly, such fees should be clearly defined (normally as a percentage *per annum* of the face amount of the Letter of Credit), and the Issuing Bank should not be allowed to modify these fees at its discretion. The MFI also should resist provisions allowing the Issuing Bank to assess additional costs and expenses against the MFI in the ordinary course (as opposed to certain extraordinary expenses, such as taxes, increased regulatory capital requirements, indemnification for litigation expenses, and the like, which the Issuer is typically entitled to recover from the Applicant under reimbursement agreements). *See* Annotation 25 to the Annotated Sample Reimbursement Agreement (Exhibit B-3).

- ***Representations, warranties, covenants, and events of default under the Reimbursement Agreement.*** Breach of a representation, warranty, or covenant, and other events of default by the MFI under the Reimbursement Agreement normally allows the Issuing Bank to accelerate the MFI's reimbursement obligation and foreclose on the collateral account. These occurrences also may trigger cross-defaults under the Local Loan Agreement, the hard currency loan agreement, or other agreements between the MFI and third parties. Such provisions accordingly should be negotiated carefully and, to the extent possible, harmonized with those in the hard currency loan agreement and Local Loan Agreement. The MFI also should ensure that such provisions do not impose excessively costly obligations (such as producing audited financial statements or reconciling its financial statements to U.S. Generally Accepted Accounting Principles). *See* Section 14 of the Annotated Sample Reimbursement Agreement and the corresponding Annotations (Exhibit B-3).

*Exhibit B-2*

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Annotated Sample Letter of Credit

**ISSUING BANK, N.A.**

Date: July 1, 2006

Beneficiary:     **Local Bank**  
                      **11 Independence Place**  
                      **Capital City 70000**  
                      **Republic of Ruritania**

1. This paragraph identifies the Local Bank as the beneficiary of the Letter of Credit. To avoid any operational issues or confusion after the Letter of Credit has been issued, it is important that it (and all other documents presented to the issuer) accurately identify the beneficiary and the other parties to the Letter of Credit.

See Annotation 4 regarding issues relating to identification of the Issuing Bank and the relevant branches, where applicable.

Letter of Credit No. 123456

Ladies and Gentlemen:

By order of **Microfinance Institution** (“Applicant”), we hereby open our irrevocable Standby Letter of Credit No. 123456, in your favor for an amount not to exceed in aggregate **USD 400,000** (four hundred thousand U.S. dollars and 00/100), effective immediately and expiring on June 30, 2007.

2. This paragraph identifies the MFI as the Applicant. It also sets forth the amount of the Letter of Credit. The statement that the amount is “not to exceed in aggregate” the stated maximum amount reflects the beneficiary’s right to draw less than the full available amount of the Letter of Credit.

The paragraph specifies that the Letter of Credit is effective immediately and expires on June 30, 2007. UCC Section 5-106 provides that a letter of credit without a stated expiry date is deemed to expire one year after its issuance. UCP Article 42 requires a letter of credit to contain an expiry date. ISP98 Rule 9.01 requires a standby to either contain an expiry date, or to permit the issuer to terminate the standby upon reasonable prior notice. To avoid an interpretation of the Letter of Credit that would result in expiry of the Letter of Credit after one year, or that would allow for termination by the Issuing Bank upon reasonable notice, it is important to ensure that an expiration date is clearly stipulated. The Local Bank will undoubtedly require in the Local Loan Agreement that the Letter of Credit expire no earlier than the scheduled maturity of the Local Loan. The Local Bank also may request that the Letter of Credit expire later than the maturity of the Local Loan, so as to provide the Local Bank with sufficient time to draw on the Letter of Credit if the MFI does not repay the Local Loan at maturity. In such cases, the MFI should make appropriate arrangements with the Issuing Bank and the hard currency lender whose loan proceeds are being used as cash collateral for the Letter of Credit to ensure the cash collateral deposit with the Issuing Bank will be released in time to repay the hard currency loan at maturity. This may require the hard currency loan to have a slightly longer term than the Local Loan and result in additional interest costs for the MFI.

This paragraph also indicates that the Letter of Credit is “irrevocable.” This means that, once the Letter of Credit is issued, the Issuing Bank may not terminate the Letter of Credit before its stated expiry date. Under each of the UCC, the UCP, and the ISP98, a standby letter of credit is irrevocable unless it expressly states otherwise. Although it is therefore not strictly necessary to state that a standby is irrevocable, as a matter of practice, the standby always should provide that it is irrevocable to avoid possible arguments to the contrary. Under no circumstances should the MFI accept a revocable letter of credit, because such a letter of credit very likely will not be considered

acceptable by the Local Bank. In addition, depending on the terms of the Local Loan Agreement, revocation of the Letter of Credit before the Local Loan matures could result in a default under the Local Loan, give the Local Bank the ability to require substitute collateral, or result in other adverse consequences for the MFI.

The fact that standbys are irrevocable unless otherwise stated is important in the context of amendments or other modifications to a standby, discussed in Annotation 7.

This Standby Letter of Credit has been issued pursuant to the Agreement for Standby Letter of Credit, dated as of July 1, 2006, among Applicant and us.

3. This paragraph identifies the Reimbursement Agreement, which governs the rights and obligations of the Issuing Bank and the MFI toward each other, particularly the MFI's obligation to reimburse the Issuing Bank for any drawings made under the Letter of Credit. Refer to the Annotated Sample Reimbursement Agreement in Exhibit B-3 for more details.

Funds hereunder are available upon presentation by you of the following documents at our office located at 300 Park Avenue, New York, NY 11111, USA:

1. Your sight draft, in the form of Annex A hereto, drawn on us and marked drawn on Issuing Bank, N.A. Standby Letter of Credit No. 123456, and
2. Your signed statement reading as follows:  
“We hereby demand the payment of the amount of USD \_\_\_\_\_ because, in connection with the Local Loan Agreement, there has been an Event of Default (as defined therein) and, as a result of such Event of Default, we have become entitled to and have declared the principal of the Local Loan to be immediately due and payable prior to its stated maturity. The amount being drawn does not exceed the amount that we are entitled to be paid under such Local Loan Agreement.”

4. This paragraph sets forth the documents that the Local Bank must present to the Issuing Bank in order to draw on the Letter of Credit. In this case, the documents consist of a sight draft and a signed statement from the Local Bank. A “draft” is a written direction by a party to a second party to make payment to the first party, to a specified third party, or to the holder of the draft. A “sight draft” is a draft that is payable upon demand (as opposed to a “time draft,” which is a draft that is payable a certain number of days after it has been delivered).

To protect against uncertainty concerning the precise identity and location of the Issuing Bank, particularly in the context of standbys issued by bank branches or foreign banks, it is important that the standby identify the Issuing Bank as precisely and with as much relevant information as possible. Where a standby is issued by one bank branch, but requires or permits presentation of documents at a different branch or bank, the standby should identify each branch or bank as precisely as possible.

Upon presentation of complying documents, the Issuing Bank will pay the amount demanded by the Local Bank, up to the full amount of the Letter of Credit.

Each of the UCC, UCP, and ISP98 entitles the Issuing Bank to review presented documents for compliance within a reasonable period not exceeding seven business days. It is important to understand that the Issuing Bank will not verify the accuracy of the statement regarding any default under the Local Loan Agreement, nor will it verify the observance of any nondocumentary conditions in the statement (or anywhere else in the Letter of Credit). As a result, if the Local Bank draws against the Letter of Credit without being entitled to do so, the MFI will not have a remedy against the Issuing Bank (unless the demand appeared on its face not to comply with the requirements set forth above, for instance if it did not include the required statement or included a different statement). Instead, any remedies the MFI may have will arise under the Local Loan Agreement and any relevant local law. In addition, the MFI’s rights against the Issuing Bank under such circumstances may be further limited under the Reimbursement Agreement. See Section 7 of the Annotated Sample Reimbursement Agreement and the corresponding annotations (Exhibit B-3).

Nevertheless, the required statement is important because it reflects the parties' intent concerning the circumstances under which the Local Bank is entitled to draw on the Letter of Credit. It should be drafted consistently with the Local Loan Agreement to avoid any ambiguity regarding the Local Bank's right to draw under any given set of circumstances. Moreover, the MFI should attempt to negotiate drawing conditions that are as precisely and narrowly defined as possible, to protect itself against unnecessary drawings by the Local Bank. More specifically:

(A) **Provision to Be Avoided.** The MFI should resist the Local Bank's demand for a generic statement such as the following, if proposed by the Local Bank or the Issuing Bank, and rather request the inclusion of a more specific statement (see B and C, below):

"We hereby demand the payment of the amount of USD \_\_\_\_\_ because Microfinance Institution has not performed in accordance with the terms of an agreement between Local Bank and Microfinance Institution."

Such a clause is undesirable because it effectively extends the security provided by the MFI in the form of the Letter of Credit from the specific Local Loan Agreement to all relationships between the Local Bank and the MFI. As a result, it is conceivable that a default or business dispute between the MFI and the Local Bank arising under a relationship other than the Local Loan Agreement could lead to the Letter of Credit being drawn, thus forcing the MFI immediately to reimburse the Issuing Bank for the amount of the drawing. In negotiating against such a clause, the MFI might point out that, in most jurisdictions, for purposes of regulatory bank capital requirements, where a letter of credit is provided as collateral under a particular agreement, the letter of credit should specifically identify that underlying agreement.

(B) **Better Alternatives.** The following sample statements specifically identify the Local Loan Agreement, thus avoiding the problem noted under A, above:

*Alternative 1:* "We hereby demand the payment of the amount of USD \_\_\_\_\_ because we are entitled to draw on this Letter of Credit pursuant to

the Local Loan Agreement dated as of July 1, 2006, between Local Bank and Microfinance Institution.”

*Alternative 2:* “We hereby demand the payment of the amount of USD \_\_\_\_\_ because Microfinance Institution has not performed in accordance with the terms of the Local Loan Agreement dated as of July 1, 2006, between Local Bank and Microfinance Institution.”

Whenever possible, the MFI should attempt to negotiate a more specific statement, in the form of the sample statement under C, below. If the Local Bank insists on including a broader statement, such as the two samples above, the MFI should insist on (1) including detailed provisions governing the Local Bank’s right to draw in the Local Loan Agreement, and (2) appending the following terms to the statement: “and the amount being drawn does not exceed the amount that we are entitled to draw under such Local Loan Agreement.”

(C) **Best Alternative.** Ideally, the statement should refer specifically to the Local Loan Agreement and be circumscribed to circumstances where the Local Bank has become fully entitled to exercise its remedies under the Local Loan Agreement. For instance, if the MFI is entitled to certain notices, cure periods, or other conditions before acceleration of the Local Loan following an event of default, this should be reflected in the drawing condition by specifying that the Local Bank has become entitled to accelerate the Local Loan and has in fact accelerated it. As an example, instead of a drawing statement such as:

“We hereby demand the payment of the amount of USD \_\_\_\_\_ because, in connection with the Local Loan Agreement, there has been an Event of Default (as defined therein).”

The MFI should insist on language such as:

“We hereby demand the payment of the amount of USD \_\_\_\_\_ because, in connection with the Local Loan Agreement, there has been an Event of Default (as defined therein) and, as a result of such Event of Default, we have become entitled to and have declared the principal of the Local Loan to be immediately due and payable prior to its stated maturity.”



Even in such cases, the MFI should request the addition of the following language: “and the amount being drawn does not exceed the amount that we are entitled to draw under such Local Loan Agreement.”

Of course, this is only an example—the actual statement should be adapted as needed to make it consistent with the remedies and other provisions of the Local Loan Agreement.

In addition, presentation of drawing document(s) also may be made by fax transmission to (212) 994-0847, or such other fax number identified by Issuing Bank, N.A., in a written notice to you. To the extent a presentation is made by fax transmission, you must provide telephone notification thereof to Issuing Bank, N.A., phone number (302) 894-6061 before or simultaneously with the sending of such fax transmission, provided, however, that Issuing Bank, N.A.’s receipt of such telephone notice shall not be a condition to payment hereunder.

5. Standby letters of credit sometimes permit required documents to be presented via fax, email, or SWIFT (an international interbank communication system). Under normal circumstances, this paragraph should primarily concern the Issuing Bank and the Local Bank rather than the MFI.

We hereby agree to honor your drawing documents as specified above, if presented in compliance with the terms and conditions of this Standby Letter of Credit.

[Transfer of this Standby Letter of Credit is subject to your request and instruction in a form and in substance satisfactory to us.]

6. A letter of credit is “transferable” if it allows the beneficiary to request that an issuer honor a drawing from another person as if that person were the beneficiary. Under each of the letter-of-credit regimes, a standby is not transferable unless it provides otherwise (ISP98 Rule 6.02, UCP Article 48, UCC Article 5-112(a)).

The bracketed paragraph above provides that the right to draw under the Letter of Credit may be transferred by the Local Bank to a third party if the Issuing Bank consents. Such assignment by the Local Bank may give rise to uncertainty upon presentation of a drawing by the assignee. If the Local Bank requests the inclusion of such a provision, the MFI should resist the request. Neither the Local Loan nor the Letter of Credit supporting it should be assignable without the MFI's consent.

This Letter of Credit may not be amended, changed, or modified without the express written consent of you, us, and Applicant.

7. This paragraph requires the consent of all three parties (the Issuing Bank, the MFI, and the Local Bank) to any amendment of the Letter of Credit. This approach is consistent with each of the UCC, the UCP, and the ISP98. Because a letter of credit is irrevocable, each one of these regimes provides that the parties' respective rights and obligations under a letter of credit cannot be affected by an amendment to or cancellation of the Letter of Credit to which the parties do not consent, except to the extent provided otherwise in the Letter of Credit. The MFI should not consent to any provision that allows the Issuing Bank and the Local Bank to amend the Letter of Credit without the MFI's written consent.

Partial drawings are permitted hereunder.

8. This paragraph allows the Local Bank to draw less than the full amount of the Letter of Credit. Under the UCP and ISP98, partial drawdown is permitted unless provided otherwise by the Letter of Credit (ISP98 Rule 3.08, UCP Article 40). The UCC contains no provision expressly authorizing partial drawdowns. Under the UCC, the parties may, as here, expressly allow partial drawdowns in the standby itself. Such a provision is not normally problematic and may be necessary in cases where the drawing condition or the Local Loan Agreement limit the amount that may be drawn by the Local Bank following a default on the Local Loan (see Annotation 4, above).

[It is a condition of this Standby Letter of Credit that the expiry date shall be automatically extended, without amendment, for additional period(s) of one year from the expiry date hereof, or any future expiration date, unless at least 120 (one hundred and twenty) days before any expiration date we notify you by certified mail (return receipt requested) or by facsimile message or by any other receipted means that we elect not to consider this Standby Letter of Credit renewed for any such additional period[, whereupon, you may draw your sight Draft(s) on us for an amount not to exceed the available amount of this Standby Letter of Credit, referencing thereon our Letter of Credit Number.]]

9. The bracketed paragraph above is an example of an “evergreen” automatic renewal provision. This type of automatic renewal provision is generally valid and enforceable. Nevertheless, as a general rule, the Letter of Credit for the MFI transaction contemplated here should not include such a provision, because its operation might inadvertently result in the Letter of Credit remaining outstanding after the maturity of the hard currency loan. This could prevent the MFI from obtaining release of the cash collateral deposit in time to repay the hard currency loan.

Therefore, instead of including an evergreen renewal clause, the expiry date of the Letter of Credit should be carefully determined so as to appropriately match the maturities of the hard currency loan and the Local Loan. See Annotation 2, above. The last bracketed clause is a common component of an evergreen clause of this type. It allows the beneficiary to draw on the Letter of Credit upon expiration if it is not renewed. Carefully matching the maturities of the hard currency loan and the Local Loan make such a clause unnecessary, and the MFI should resist it, along with the rest of the evergreen renewal clause.

This Standby Letter of Credit is subject to the Uniform Customs and Practice for documentary Credits, Revision 1993, International Chamber of Commerce, Publication No. 500, and as to matters not addressed by the UCP, shall be governed by and construed in accordance with the laws of the State of New York and applicable U.S. Federal Law. The parties agree that any proceeding against any of them or their properties, assets, or revenues with respect to this Standby Letter of Credit shall be brought [exclusively] in the

Supreme Court of the State of New York, County of New York in the Borough of Manhattan or in the United States District Court for the Southern District of New York in the Borough of Manhattan.

10. This paragraph incorporates the UCP to the terms of the Letter of Credit. The ISP98 is an alternative code of international customs and practice that may be made applicable to the Letter of Credit. If one of these codes is applicable, it will take precedence over most provisions of the UCC. If no code is applicable, the Letter of Credit will be governed by the rules of the UCC. For a more complete explanation of the law governing letters of credit in New York State and the relevant codes of international customs and practice (i.e., the UCP and the ISP98), see Exhibit B-1. This paragraph also provides for the jurisdiction of New York State and Federal courts over disputes arising in connection with the Letter of Credit.

The MFI should note that, if that clause provides for the exclusive jurisdiction of the courts located in the Issuing Bank's jurisdiction, the MFI will likely be unable to exercise recourses against the Issuing Bank in the local jurisdiction. Therefore, if a dispute arises between the MFI and the Issuing Bank, the MFI may have to incur substantial costs to exercise legal recourses in the Issuing Bank's jurisdiction.

ISSUING BANK, N.A.

AUTHORIZED SIGNATURE

ANNEX A

SIGHT DRAFT

Capital City, Republic of Ruritania

\_\_\_\_\_, 200\_\_

TO: Issuing Bank, N.A.  
300 Park Avenue  
New York, NY 11111  
U.S.A.

Attention: Standby Letter of Credit Department

AT SIGHT

Pay to the order of Local Bank USD \_\_\_\_\_ (\_\_\_\_\_ and  
\_\_\_/100 UNITED STATES DOLLARS), and charge the account of your Irrevocable  
Standby Letter of Credit No. 123456.

LOCAL BANK  
11 Independence Place  
Capital City 70000  
Republic of Ruritania

By: \_\_\_\_\_

Name:

Title:



## *Exhibit B-3*

### Annotated Sample Reimbursement Agreement

In consideration of your issuance of an irrevocable letter of credit (the “Letter of Credit”) substantially in accordance with the terms and conditions provided by the undersigned (the “Applicant”) on the Application attached hereto or as otherwise requested by Applicant in writing, Applicant unconditionally agrees with you (“Issuing Bank”) as follows:

1. Reimbursement<sup><1></sup>. (a) Applicant will pay Issuing Bank the amount of each draft or other request for payment (each, a “Draft”) drawn under the Letter of Credit, whether drawn before, on [or, if in accordance with applicable law, after] the expiry date stated in the Letter of Credit<sup><2></sup>. Each such payment shall be made, (i) in the case of a time Draft or deferred payment obligation, without demand and sufficiently in advance of its maturity to enable Issuing Bank to arrange for its cover in same-day funds to reach the place where it is payable no later than the date of its maturity, and (ii) in the case of a sight Draft, on demand<sup><3></sup>.

(b) As a condition precedent to the issuance by Issuing Bank of the Letter of Credit, Applicant shall deposit or cause to be deposited in an account maintained by Issuing Bank for Applicant on terms reasonably satisfactory to Issuing Bank and entitled “Microfinance Institution—Collateral Account” (the “Account”), funds in an amount [no less than the available amount] under the Letter of Credit and shall maintain such funds in the Account until no earlier than the expiry date of the Letter of Credit [Ⓢ]; provided, however, that Applicant shall be permitted to withdraw on a monthly basis the interest credited or paid by Issuing Bank in respect of the Account.]<sup><4></sup>

**1. Purpose:** Clause (a) of this Section sets forth the MFI’s basic obligation to reimburse the Issuing Bank for the amount of each request for payment—normally in the form of a “draft”—under the Letter of Credit (for more information on drafts,

see Annotation 4 in the Model Letter of Credit [Exhibit B-2]). This obligation is embodied in the UCC and would exist even without the provision above. However, the Reimbursement Agreement supplements and, in certain cases, varies this pre-existing reimbursement obligation. Notably, the Reimbursement Agreement expressly specifies numerous actions and circumstances that, although they could constitute a defense against, or otherwise affect, the MFI's obligation to reimburse the Issuing Bank under the UCC, will not constitute a defense under the terms of this Agreement. See Section 7, and the corresponding Annotations, for more details.

Clause (b) of this Section requires the MFI to deposit an amount equal to the face amount of the Letter of Credit in an Account at the Issuing Bank. In the context of this financing transaction, the funds deposited in the Account will be the proceeds of the hard currency loan obtained by the MFI. The Account, and the funds deposited therein, will serve as collateral to secure the MFI's obligation under clause (a) to reimburse the Issuing Bank for any drawings by the Local Bank under the Letter of Credit, and the MFI's other obligations under this Reimbursement Agreement. The collateral account mechanism is further discussed in the Annotations to Sections 12 ("Collateral"), 17 ("Remedies"), and 18 ("Set Off"). Note that some Issuing Banks may not require the Letter of Credit to be fully collateralized. If this is the case, then the above provision would need to be revised accordingly to reflect the actual amount of cash collateral on deposit.

**2. Drawdowns after the Expiration Date:** Under certain circumstances, the Issuing Bank would have to honor drawings by the Local Bank on the Letter of Credit after its expiration date.

For example, some letters of credit have clauses that allow for extensions of stated expiration dates if there is a *force majeure* event (typically something like a war, natural disaster, or labor dispute) that prevents the Issuing Bank from performing its obligation under the Letter of Credit for a period of time. Such a *force majeure* extension must be explicitly stated in the Letter of Credit. Otherwise, the Issuing Bank has no obligation to honor drawdowns during a *force majeure* event that disrupted normal business operations if the Letter of Credit expired during



such a *force majeure* event. The Model Letter of Credit does not contain a *force majeure* event. However, if the draft Letter of Credit proposed by the Issuing Bank does, the MFI should ensure that the Letter of Credit, the Reimbursement Agreement, the Local Loan Agreement, and the hard currency loan agreement treat *force majeure* events in a consistent manner (i.e., the MFI should avoid allowing for a *force majeure* extension to the Letter of Credit if there is no parallel extension in the hard currency loan agreement.)

Additionally, with respect to letters of credit that incorporate the UCP, the expiration date also can be extended if it happens to fall on a date when the Issuing Bank is ordinarily closed, such as a weekend or holiday. In that case, the next day the Issuing Bank is open becomes the expiration date, and drawdowns by the Beneficiary on that date will be honored. As with the *force majeure* extension, the MFI should ensure that the extension of the expiration date to the next working day does not create a mismatch with the way the maturity date of the hard currency loan agreement is calculated. This can become very complicated when several jurisdictions are involved because all may have different holidays and, thus, different working days.

**3. Reimbursement on Demand:** Note that the form of Draft attached to the model Letter of Credit is a “sight draft,” which means that the Issuing Bank is obligated to pay the Local Bank on demand immediately upon presentation and acceptance of the required documents. A sight draft is typical for a standby Letter of Credit. As a result, pursuant to clause (b) above, the MFI will be obligated to reimburse the Issuing Bank on demand by the Issuing Bank, which demand may be made immediately after the Issuing Bank pays a draft by the Local Bank under the Letter of Credit. Section 17 “Remedies” specifies the actions the Issuing Bank may take against the MFI’s hard currency cash collateral account to satisfy the MFI’s reimbursement obligation.

**4. Withdrawals of Interest Earned:** The MFI should confirm with the Issuing Bank that the interest earned on the Account will be available for withdrawal on a periodic basis by the MFI, because the MFI will likely want to use these amounts

to fund part of its periodic interest payments on the hard currency loan. Under normal circumstances, this should be possible, because the principal amount of the deposit in the Account will be equal to the face amount of the Letter of Credit, so the Issuing Bank does not need to retain the interest earned on the Account as additional collateral. If possible, language to that effect should be included in the Reimbursement Agreement or in the documentation relating to the Account.

2. Commissions, Fees, Charges, and Expenses<sup><5></sup>. Applicant will pay Issuing Bank [☺ (a) a fee on the amount then available for drawing under the Letter of Credit at a rate per annum equal to [0.50] percent, payable in arrears [on the first day of each month]<sup><6></sup>, beginning on the day on which the Letter of Credit is issued and ending on the earlier of (i) the expiry date of the Letter of Credit and (ii) the day on which the amount available for drawing under the Letter of Credit has been fully drawn.] [☹ *variant*: (a) commissions, fees, and other charges on the Letter of Credit (for as long as Issuing Bank shall be obligated under the Letter of Credit in accordance with applicable law) at such rates and times as Applicant and Issuing Bank may agree in writing [☹ or, in the absence of such an agreement, in accordance with Issuing Bank's commissions, fees, and other charges then in effect], payable on demand] [☹, and (b) on demand, all expenses the Issuing Bank may pay or incur in connection with the Letter of Credit]<sup><7></sup>.

**5. Purpose:** This provision sets forth the fee charged by the Issuing Bank for issuing and maintaining the Letter of Credit. This fee is typically expressed as a percentage of the available amount under the Letter of Credit. The variant of clause (a) may be acceptable, but the MFI will wish to ensure that its separate agreement with the Issuing Bank concerning the fees covers the entire period during which the Letter of Credit will be outstanding, and does not provide the Issuing Bank with discretion to either charge additional fees (unless such fees are clearly defined and acceptable to the MFI) or to change the applicable fee without the MFI's consent. In particular, the bracketed language within the second version of clause (a) allows the Issuing Bank, in the absence of a separate written agreement, to change its fees at any time and should be avoided.

**6. Payment Dates:** To the extent possible, the MFI should attempt to match the payment dates and day count convention for the Issuing Bank’s fee (see Annotation 13 and the corresponding language in Section 3) to the provisions providing for receiving interest on the cash collateral account (which may be included in the Reimbursement Agreement or in the documentation concerning the account) and/or to the terms of the hard currency loan agreement. This will simplify the MFI’s administration of the flow of funds among the MFI, the Issuing Bank, and the hard currency lender (particularly if the Issuing Bank is also the hard currency lender and allows payments due under the hard currency loan and the Reimbursement Agreement and interest earned on the cash collateral account to be netted on each payment date).

**7. Optional Language:** Clause (b) gives the Issuing Bank discretion to charge the MFI for any expenses incurred in connection with the Letter of Credit. As a general matter, the Issuing Bank’s argument for this provision is that the Letter of Credit is being arranged for the MFI’s benefit, so the MFI should pay the associated costs. The MFI should argue that the Issuing Bank’s costs of business are covered by the fee it charges. The MFI might ask why both charges, apparently covering the same costs, are required. The MFI might also point out that other provisions of the Reimbursement Agreement also provide for payment by the MFI of unforeseen costs (see, e.g., Sections 4, 5, and 6 below). If the Issuing Bank is inflexible on this point, the MFI must be aware that it may incur significant costs if this provision is not carefully drafted. The addition of the words “reasonable and documented” may help to insulate the MFI from excessive costs. The MFI also may seek to place a limit (a “cap”) on the amount of fees and expenses it is required to pay under this clause.

3. Payments; Interest on Past Due Amounts; Computations. All amounts due from Applicant shall be paid to Issuing Bank at \_\_\_\_\_ (or such other address notified to Applicant in writing), without defense, set off, cross-claim, or counterclaim of any kind, in United States Dollars<sup><8></sup> and in same-day funds<sup><9></sup>, provided, however, that if any such amount is denominated in a currency other than

United States Dollars, Applicant will pay the equivalent of such amount in United States Dollars computed at Issuing Bank's selling rate for cable transfers to the place where and in the currency in which such amount is payable, or such other currency, place, form, and manner acceptable to Issuing Bank in its sole discretion. Any amount not paid when due shall bear interest until paid in full at a daily fluctuating interest rate per annum equal to [two percent (2.00%) per annum]<sup><10></sup> above the rate of interest announced publicly from time to time by Issuing Bank in New York as Issuing Bank's Base Rate<sup><11></sup>. Applicant authorizes Issuing Bank to charge any account of Applicant for any amount when due<sup><12></sup>. Unless otherwise agreed in writing as to the Letter of Credit, all computations of commissions, fees, and interest shall be based on a 360-day year and actual days elapsed<sup><13></sup>.

**8. Currency of Repayment:** Under most circumstances, the amount of hard currency deposited as collateral for the Letter of Credit will be equal to the face value of the Letter of Credit, and both will be denominated in the same hard currency. Therefore, the amount of cash collateral should be sufficient to cover the amount of the MFI's reimbursement obligation with respect to the face amount of Drafts drawn by the Local Bank under the Letter of Credit. However, the MFI may have to make additional payments to the Issuing Bank following a Draft, to cover additional amounts like any accrued and unpaid fees under this Section and any additional fees payable pursuant to other provisions of the Reimbursement Agreement (see, e.g., Sections 2 above, and 4, 5, and 6 below). Or the MFI may have successfully negotiated for a less than fully collateralized Letter of Credit, thereby allowing it to get some leverage from the hard currency loan it obtained. In all such cases, any additional payments will have to be made in U.S. dollars (or such other currency as the parties may agree in this provision) pursuant to the prescribed payment method (see Annotation 9). The clause governing the repayment currency will be relevant if the Letter of Credit is denominated in a currency other than the hard currency deposit, or if the total amount owed by the MFI (including fees and adjustments pursuant to this Agreement) is greater than the amount in deposit in the Account.

**9. Payment Method:** This clause describes the mechanics of repaying the Issuing Bank if the Local Bank draws upon the funds available under the Letter of Credit. The most common types of funds the MFI will be asked to use in repayment are as follows:

- “immediately available funds” (the Issuing Bank will have access to the money immediately upon crediting to its account);
- “same-day funds” (the Issuing Bank will receive the funds “for value” the day [but not the instant] they are credited to its account); and
- “next-day funds” (the Issuing Bank can use the money only the day *after* it is credited to its account).

Before agreeing to a provision specifying one of these particular types of funds, the MFI should ascertain that the provider of wire transfer services it intends to use for such purposes offers transfers in the relevant type of funds and that the costs of such service are acceptable to the MFI.

**10. Applicable Interest Rate:** The size of the penalty margin is a subject of frequent negotiation. One percent or 2 percent above the Issuing Bank’s base interest rate is typical, but banks sometimes ask for much more. In some countries, penalty interest is prescribed or limited by statute.

**11. Interest for Repayments Not Paid When Due:** Many reimbursement agreements specify that the interest rate on overdue reimbursement payments will be higher than the interest rate applicable to a loan for the same amount of principal. The purpose of this increase is to compensate the Issuing Bank for the additional risk and administrative expense involved in a reimbursement obligation that is, by definition, in default. The higher interest rate is designed to give the MFI an added financial incentive to cure the payment default.

**12. Negotiation Point:** If the set-off provision has been negotiated to exclude certain amounts due from the Issuing Bank to the MFI from the Issuing Bank’s right of set off (see Section 18 and the corresponding Annotations), this sentence should be removed or edited so as to be subject to the same limitations.

**13. Calculation of Interest Period:** The computation basis, or day-count fraction, set forth above is used for calculating interest for periods shorter than a year at rates that are expressed as annual rates. This Reimbursement Agreement uses a 360-day year, with the corresponding day-count convention typically referred to as “actual/360” or “actual over 360.” This is the same day-count fraction customarily used in LIBOR-based floating rate loans and is therefore likely to be the one used in the MFI’s corresponding hard currency loan agreement. However, other day-count fractions also are in use. For example, loans in U.S. dollars priced on the basis of the U.S. prime rate are often computed on the basis of actual days over 365 (or 366 in leap years), with the result that the interest due for each entire year actually equals the stated rate. The choice of day-count convention is important, because interest based on actual/360 will result in a larger annual interest payment than interest based on the actual/365 or actual/actual. Accounting for a leap year by basing the day-count computation on “a year of 365 or 366 days, as the case may be,” will save additional interest.

4. Additional Costs<sup>14</sup>. If Issuing Bank determines that the introduction or effectiveness of, or any change in, any law or regulation or compliance with any guideline or request from any central bank or other governmental or quasi-governmental authority (whether or not having the force of law) affects or would affect the amount of capital or reserves required or expected to be maintained by Issuing Bank or any corporation controlling Issuing Bank and Issuing Bank determines that the amount of such capital or reserve is increased by or based on the existence of the Letter of Credit, then Applicant shall pay Issuing Bank on demand from time to time additional amounts sufficient in Issuing Bank’s judgment to compensate for the increase. Issuing Bank’s certificate as to amounts due shall be conclusive, in the absence of manifest error.

**14. Purpose:** This sort of provision is fairly standard for reimbursement agreements and for most loan agreements. The Issuing Bank’s fees that it charges the MFI in exchange for issuing the Letter of Credit are meant to cover the Issuing Bank’s costs and to earn a certain amount of profit. The Issuing Bank is concerned about the risk that future laws and regulations governing banks may increase its

costs. With this Section, the Issuing Bank is transferring the risk of such future government regulation on to the MFI and preserving its profit margin.

**Negotiation Point:** The MFI could try to condition its payment of increased costs incurred by the Issuing Bank on the Issuing Bank's taking reasonable steps (such as charging its lending branch or office) to mitigate the costs. The Issuing Bank will probably agree to such a provision only if the actions the Issuing Bank would have to take to mitigate the additional costs are themselves cost-free and do not otherwise harm the Issuing Bank's operations. The MFI also could request that, in the event that it is required to pay increased costs despite the Issuing Bank's efforts to mitigate, the Issuing Bank allow the MFI to assign the transactions to another bank to avoid incurring the increased costs. This will, of course, require the MFI to ensure that the Local Bank will be willing to accept a replacement letter of credit from the new bank as collateral for the Local Loan.

**Negotiation Point:** A point the MFI should address, if raised by the Issuing Bank's draft, is that additional cost provisions should not (and in the context of loan agreements often do not) cover increases in income tax in the Issuing Bank's own country or in the country of its branch office that is working with the MFI. The Issuing Bank would be facing such a cost regardless of whether it was issuing the Letter of Credit on the MFI's behalf or not, and the MFI should not be acting as the Issuing Bank's insurer for this type of risk. Furthermore, this additional costs provision should not duplicate the treatment of other taxes besides income taxes that are dealt with elsewhere in the Reimbursement Agreement. See Section 5.

**Negotiation Point:** Last, the MFI can try to limit the retroactivity of any claims for increased costs that the Issuing Bank may have. For example, the Issuing Bank would have 90 days to give notice to the MFI of its increased costs following the effectiveness of the government action that gave rise to the increased costs in the first place. If the Issuing Bank did not make an increased costs claim during that period, it would be precluded from doing so in the future. Finally, the MFI could request a clause specifying that the increased costs charged to the MFI will not exceed the costs imposed to other similarly situated borrowers by the Issuing Bank.

5. Taxes<sup><15></sup>. All payments made to Issuing Bank shall be made free and clear of and without deduction for any present or future taxes, levies, imposts, deductions, charges, or withholdings, and all related liabilities imposed by the Republic of Ruritania or any political subdivision or taxing authority thereof or therein or any other jurisdiction from or through which the Borrower makes payment hereunder<sup><16></sup> (all such taxes, levies, imposts, deductions, charges, withholdings, and liabilities are called “Taxes”). If any Taxes shall be required by law to be deducted from or in respect of any sum payable under this Agreement, (a) the sum payable under this Agreement shall be increased as may be necessary so that, after making all required deductions, Issuing Bank receives an amount equal to the sum Issuing Bank would have received had no such deductions been required, (b) Applicant shall be responsible for payment of the amount to the relevant taxing authority, (c) Applicant shall indemnify Issuing Bank on demand for any Taxes paid by Issuing Bank (other than Taxes for which no additional amounts are payable pursuant to this section 5) and any liability (including penalties, interest, and expenses) arising from its payment or in respect of such Taxes, whether or not such Taxes were correctly or legally asserted<sup><17></sup>, and (d) Applicant shall provide Issuing Bank with the original or a certified copy of the receipt evidencing each Tax payment within 30 days of the tax payment date<sup><18></sup>; [optional language: provided, however, that no such additional amounts shall be payable in respect of<sup><19></sup>] [☺ (i) any Taxes imposed on the Issuing Bank by reason of any connection between the Issuing Bank and the taxing jurisdiction other than entering into this Agreement and receiving payments hereunder<sup><20></sup>] [☺ or (ii) any Taxes imposed by reason of the Issuing Bank’s failure to comply with any certification, identification, information, documentation, or other reporting requirement if (A) such compliance is required by law, regulation, administrative practice, or an applicable treaty as a precondition to exemption from, or reduction in the rate of, deduction or withholding and (B) at least [30 days] prior to the first Payment Date with respect to which the Applicant shall apply this subsection (ii), the Applicant shall have notified the Issuing Bank that the Issuing Bank will be required to comply with such requirement<sup><21></sup>.] [☺ Notwithstanding the foregoing, in the event of an assignment and delegation by the Issuing Bank of its rights and obligations under this Agreement, the Applicant shall not be required to pay to such assignee or successor any amount greater than that which the original Issuing Bank would have been entitled to receive with respect to the rights assigned<sup><22></sup>.]



15. **Purpose:** The MFI's (or the Issuing Bank's) jurisdiction may impose a tax on payments made under the Reimbursement Agreement, which such jurisdiction collects by requiring the MFI to withhold or deduct the amount of the tax from payments to the Issuing Bank. The Issuing Bank requires this tax "gross up" clause to shift to the MFI the risk that a withholding tax is or might be imposed on payments due under the agreement. The provision requires the MFI to gross-up its payments to ensure that the Issuing Bank receives the payment amount it would have received had there been no withholding tax. If the withholding tax is 20 percent and the gross-up amount itself is not subject to the tax, the MFI will have to pay \$120 (\$100 plus a gross-up amount of \$20) in respect of each \$100 payment due the Issuing Bank. If the gross-up amount is also subject to the 20 percent withholding tax (which is typically the case), then the MFI will have to pay \$125 in respect of each \$100 payment due the Issuing Bank, calculated by dividing \$100 by  $(100\% - 20\%)$ . Only by paying the Issuing Bank \$125 will the Issuing Bank receive the \$100 payment due (after 20% of the \$125 is withheld).

16. **BEWARE!** Although it may be fair for the Issuing Bank to seek a gross up for taxes imposed by the jurisdiction where the MFI is organized, a gross-up clause that purports to shift to the MFI the risk of any tax being imposed anywhere in the world on payments due under the loan agreement is unreasonable and the MFI should avoid it. The model clause above is limited to taxes imposed by (i) the jurisdiction in which the MFI is organized (in this case, Ruritania) and (ii) any other jurisdiction from or through which the MFI makes payment. The rationale for having a gross up for taxes imposed by the jurisdiction through which the MFI makes payment is that the MFI will be able to control the method by which it makes payments and should therefore accept liability for any taxes imposed by a jurisdiction through which such payments are made.

17. **BEWARE!** The Issuing Bank may propose a version of this clause (c) that is inappropriately broad. The parenthetical exclusion of indemnity payments for amounts that are excluded under Section 5 is necessary to ensure that the indemnity clause does not supersede the exceptions set forth in Section 5 by requiring that the MFI reimburse the Issuing Bank for Taxes that otherwise would be

excluded (for example, the Issuing Bank's normal income Taxes). In addition, Issuing Banks frequently include the "whether or not such Taxes were correctly or legally asserted" language, although the MFI should take the position that it should not be required to indemnify the Issuing Bank for Taxes that clearly are incorrectly imposed. (Note that, because the Issuing Bank will expect to be indemnified in respect of such Taxes, it will have no incentive to challenge even the most frivolous tax claims.)

18. **BEWARE!** The provision of a receipt for payment of Taxes within 30 days may not be practicable in all jurisdictions. The MFI should be careful to agree to a time restriction that it will be able to meet.

19. The MFI should consider proposing one or more of the following exceptions to its obligation to gross-up payments in respect of taxes, in each case after taking into consideration the withholding and other tax laws in the applicable jurisdictions to assess the risk of such taxes being imposed on payments under the Reimbursement Agreement.

20. **First Optional MFI-Friendly Clause:** This clause carves out (excludes) from the MFI's gross-up obligation any Taxes the Issuing Bank would otherwise be responsible for, such as income taxes imposed by the Issuing Bank's taxing jurisdictions. This formulation is a MFI-favorable provision. A more Issuing Bank-favorable provision would specifically carve out income and franchise taxes imposed on an Issuing Bank by the Issuing Bank's taxing jurisdiction, thus leaving the MFI responsible for any other taxes imposed on the Issuing Bank by the taxing jurisdiction, even those not connected to the Reimbursement Agreement. An example of such a clause would be: "provided, however, that no such additional amounts shall be payable in respect of any Taxes imposed by the jurisdiction of Issuing Bank's head office or the office issuing the Letter of Credit or any of its political subdivisions."

21. **Second Optional MFI-Friendly Clause:** Clause (ii) carves out from the MFI's gross-up obligation any taxes imposed due to a failure of the Issuing Bank

to provide certification that would reduce or eliminate the withholding tax applicable to payments made by the MFI. The MFI should not be obligated to gross up for withholding tax at the maximum rate, when the rate can be reduced or eliminated if the Issuing Bank complies with certification requirements. Many jurisdictions require certification as a precondition to a reduction or elimination in the rate of withholding.

**22. Third Optional MFI-Friendly Clause:** This provision limits the obligation of the MFI so that it pays no amount to a subsequent Issuing Bank (the transferee, assignee, or successor, in this case) that is greater than the withholding tax rate of the original Issuing Bank (the transferor or assignor, in this case). An alternative way of protecting the MFI from paying additional amounts as a result of an assignment is to include language that restricts the assignment rights of the Issuing Bank completely or subjects it to the consent of the MFI.

6. Indemnification<sup><23></sup>. Applicant will indemnify and hold Issuing Bank and its officers, directors, affiliates, employees, attorneys, and agents (each, an “Indemnified Party”) harmless from and against any and all claims, liabilities, losses, damages, costs, and expenses including, without limitation, reasonable fees and disbursements of [☺ special] counsel<sup><24></sup>, other dispute resolution expenses (including fees and expenses in preparation for a defense of any investigation, litigation, or proceeding) and costs of collection that arise out of or in connection with or by reason of: (a) [⊗ the issuance of the Letter of Credit,]<sup><25></sup> (b) any payment or action taken or omitted to be taken in connection with the Letter of Credit (including any action or proceeding seeking (i) to restrain any drawing under the Letter of Credit, (ii) to compel or restrain the payment of any amount or the taking of any other action under the Letter of Credit<sup><26></sup>, (iii) to compel or restrain the taking of any action under this Agreement, or (iv) to obtain similar relief (including by way of interpleader, declaratory judgment, attachment, or otherwise), regardless of who the prevailing party is in any such action or proceeding), (c) the enforcement of this Agreement<sup><27></sup>, or (d) any act or omission, whether rightful or wrongful, of any present or future *de jure* or *de facto* government or governmental authority or any other cause beyond Issuing Bank’s control, except, in each case, to the extent such claim, liability, loss,

damage, cost, or expense is found in a final, nonappealable judgment by a court of competent jurisdiction to have resulted from such Indemnified Party's gross negligence or willful misconduct<sup><28></sup>. Applicant will pay on demand from time to time all amounts owing under this section.

**23. Indemnification:** This provision establishes the MFI's obligation to "indemnify" the Issuing Bank—that is, the MFI will be required to make a payment to the Issuing Bank to compensate it for liabilities and expenses incurred by the Issuing Bank in connection with (i) any payment or action taken or omitted to be taken in connection with the Letter of Credit, (ii) enforcing the Reimbursement Agreement, and (iii) government acts beyond the Issuing Bank's control. Two potentially significant sources of indemnification by the MFI under this Section are the following:

**24. Special Counsel:** The MFI should resist paying the fees of the Issuing Bank's "in-house" (as opposed to "special" or "outside") counsel.

**25. Normal Course Expenses:** Note that, under this model Reimbursement Agreement, expenses incurred by the Issuing Bank in connection with negotiating, documenting, and administering the Letter of Credit, and other "normal course" expenses of the Issuing Bank, should be covered by the fee charged under Section 2. Accordingly, the MFI should carefully review the indemnification provision to ensure it does not provide an avenue for the Issuing Bank to charge such additional costs and expenses to the MFI in addition to the fee set forth in Section 2. The indemnification provision should be limited to a specific and narrow list of extraordinary expenses. The same comment applies to the MFI's basic reimbursement obligation, which is covered by Section 1.

**26. Actions to Restrain Payment under the Letter of Credit:** Under clause (b)(ii), the Issuing Bank is entitled to indemnification for costs and expenses incurred in connection with legal actions by the MFI to restrain payments under the Letter of Credit. Thus, even though the UCC allows the MFI, under certain circumstances, to obtain an injunction restraining payment to the Local Bank under

the Letter of Credit if the MFI establishes that the payment request is fraudulent, the MFI will have to reimburse the Issuing Bank's costs and expenses in defending against such an action (including attorneys' fees), even if the MFI prevails.

**27. Enforcement Proceedings:** In some jurisdictions (the United States, for example), a party's expenses incurred in enforcing a contract through litigation are not automatically recoverable even if that party wins the lawsuit. This explains the Issuing Bank's desire to have the agreement contain a separate undertaking by the MFI to pay such enforcement expenses. Under clause (c), the Issuing Bank is entitled to indemnification for costs and expenses incurred in enforcing the Reimbursement Agreement. Therefore, if the Issuing Bank alleges that the MFI has defaulted under the Reimbursement Agreement and initiates legal proceedings, the MFI will have to reimburse the Issuing Bank's costs and expenses in connection with that action (including attorneys' fees).

**28. Gross Negligence or Willful Misconduct:** Importantly, the model clause above excludes fees and expenses arising out of the Issuing Bank's gross negligence or willful misconduct. Such a carve out should always be included, and the MFI should verify that it is drafted so as to cover all types of indemnification claims (in this case, by the inclusion of the words "in each case").

7. Obligations Absolute: Limitations of Liability<sup><29></sup>. (a) Applicant's obligations under this Agreement (the "Obligations") shall be unqualified, irrevocable, and payable in the manner and method provided for under this Agreement irrespective of any one or more of the following circumstances: (i) any lack of validity or enforceability of this Agreement, the Letter of Credit, or any other agreement, application, amendment, guaranty, document, or instrument relating thereto, (ii) any change in the time, manner, or place of payment of or in any other term of all or any of the Obligations of Applicant or the obligations of any person or entity that guarantees the Obligations, (iii) the existence of any claim, set off, defense, or other right that Applicant may have at any time against any beneficiary or any transferee of the Letter of Credit (or any person or entity for whom any such beneficiary or transferee may be acting), Issuing Bank or any other person or entity, whether in

connection with any transaction contemplated by this Agreement or any unrelated transaction, or any claim by Issuing Bank or Applicant against the beneficiary of the Letter of Credit for breach of warranty, (iv) any exchange, release, or nonperfection of the Collateral (as hereafter defined) or other collateral, or release or amendment or waiver of or consent to departure from the terms of any guarantee or security agreement, for all or any of the Obligations, (v) any Draft, or other document presented under the Letter of Credit being forged, fraudulent, invalid, or insufficient or any statement therein being untrue or inaccurate<sup><30></sup>, (vi) any failure by Issuing Bank to issue the Letter of Credit (or any amendment) as requested, unless Issuing Bank receives written notice from Applicant of such error within [⊕ three business days] after Applicant shall have received a copy of the Letter of Credit (or such amendment) and such error is material and consequential<sup><31></sup>, (vii) any previous Obligation, whether or not paid, arising from Issuing Bank's payment against any Draft, certificate, or other document that appeared on its face to be signed or presented by the proper party but was in fact signed or presented by a party posing as the proper party<sup><32></sup>, (viii) [⊕ payment by Issuing Bank under the Letter of Credit against presentation of a Draft or other document that does not comply with the terms and conditions of the Letter of Credit unless Issuing Bank receives written notice from Applicant of such discrepancy within [⊕ three business days] following Applicant's receipt of such Draft or other document]<sup><33></sup>, and (ix) any action or inaction taken or suffered by Issuing Bank or any of its correspondents in connection with the Letter of Credit or any relevant Draft, certificate, other document, or collateral, if taken in good faith (i.e., honesty in fact in the conduct or transaction concerned, "Good Faith") and in conformity with applicable U.S. or foreign law or letter of credit practices. (b) Without limiting any other provision of this Agreement, Issuing Bank and any of its correspondents: (i) may rely upon any oral, telephonic, telegraphic, facsimile, electronic, written, or other communication believed in Good Faith to have been authorized by Applicant, whether or not given or signed by an authorized person [⊕, subject to the provisions of Section 22]<sup><34></sup>, (ii) shall not be responsible for errors, omissions, interruptions, or delays in transmission or delivery of any message, advice, or document in connection with the Letter of Credit, whether transmitted by courier, mail, telex, any other telecommunication, or otherwise (whether or not they be in cipher), or for errors in interpretation of technical terms or in translation (and Issuing Bank and its correspondents may transmit Letter of Credit terms without translating them), (iii) shall not be responsible for the identity or authority of any signer or the form, accuracy, genuineness, falsification, or legal effect of any

Draft, certificate, or other document presented under the Letter of Credit if such Draft, certificate, or other document on its face appears to be in accordance with the terms and conditions of the Letter of Credit, (iv) shall not be responsible for any acts or omissions by or the solvency of the beneficiary of the Letter of Credit or any other person or entity having any role in any transaction underlying the Letter of Credit<sup><35></sup>, (v) may accept or pay as complying with the terms and conditions of the Letter of Credit any Draft, certificate, or other document appearing on its face (A) [*variants: substantially or strictly*] to comply with the terms and conditions of the Letter of Credit<sup><36></sup>, (B) to be signed or presented by or issued to any successor of the beneficiary or any other person in whose name the Letter of Credit requires or authorizes that any Draft, certificate, or other document be signed, presented, or issued, including any administrator, executor, personal representative, trustee in bankruptcy, debtor in possession, liquidator, receiver, or successor by merger or consolidation, or any other person or entity purporting to act as the representative of or in place of any of the foregoing<sup><37></sup>, or (C) to have been signed, presented, or issued after a change of name of the beneficiary<sup><38></sup>, (vi) may disregard (A) any requirement stated in the Letter of Credit that any Draft, certificate, or other document be presented to it at a particular hour or place and (B) [⊗ any discrepancies that do not [materially] reduce the value of the beneficiary's performance to Applicant in any transaction underlying the Letter of Credit]<sup><39></sup>, (vii) may accept as a Draft any written or electronic demand or other request for payment under the Letter of Credit, even if such demand or other request is not in the form of a negotiable draft, (viii) shall not be responsible for the effectiveness or suitability of the Letter of Credit for Applicant's purpose, or be regarded as the drafter of the Letter of Credit regardless of any assistance that Issuing Bank may, in its discretion, provide to Applicant in preparing the text of the Letter of Credit or amendments thereto<sup><40></sup>, (ix) shall not be liable to Applicant for any consequential or special damages, or for any damages resulting from any change in the value of any foreign currency, services, or goods or other property covered by the Letter of Credit, (x) may assert or waive application of UCP (as defined below) Articles 17 (*force majeure*) and 45 (hours of presentation) [and all other UCP articles primarily benefiting bank issuers]<sup><41></sup>, (xi) may honor a previously dishonored presentation under the Letter of Credit, whether pursuant to court order, to settle or compromise any claim that it wrongfully dishonored, [⊗ or, [⊙ with Applicant's prior written consent,] otherwise], and shall be entitled to reimbursement to the same extent as if it had initially honored [⊙ plus reimbursement of any interest paid by it]<sup><42></sup>, and (xii) may pay any paying or negotiating bank (designated

or permitted by the terms of the Letter of Credit) claiming that it rightfully honored under the laws or practices of the place where it is located [☺ in good faith and without notice or forgery or material fraud]<sup><43></sup>. None of the circumstances described in this section shall place Issuing Bank or any of its correspondents under any resulting liability to Applicant.

**29. Purpose:** In this Section, the Issuing Bank is asking the MFI to waive or limit a number of rights the MFI might otherwise have under the UCC and, in certain cases, under the UCP or ISP98. U.S. law requires that waivers of the MFI's rights or limitations on Issuing Bank's liability be made specifically rather than generally to be effective. This explains why this Section of the Reimbursement Agreement may be quite lengthy because the Issuing Bank tries to present a long list of possible scenarios. Not all of these scenarios are equally relevant to the MFI's concerns in this transaction. The Annotations below cover some of the most important provisions and variations.

**30. Forgery and Fraud:** Intuitively, one might assume that if the Local Bank forges documents and presents them to the Issuing Bank with a draft under the Letter of Credit, the Issuing Bank ought not to honor the draft, or even if it does, the MFI ought not to be liable for reimbursing the Issuing Bank. However, as explained in greater detail in the introduction to the model letter of credit provisions, the nature of letters of credit and reimbursement agreements is that each is an independent legal obligation that must be fulfilled, even in some cases where the Beneficiary under the Letter of Credit has made a fraudulent draft. This feature of letter of credit arrangements limits the Issuing Bank's liability to the MFI, but it does not limit the legal remedies the MFI may have against the Local Bank for having perpetrated the fraud.

UCC Section 5-109(b) permits an applicant to ask a court to prevent an issuing bank from paying a beneficiary the applicant believes has presented a fraudulent draft. Although this is an important provision, in practice it may be difficult for the MFI (or a local court) to act quickly enough to prevent the beneficiary from receiving the proceeds after it has submitted a fraudulent draft. Moreover, in some jurisdictions, courts may be reluctant to issue an injunction if the MFI could instead sue the Local Bank for money damages after the fact. See also Annotation 53 for further discussion.



**31. Waiver of Liability for Nonissuance:** In this clause, the Issuing Bank is asking the MFI to agree that even if the Issuing bank does not issue the Letter of Credit, or any amendments to it, exactly as requested by the MFI, that is not an excuse for the MFI not to pay the Issuing Bank any fees or reimbursements owed under the Reimbursement Agreement. There is an important qualification to this waiver provision as written above: the MFI does not waive its remedies if the error by the Issuing Bank is material *and* the MFI has given notice of the error to the Issuing Bank within a specified period. The materiality requirement is fairly straightforward. The second requirement is that a notice from the MFI to the Issuing Bank, stating that the Letter of Credit or amendment was not issued as instructed, must be received by the Issuing Bank within three business days after the MFI itself received that Letter of Credit or amendment. Three days is very likely too short a time for the MFI to be able to respond to the Issuing Bank with a notice, especially if they are geographically remote from one another. The MFI should negotiate for more time and carefully review the Letter of Credit when it is issued by the Issuing Bank, so as to be able to report any deficiencies within the period agreed in this clause.

**32. Party Posing as the Proper Party:** This clause is similar to the one dealing with forged or fraudulent documents. See Annotation 30. If the MFI has already agreed to incorporate the rules governing standby letters of credit in ISP98, this clause merely restates the ISP98 rule that the Issuing Bank has no obligation to ascertain the identity of the person making the drawdown request. Otherwise, the clause limits the Issuing Bank's obligations further than would be the case under the UCC and/or UCP, which do not contain such an Issuing Bank-favorable rule.

**33. Payment of a Noncompliant Draft:** Under applicable U.S. law, the issuer of a standby letter of credit normally has the responsibility, before honoring the Beneficiary's draft, to review the documents presented by the Beneficiary for compliance with the requirements of the Letter of Credit. This clause modifies this allocation by essentially shifting the Issuing Bank's responsibility to the MFI. Under this clause, the MFI must send a notice to the Issuing Bank within three business days of the MFI's receipt of a noncompliant draft or related documentation.

Otherwise, the MFI will be required to reimburse the Issuing Bank for the payment it has made to the Local Bank, even if the draft did not comply with the requirements of the Letter of Credit.

This clause therefore imposes on the MFI significant risks and responsibilities that should normally be assumed by the Issuing Bank in a letter of credit transaction. The clause also may limit the MFI's ability to exercise legal recourses against the Issuing Bank for wrongfully honoring a draft. If faced with such a clause, the MFI should negotiate against its inclusion. The MFI should point out that clause (b)(v), already substantially circumscribes the Issuing Bank's responsibilities in reviewing the documents presented by the Beneficiary. If the Issuing Bank is inflexible on this point, the MFI should negotiate for a more time and carefully review any drafts and accompanying documentation when they are received, to be able to report any noncompliance within the period agreed in this clause. As in clause (vi) above, three days is most likely not enough time for the MFI to identify any discrepancies in the presented documents and provide notice to the Issuing Bank.

Rule 5.09 of the ISP98 includes a similar rule requiring the Applicant to "timely object" to an issuer's honor of a noncomplying presentation. The official commentary to the ISP98 specifies that the objection must normally be made within seven days. Like the clause described above, Rule 5.09 of the ISP98 significantly impairs the MFI's rights and, if the Letter of Credit incorporates the ISP98, the MFI should require that Rule 5.09 be excluded. See Annotation 108 and the accompanying provision for specific suggested language precluding the application of Rule 5.09.

**34. Method of Communication:** This subsection describes the acceptable methods of communication by the MFI to the Issuing Bank. Although unobjectionable under most circumstances, some of these methods may be too informal when it comes to amendments or waivers to be consented to by the MFI. The MFI should ensure this subsection remains subject to the amendment requirements in Section 22.

**35. No Responsibility for the Identity or Authority of the Signatory:** Clause (iii) is similar to that dealing with fraud and persons posing as someone else. See Annotations 30 and 32. Clause (iv) specifies that the Issuing Bank is not respon-

sible for acts, omissions, or creditworthiness of the beneficiary or other parties to the relationship.

**36. Strict or Substantial Compliance:** This clause defines the level of care with which the Issuing Bank is expected to examine the documentation the Local Bank will present when making a draft. Under the UCC, the Issuing Bank is obligated to honor a presentation only if the documents presented to the Issuing Bank by the Local Bank appear on their face to “strictly” comply with the requirements set out for such documents in the Letter of Credit. Under the UCP, the Issuing Bank has an additional duty to examine the documents with “reasonable care.” Under the ISP98, the strictness of compliance of the documents presented with the requirements of the Letter of Credit varies depending on the wording of the Letter of Credit, with the default being that the presented documents merely have to appear to convey the same meaning as what is required by the Letter of Credit.

However, under this clause, if the Issuing Bank elects to pay under a draft that does not *strictly* comply but *substantially* complies, the MFI will nevertheless be obligated to reimburse the Issuing Bank. In other words, this clause bifurcates the Issuing Bank’s obligation to pay a draft drawn under the Letter of Credit—which is based on *strict* compliance—and the MFI’s obligation to reimburse the Issuing Bank for any payment under a draft—which is based on *substantial* compliance.

The Issuing Bank will seek as low a standard of review as possible, while the MFI should try to hold the Issuing Bank more accountable. “Strict” compliance generally will afford the MFI more protection than “substantial” compliance. However, it may serve the MFI’s interests for the Local Bank to be able to draw upon the Letter of Credit despite making an immaterial mistake in its documentation. The MFI should take care to avoid waiving the “reasonable care” duty of the Issuing Bank under the UCP (if applicable) even if it accepts that only “substantial” compliance is necessary before the Issuing Bank will honor the Local Bank’s draft.

**37. Signature by Successors to the Beneficiary:** This subsection merely restates the applicable law with respect to successors of the Local Bank. For example, when the beneficiary of a letter of credit goes bankrupt or merges into another company,

the applicable law treats the drawing rights held by the original beneficiary under the Letter of Credit as having transferred to another entity (e.g., the trustee in bankruptcy or the surviving company after the merger). This sort of transfer often is called a “transfer by operation of law” because the transfer of the drawing rights is done automatically without any specific action required on the part of the original beneficiary beyond the act of filing for bankruptcy or merging into another company. There is nothing inherently objectionable with allowing successors of the Local Bank to draw on the Letter of Credit apart from the underlying nature of the transaction necessitating the succession—the MFI would be understandably concerned if the Local Bank filed for bankruptcy, for example. There is an important distinction between this type of automatic succession provision and a provision allowing the Local Bank to assign its rights under the Letter of Credit. Although the former should generally be acceptable, the MFI should generally resist the latter for the reasons discussed in Annotation 6 in the Model Standby Letter of Credit.

**38. Beneficiary Name Changes:** The applicable law in the United States treats entities that have changed their names as it does any other “transfer by operation of law.” See Annotation 37.

**39. Discrepancies:** This provision would allow the Local Bank to present non-compliant documents and be paid by the Issuing Bank as long as the value of the Local Bank’s performance to the MFI under the Local Loan Agreement was not reduced by the discrepancy. This provision was drafted primarily with a commercial letter of credit in mind. With a commercial letter of credit where the beneficiary will draw upon the Letter of Credit as payment for a sale of goods upon the presentation of written proof that goods were shipped, for example, some discrepancies in the performance of the Beneficiary (i.e., the seller) may be fairly self-evident from the documents presented. Furthermore, it may also be self-evident that such a discrepancy has caused a decrease in the value of the performance (e.g., fewer goods were listed in a proof of shipment than were contemplated in the text of the commercial letter of credit). In the context of a standby transaction, however, the Issuing Bank is unlikely to be able to discern from the mere presentation of documents whether or not any discrepancy has decreased the value of the Local

Bank's performance under the Local Loan Agreement. If the MFI is faced with such a clause, the MFI should negotiate for its deletion or request that the Issuing Bank justify the clause by explaining how it would be applied in the standby context.

**40. Suitability for Applicant's Purpose/Drafting:** This provision reduces the possibility that the MFI or a court would be able to claim or find an implied warranty of some sort in this Agreement or the Letter of Credit. In some circumstances, manufacturers of goods or providers of services are bound by certain legally created warranties (e.g., warranties that a product or service will be effective for the purpose or application that it was intended) whether or not they clearly state such warranties to their customers. This provision makes it clear that the Issuing Bank is not intending, by this Agreement, to extend to the MFI a warranty that the Letter of Credit will be able to mitigate the MFI's foreign exchange risk as contemplated. This is yet another reason why the MFI should carefully review and, to the extent possible, negotiate the relevant provisions.

**41. Asserting or Waiving UCP Provisions:** The Issuing Bank is trying to maintain maximum flexibility with this provision by reserving for itself the power to selectively apply the provisions of the UCP when that would suit its needs. Article 17 of the UCP excuses the Issuing Bank from being responsible for honoring drafts under the Letter of Credit in the event of a *force majeure* event (such as a natural disaster, war, or strike) and states that the expiration of the Letter of Credit will not be extended by the length of the duration of the *force majeure* event. (For more on this latter point and avoiding a mismatch with the MFI's obligations under its hard currency loan agreement, see Annotation 2). UCP Article 45 provides that the Issuing Bank need not accept any drafts or documents from the Local Bank outside the Issuing Bank's normal banking hours. The last phrase, which reserves to the Issuing Bank the right to apply or waive "all other UCP articles primarily benefiting bank issuers," does not appear to add anything to this Agreement that the adoption of the UCP provisions in Section 25 does not already accomplish. Once the MFI and the Issuing Bank agree that the UCP applies to this Agreement and the Letter of Credit, the Issuing Bank may waive any provisions that benefit it regardless of the existence of this provision.

**42. Reinstatement of Wrongfully Dishonored Drafts:** In cases where the Issuing Bank dishonors the presentation of a draft by the Local Bank and it later develops that such dishonor was improper or if the Issuing Bank simply changes its mind about dishonoring such draft (e.g., in case of a settlement with the Local Bank), the Issuing Bank may pay the Local Bank as if its original draft were valid and then expect to be reimbursed by the MFI under this Agreement. This provision, although it may create timing problems for the MFI in case of a protracted dispute and may require the MFI to secure alternative financing arrangements before expiration of the hard currency loan, is justifiable in cases where a court order reinstates a dishonored draft. However, as drafted here, this provision grants the Issuing Bank far too much freedom to change its mind about drafts by the Local Bank (e.g., note the word “otherwise”). The MFI should be willing to allow the Issuing Bank some flexibility in settling claims with the Local Bank, but should insist on a requirement for its consent before the Issuing Bank reinstates a previously dishonored claim without a court order. Furthermore, the MFI should resist agreeing to reimburse the Issuing Bank for any interest owed to the Local Bank due to a wrongful dishonor by the Issuing Bank. The MFI may want to review the provisions of the Local Loan Agreement to determine at what time the exchange rate would be determined in respect of a draft that is initially dishonored and later reinstated (i.e., the exchange rate prevailing at the time of the initial draft or at the time of reinstatement).

**43. Payments to a Paying or Negotiating Bank:** The Issuing Bank may nominate another bank to make payments to the Local Bank, which the Issuing Bank would then reimburse to the “paying bank” and for which the Issuing Bank would ultimately expect reimbursement from the MFI. As a general matter, there is nothing for the MFI to be concerned about in such an arrangement. The existence of a paying bank becomes relevant to the MFI when there is a fraud or forgery being perpetrated either in the presentation of the draft itself or in the underlying transaction, the Local Loan Agreement. In such circumstances under the applicable U.S. law, the Issuing Bank must still honor requests for reimbursement by the paying bank as long as the paying bank has already honored the fraudulent draft in good faith and had no notice of the fraud or forgery. This provision, however, states that

the Issuing Bank has to repay the paying bank (and by implication, the MFI has to repay the Issuing Bank) as long as the paying bank complied with the laws applicable to letters of credit in its own jurisdiction. The MFI may wish to include further requirements for “good faith” and lack of notice of fraud or forgery on the part of the paying bank to make sure it is not waiving its baseline of protections under U.S. letter of credit law.

8. Independence<sup><44></sup>. Applicant acknowledges that the rights and obligations of Issuing Bank under the Letter of Credit are independent of the existence, performance, or non-performance of any contract or arrangement underlying the Letter of Credit, including contracts or arrangements between Issuing Bank and Applicant and between Applicant and the Beneficiary of the Letter of Credit. Issuing Bank shall have no duty to notify Applicant of its receipt of a Draft, certificate, or other document presented under the Letter of Credit or of its decision to honor the Letter of Credit. Issuing Bank may, without incurring any liability to Applicant or impairing its entitlement to reimbursement under this Agreement, honor the Letter of Credit despite notice from Applicant of, and without any duty to inquire into, any defense to payment or any adverse claims or other rights against the Beneficiary of the Letter of Credit or any other person. Issuing Bank shall have no duty to request or require the presentation of any document, including any default certificate, not required to be presented under the terms and conditions of the Letter of Credit. Issuing Bank shall have no duty to seek any waiver of discrepancies from Applicant, nor any duty to grant any waiver of discrepancies the Applicant approves or requests. Issuing Bank shall have no duty to extend the expiration date or term of the Letter of Credit or to issue a replacement letter of credit on or before the expiration date of the Letter of Credit or the end of such term.

44. **Purpose:** Much of this provision merely restates the independence principle, which is one of the hallmarks of letter of credit law. Namely, letters of credit and reimbursement agreements are independent legal obligations. What this means for the MFI is that even if the Local Bank breaches the Local Loan Agreement—for example by drawing on the Letter of Credit even though the MFI has not defaulted on its local currency loan—it is very likely that the MFI still will be obli-

gated to reimburse the Issuing Bank under this Agreement. What is more, the Issuing Bank would not be required to obey any notice from the MFI stating that the Issuing Bank should not honor an impending improper draft by the Local Bank. Although the MFI would have little time to act, this provision would not preclude the MFI from going to a court and asking for a judicial order to prevent the Issuing Bank from honoring the Local Bank's fraudulent (as opposed to merely deficient) draft. See Annotation 30 for further discussion of this potential remedy.

9. Nondocumentary Conditions<sup><45></sup>. Issuing Bank is authorized (but shall not be required) to disregard any nondocumentary conditions stated in the Letter of Credit<sup><46></sup>.

**45. Purpose:** This section restates the applicable law on letters of credit. Under U.S. law, a letter of credit is defined as "a definite undertaking...to honor a documentary presentation by payment or delivery of an item of value." This means that the Issuing Bank does not have to take into account any preconditions in the Letter of Credit before it honors the Local Bank's draft, aside from the documents listed in the Letter of Credit that must be presented by the Local Bank along with its draft. For example, the Issuing Bank would be free to disregard a requirement in the Letter of Credit that the MFI must have defaulted on its local loan before the Issuing Bank can honor a draft by the Local Bank (i.e., the Issuing Bank could not be obligated to judge whether or not the MFI was in default). In contrast to that example, however, the Model Letter of Credit requires that draft be accompanied by the presentation of a written document from the Local Bank stating that the MFI had defaulted on the local loan, and that requirement is a valid *documentary* condition that the Local Bank has to fulfill before drawing on the Letter of Credit.

**46. Negotiation Point:** The applicable law in the United States and the ISP98 both have as a default rule that nondocumentary conditions shall be disregarded by the Issuing Bank, while the UCP's default rule is that such conditions are to be disregarded by the Issuing Bank if the Letter of Credit does not spell out what documents ought to be presented to comply with such conditions. Because these are only default



rules, they may be modified by an agreement between the relevant parties. In this case, this Agreement modifies these rules on nondocumentary conditions to give the Issuing Bank discretion in determining whether or not to honor them. This provision is likely included by the Issuing Bank to protect itself against liability. However, it rarely will be relevant because most issuers will not issue a standby Letter of Credit containing a nondocumentary condition (and most beneficiaries will not accept such a letter of credit as security for the Applicant's obligations).

10. Transfers<sup><47></sup>. If, at Applicant's request, the Letter of Credit is issued in transferable form, Issuing Bank shall have no duty to determine the proper identity of anyone appearing in any transfer request, Draft, or other document as transferee, nor shall Issuing Bank be responsible for the validity or correctness of any transfer.

**47. Transferability:** The Letter of Credit is transferable if it allows the Local Bank to request that the Issuing Bank honor a drawing from another person as if that person were the Local Bank. The Letter of Credit is not generally transferable unless the terms of the Letter of Credit explicitly say that it is. Because a transferable Letter of Credit opens the door to potential uncertainty as to what documentation will be acceptable after the Local Bank transfers the Letter of Credit drawing rights to a new beneficiary, the MFI should strongly resist agreeing to a transferable Letter of Credit. For further discussion of the transferability of the Letter of Credit, refer to Annotation 6 in the Model Standby Letter of Credit. Transferability of the Letter of Credit should be distinguished from automatic succession in circumstances such as a merger or bankruptcy of the Local Bank, discussed in Annotation 37.

11. Extensions and Modifications of the Letter of Credit<sup><48></sup>. This Agreement shall be binding upon Applicant with respect to any extension or modification of the Letter of Credit made at Applicant's request or with Applicant's consent. [⊕ Applicant's obligations shall not be reduced or impaired in any way by any agreement by Issuing Bank and the beneficiary of the Letter of Credit extending Issuing Bank's time to honor or to give notice of discrepancies and any such agreement shall be binding upon Applicant]<sup><49></sup>.

48. **Purpose:** The first sentence of this provision restates the applicable provisions in the U.S. UCC governing letters of credit: the MFI will be bound by any modifications to the Letter of Credit to which it has consented.

49. **BEWARE!** The applicable law also states that the MFI is not bound by any amendments to which it has not consented *unless* the MFI agrees in advance to waive that consent requirement. The last sentence of this provision would constitute a waiver by the MFI with respect to agreements between the Issuing Bank and the Local Bank to amend the terms of the Letter of Credit. The MFI should negotiate to avoid this result if at all possible. Otherwise, the MFI faces the possibility of the Issuing Bank and the Local Bank agreeing to change some term of the Letter of Credit that would create a mismatch between the MFI's obligations under this Agreement and its obligations to repay the hard currency loan. For example, if the Issuing Bank and the Local Bank agree to extend the Issuing Bank's time to honor drafts under the Letter of Credit, the Issuing Bank may extend the period of time the collateral must remain in the Account to cover such later drafts. Such an extension could potentially lead the MFI to default on the hard currency loan.

12. Collateral<sup><50></sup>. Applicant, as pledgor, hereby pledges to Issuing Bank, as the secured party, as security for Applicant's obligations from time to time under this Agreement, and grants to Issuing Bank a first priority continuing security interest in, the Account and all amounts deposited therein and proceeds thereof (collectively, the "Collateral")<sup><51></sup>. This lien against the Collateral (and any collateral requested pursuant to Section 13) shall remain in effect until Issuing Bank's liability under the Letter of Credit is extinguished and Applicant's obligations are paid<sup><52></sup>.

50. **Purpose:** This provision creates a security interest in favor of the Issuing Bank in the Account in which the MFI has deposited the proceeds of the hard currency loan pursuant to Section 1(b). This means that, upon an Event of Default, the Issuing Bank will be allowed to retain the funds in the Account in satisfaction of the sums owed by the MFI to the Issuing Bank. See Section 17 ("Remedies") and the cor-

responding Annotations for more details. Note that the Issuing Bank may omit such provision and instead rely exclusively on its right under Section 18 to offset its obligation to return the funds in the Account to the MFI against the MFI's obligations under this Reimbursement Agreement. As long as the set-off provision is not overbroad, the MFI should not have a strong preference for one technique over the other. On the scope of the set-off clause, see the Annotations to Section 18.

**51. Negotiation Point:** This illustrative provision is appropriately crafted to cover only the particular Account in which the proceeds of the hard currency loan—and no other funds—are to be deposited (and the funds themselves and their proceeds). However, the Issuing Bank's form may contain broader language granting the Issuing Bank security interests over a much wider range of the MFI's assets. For instance, forms of reimbursement agreements sometimes contain a collateral provision granting the Issuing Bank a security interest in "all goods, documents, instruments, securities, general intangibles, policies of insurance, and all proceeds and products thereof, in which Applicant may have or obtain any interest in connection with the Credit or any underlying transaction" (or similar language). Such language may be appropriate in some contexts, for instance for certain commercial letters of credit where, pending reimbursement by the applicant, the Issuing Bank will be holding a valuable negotiable instrument (such as a bill of lading representing the goods in transit). However, it is not appropriate in the context of this transaction. The MFI's reimbursement obligation already will be fully collateralized by the Account containing the proceeds of the hard currency loan in an amount equal to the face value of the Letter of Credit. As a result, the Issuing Bank does not need the additional collateral. In addition, the scope of the collateral covered by such language would be unclear. The Issuing Bank could interpret the collateral provision to include various assets of the MFI that it considers to have been obtained "in connection with" the underlying transaction—for example, the MFI's rights in microcredits funded with the Local Loan. Although it may not be possible to proceed against intangible assets under the legal system in force in the MFI's jurisdiction, the MFI should not rely on this fact alone. Instead, the MFI should resist the inclusion of any pledge language relating to collateral other than the Account.

**52. Negotiation Point:** The Issuing Bank’s form may contain language authorizing the Issuing Bank to file “financing statements” against the MFI with respect to the collateral. Financing statements are filings made in a central registry system to record a secured party’s interest in the collateral identified in the financing statement. When the security interest relates to certain types of collateral, the secured party must file a financing statement to “perfect” its security interest, i.e., to make it valid and enforceable against third parties so that the secured party will be given priority in the proceeds of such collateral in a liquidation of the debtor. However, in this case, the collateral consists of a deposit account where the secured party is also the bank where the Account is maintained (i.e., the Issuing Bank). Under New York law, no financing statement is necessary to perfect such a security interest (and any such financing statement is ineffective). Accordingly, the MFI should confirm with the Issuing Bank that no financing statement will be filed and request that the corresponding language be removed. If the collateral pledged to the Issuing Bank includes assets other than the Account, the MFI should ensure that any financing statements the Issuing Bank may file pursuant to the Reimbursement Agreement will not unduly interfere with the MFI’s control of its assets or with its financing activities (whether currently in place or planned).

13. Additional Bond or Collateral. If at any time Applicant shall seek to restrain or preclude payment of or drawing under the Credit or any court shall extend the term of the Credit or take any other action that has a similar effect, then, in each case, Applicant shall provide Issuing Bank with a bond or other Collateral of a type and value satisfactory to Issuing Bank as security for the Obligations<sup><53></sup>. [⊗⊗ If at any time and from time to time Issuing Bank, in its discretion, requires Collateral (or additional Collateral), Applicant will on demand assign and deliver to Issuing Bank as security for the obligations, Collateral of a type and value satisfactory to Issuing Bank or make such cash payment as Issuing Bank may require.]<sup><54></sup>

**53.** In certain circumstances, the MFI may commence proceedings against the Issuing Bank to prevent a drawing under the Letter of Credit (for instance, if a

fraudulent drawing appears to be imminent, see Annotation 30). However, if the MFI succeeds in restraining such drawing, but it later turns out that the resulting refusal by the Issuing Bank to honor the drawing was wrongful, the Issuing Bank may be obligated to indemnify the Local Bank for damages suffered as a result of such wrongful dishonor (in addition to the face amount of the Letter of Credit). This provision allows the Issuing Bank, in the event that the MFI attempts to restrain a drawing, to require additional Collateral to cover its potential liability to the Local Bank. Although such circumstances are unusual, the MFI should be aware that the additional Collateral will very likely need to be posted in hard currency within a short timeframe.

54. **BEWARE!** The second sentence allows the Issuing Bank, at its discretion, to require additional Collateral to be posted by the MFI. The MFI should be very careful to avoid the inclusion of any such clause in the Reimbursement Agreement. As discussed above (see Annotation 51), where the MFI's reimbursement obligation is fully collateralized by the hard currency in the Account, no additional Collateral should be necessary. The MFI should be conscious that, in some circumstances, there may be no additional hard currency collateral available for the MFI to post and that failure to post such additional Collateral when required by the Issuing Bank would constitute an Event of Default.

14. Covenants of Applicant<sup><55></sup>. Applicant will (a) comply with all U.S. and foreign laws, regulations, and rules (including foreign exchange control regulations, U.S. foreign assets control regulations, and other trade-related regulations) now or later applicable to the Letter of Credit, transactions related to the Letter of Credit, or Applicant's execution, delivery, and performance under this Agreement, and deliver to Issuing Bank, upon reasonable request, satisfactory evidence of such compliance<sup><56></sup>, (b) deliver to Issuing Bank, upon reasonable request, financial statements and other information concerning Applicant's financial condition and business operations<sup><57></sup>, [☺ which information shall be held in confidence,] (c) [☺ to the extent permitted by applicable law] permit Issuing Bank to inspect its books and records on reasonable notice<sup><58></sup> [☺; *provided* that any such inspections shall be at the expense of Issuing Bank and shall be conducted upon reason-

able advance notice, during normal business hours, and in a manner that will not unreasonably interfere with the Applicant's business, and that any information obtained by Issuing Bank in or as a result of such inspections shall be held in confidence<sup><59></sup>], (d) not create or permit to be created any lien or other encumbrance on any of the Collateral,<sup><60></sup> and (e) inform Issuing Bank promptly upon Applicant becoming aware of the occurrence of an Event of Default (as defined below)<sup><61></sup>.

**55. General Explanation of Covenants:** Covenants are promises about the future. In this context, covenants deal with the conduct and financial situation of the MFI *after* the Letter of Credit is issued. Failure to abide by a covenant is one possible basis for the Issuing Bank's declaration of an Event of Default and the exercise of its rights with respect to the hard currency collateral deposit. Covenants in *loan agreements* are usually heavily negotiated, because they can impose significant constraints on the borrower's conduct of its business.<sup>1</sup> Covenants, particularly covenants that impose certain financial requirements on the borrower, are seen as important by lenders, because repayment of the loan depends on maintenance of the borrower's creditworthiness on an ongoing basis after the loan is issued. However, because the MFI's reimbursement obligation under the Reimbursement Agreement typically will be fully collateralized by the MFI's cash collateral deposit with the Issuing Bank, the Issuing Bank's exposure to variations in the MFI's creditworthiness is much reduced relative to that of a lender. For this reason, the covenants in the Reimbursement Agreement should be shorter and less demanding than those under a loan agreement, as illustrated by the sample provision above. Nevertheless, the covenants should be carefully reviewed by the MFI to ensure that they do not impose requirements that would be difficult or costly for the MFI to meet given its particular circumstances. In addition, if the Issuing Bank is also the lender under the hard currency loan agreement, the MFI should request that any similar covenants in both agreements be harmonized so as to avoid duplicative requirements.

<sup>1</sup> For a full discussion of the principal types of covenants often found in hard currency loan agreements with MFIs, see the Model Loan Agreement (CGAP 2006).

**56. Compliance with Government Regulations:** A concern for the Issuing Bank is compliance with the laws of the MFI's home jurisdiction governing trade and foreign exchange (sometimes called "exchange controls"), because the penalties for failure to comply with them can be quite severe and may even make the agreement unenforceable. This area is primarily the responsibility of the MFI's local counsel, who should be asked to review this covenant.

**57. Financial Statements:** Before agreeing to such a clause, the MFI should ensure that the clause is not drafted in such a way as to require the MFI to produce financial statements or other documents the MFI does not currently prepare in the regular course of its business (for instance, financial statements audited by an external auditing firm, or financial statements prepared in accordance with U.S. GAAP, or reconciled to U.S. GAAP). For a discussion of this issue in the context of representations and warranties, see Annotation 66.

**58. Inspection by the Issuing Bank:** Some MFIs may not wish to include an inspection clause in the agreement. MFIs in certain businesses, particularly banks, may be subject to bank secrecy laws or other confidentiality requirements applicable to the MFI by law or contract that would make compliance with this clause unlawful. Other MFIs may be concerned about the confidentiality of their business plans.

**59. Optional Language:** The MFI may wish to include language clarifying that the Issuing Bank will assume all costs for such inspections or itemizing which costs the Issuing Bank will assume, and that the inspections will not unreasonably interfere with the MFI's business or violate any applicable laws (such as bank secrecy laws in the MFI's jurisdiction). Information that the Issuing Bank or the Issuing Bank's representative learns during such examinations should be subject to a confidentiality provision.

**60. Purpose:** This provision, which prohibits the MFI from pledging the Collateral to another creditor unless the pledge falls into one of the stated exceptions, is called the "negative pledge clause." The terms "liens" and "encumbrances" refer

to legal interests that lenders and others might acquire in the Collateral, as a result of a pledge of Collateral for example, that could impair any subsequent transfer or liquidation of that Collateral by the Issuing Bank in the event of nonpayment or insolvency by the MFI. This sample negative pledge clause, like the representation in Subsection 15(f), relates only to encumbrances affecting the Collateral. Although negative pledge clauses in loan agreements typically contain exceptions for certain “permitted liens,” such exceptions should not be necessary where the pledge is limited to a specific asset (in this case, the hard currency Account). However, the MFI should consider whether any liens affecting the Collateral might arise by operation of law in the MFI’s home jurisdiction and, if so, request an exception for such liens. As long as these potential liens would not affect the Issuing Bank’s prior lien on the Collateral, this should not be problematic.

**61. Notice of Event of Default:** The principal purpose of this clause is to require the MFI to inform the Issuing Bank of Events of Default (and sometimes other serious events) that are likely to be known to the MFI before they would be known to the Issuing Bank. Some Issuing Banks may insist on language to the effect that the failure by the MFI to give notice of an Event of Default will result in the MFI’s losing any cure period for that Event of Default.

15. Representations and Warranties of Applicant<sup><62></sup>. Applicant represents and warrants that (a) it is validly existing and in good standing under the laws of the jurisdiction in which it is organized<sup><63></sup>; (b) its execution, delivery, and performance of this Agreement are within its powers, have been duly authorized, do not contravene any contract binding on or affecting it or any of its properties, do not violate any applicable law or regulation, and do not require any notice, filing, or other action to or by any governmental authority<sup><64></sup>; (c) this Agreement is valid and binding upon Applicant<sup><65></sup>; (d) the [⊕ audited<sup><66><67></sup>] financial statements most recently received by Issuing Bank from Applicant [*variants*: ⊕ are complete and correct<sup><68></sup> or ⊕ are accurate]<sup><69></sup> and [have been certified by a firm of independent accountants as fairly presenting its financial condition in accordance with generally accepted accounting principles in the Republic of Ruritania], and there has been no material adverse change<sup><70></sup> in Applicant’s business, condition



(financial or otherwise), or results of operation since the date of such financial statements; (e) to the Applicant's knowledge, there is no pending or threatened action<sup><71></sup> that may materially adversely affect<sup><72></sup> its financial condition or business or that purports to affect the validity or enforceability of this Agreement, the Letter of Credit, or any transaction related to the Letter of Credit; (f) the Applicant has good title to the Collateral, free and clear of all liens or other encumbrances<sup><73></sup>; and [⊗ (g) neither the granting of any collateral security for the obligations, nor the issuance of the Letter of Credit, nor the making of any payment thereunder or the use of any proceeds thereof, constitutes or will constitute, or be part of, a preferential or fraudulent transfer or conveyance to anyone (including Issuing Bank and the Beneficiary of the Letter of Credit) under the United States Bankruptcy Code or any other applicable law<sup><74></sup>]. Each request by Applicant for a Letter of Credit shall constitute its representation and warranty that the foregoing statements are true and correct as if made on the date of such request<sup><75></sup>.

**62. General Explanation of Representations and Warranties:** The main purpose of the representations and warranties is to elicit information to enable the Issuing Bank to make an informed decision. The MFI makes representations and warranties with respect to facts that the Issuing Bank relies upon when agreeing to issue the Letter of Credit to the Local Bank. If any representation or warranty is determined to be inaccurate before the Letter of Credit is issued, the Issuing Bank may withhold the Letter of Credit. If the inaccuracy is discovered after issuance, the Issuing Bank can declare an Event of Default.

**63. Valid Existence and Good Standing:** The representation of the organization of the MFI is very common and has counterparts in all jurisdictions. The power to “consummate the transactions contemplated” is an essential legal prerequisite to the enforcement of the Reimbursement Agreement.

**64. Power to Execute Reimbursement Agreement:** Like the representation regarding the organization of the MFI, it is customary to find a representation in which the MFI represents that it has undertaken all necessary steps to execute the agreement (for example, authorization of the Letter of Credit application and Reimbursement Agreement by its board of directors). If certain requirements can

be accomplished only *after* the Agreement is signed, those requirements should be explicitly identified as not falling within the language of the relevant representation, and the MFI should be willing to add a covenant to complete such post-signing requirements promptly.

**65. Valid and Binding Agreement:** Like the representations before it, this representation is customary. The MFI represents that the Agreement has been executed and delivered properly and that the agreement is legal, valid, and binding on the MFI, subject to certain events that may affect that enforceability, notably insolvency proceedings.

**66. Financial Statements:** From the Issuing Bank’s viewpoint, this is one of the most important representations the MFI gives, as it relates to the financial condition of the MFI and any of its subsidiaries whose financial statements are consolidated with (integrated into) the MFI’s financial statements. The Issuing Bank may also request the MFI’s most recent unaudited quarterly financial statement. If accounting principles change frequently or if there is no recognized body of generally accepted principles of good accounting practice in the MFI’s home jurisdiction, it may be necessary to include a more precise description of the required financial reporting. However, unless the MFI’s financial statements are already prepared in accordance with U.S. GAAP, the MFI should avoid any such requirement, because reconciling its statements from local GAAP to U.S. GAAP would likely impose substantial costs on the MFI. For a discussion of this issue in the context of covenants, see Annotation 57.

**67. Optional Language:** The Issuing Bank may propose that the MFI’s financial statements be audited. If appropriate, the MFI could argue that the significant cost involved in producing audited financials would be overly burdensome for an MFI.

**68. Optional Language:** Although the words “complete and correct” are commonly included in this representation, if the MFI prepares its financial statements in accordance with the “fairly presenting” standard, the representation that such financial statements are “complete and correct” is often removed.

69. **Negotiation Point:** The MFI should strongly avoid representing that the financial statements are “accurate” and instead represent that they have been certified as “fairly presenting” the financial condition of the MFI (and, if appropriate, are “complete and correct”). This is because the audit report generated by the auditors generally states that the financial statements “fairly present” the MFI’s financial condition, and the MFI should represent no more than what the audit report itself states.

70. **Material Adverse Change:** This is a so-called MAC clause (which stands for “Material Adverse Change”). It is a statement by the MFI that its financial condition has not “materially” worsened since the date of the last financial statement (which may have been audited) delivered to the Issuing Bank (typically at the start of negotiations). Determining what is or is not a material adverse change is very often difficult. The consequences of not issuing the Letter of Credit on the ground that a material adverse change has occurred may be serious for the MFI. Therefore, the MFI should be wary of situations where the Issuing Bank unjustifiably invokes a material adverse change clause solely to avoid its letter of credit commitment. If a material adverse change has occurred in the MFI’s financial condition, then the language of this clause should be adjusted accordingly, assuming the Issuing Bank is still willing to issue the Letter of Credit. For a discussion of MAC clauses in the context of Events of Default, see Annotation 86.

71. **No Material Actions:** The main purpose of this representation is to require the MFI to investigate and fully disclose information about pending and threatened litigation, because financial statements include only limited disclosure on this subject. It is appropriate and important that the MFI include “knowledge” and “materiality” qualifiers with respect to threatened lawsuits and other contingencies to (i) prevent the Issuing Bank from declaring a default under the agreement or escaping from its commitment because the MFI does not disclose threatened litigation of which it was not aware and (ii) avoid having to list irrelevant litigation matters.

72. **Optional Language:** If any claim or dispute (whether or not currently being litigated or arbitrated) might have a material adverse effect on the agreement, it should be addressed in a schedule, including a statement that the schedule

contains a complete and accurate description of each claim or dispute. The Issuing Bank may also request a letter from the MFI's counsel describing outstanding litigation and gauging the likelihood of the opposing party's success in each case.

**73. Free of Liens:** In this representation, the MFI assures the Issuing Bank that the hard currency in the Collateral Account is not being used to secure debt owed to other lenders. This assurance is important to the Issuing Bank, because it wants priority access to the Collateral if an Event of Default occurs. See Annotation 60.

**74. Not a Fraudulent Conveyance or Preference:** The bankruptcy laws of many jurisdictions, including the United States, allow certain payments made to a creditor during a specified period before bankruptcy of the debtor to be recovered by the trustee (or other administrator) in the bankruptcy proceedings. Although the MFI, as a non-U.S. entity, is unlikely to become subject to proceedings under the U.S. Bankruptcy Code, the mention of "any other applicable law" in this clause would cover the local bankruptcy and insolvency laws of the MFI's jurisdiction. As a general matter, the MFI should seek to avoid the inclusion of such a clause, because it essentially allows the Issuing Bank to declare a breach of representation by alleging that the payments enumerated in the clause would, in its opinion, be recoverable.

**75. Evergreen Provision:** The last clause of this section renews the validity of all of the previous representations and warranties made by the MFI as of the date that the MFI makes the first (and any subsequent) request to the Issuing Bank for it to issue a Letter of Credit. In all likelihood, this provision will be relevant only where the MFI has obtained a number of hard currency loans. In that case, it may make sense for the MFI to enter into a single Reimbursement Agreement with the Issuing Bank and request that the Issuing Bank issue a number of letters of credit, each matching the appropriate terms of the respective hard currency loan. The MFI should keep in mind, however, that even though it may not be entering into a new Reimbursement Agreement for each letter of credit being issued, the MFI should take care to ensure that the representations and warranties it agreed to under the

Reimbursement Agreement continue to hold true when it requests subsequent letters of credit from the Issuing Bank.

16. Default<sup><76></sup>. Each of the following shall be an Event of Default under this Agreement: (a) Applicant's failure to pay when due any obligation to Issuing Bank<sup><77></sup> [☺ or any of its subsidiaries and affiliates (under this Agreement or otherwise)<sup><78></sup>], if such failure is not remedied on or before the [fifteenth (15th)] day [variants: ☺ after notice of such failure is given to Applicant or ☹ after the due date<sup><79><80></sup>] (b) Applicant's failure to perform or observe any other term or covenant of this Agreement [☺ in a material respect] and does not remedy the failure on or before the [thirtieth (30th) day] [variants: ☺ after notice of such failure is given to Applicant or ☹ after it occurs]<sup><81></sup>, (c) Applicant's breach of any representation or warranty made in this Agreement or any document delivered by it under this Agreement [☺ in a material respect]<sup><82></sup>, (d) Applicant's dissolution or termination, (e) institution by Applicant of any proceeding under any law relating to bankruptcy, insolvency, or reorganization or relief of debtors or seeking the appointment of a receiver, trustee, or other similar official for Applicant or for any substantial part of its property, (f) consent by Applicant to the commencement against it of an involuntary case in bankruptcy or any other such action or proceeding; or entering by a court of an order for relief or a decree in an involuntary case in bankruptcy or any other such action or proceeding, or a receiver, trustee, or similar official is appointed in respect of the Applicant or substantially all of its property, and that order or decree is not dismissed or stayed or that appointment is not terminated, on or before the [ninetieth (90th)] day after the entry of the order or decree or after the appointment (as the case may be) or any such dismissal or stay ceases to remain in effect<sup><83></sup>, (g) any actual or threatened seizure, vesting, or intervention by or under authority of a government by which Applicant's management is displaced or its authority or control of its business is curtailed<sup><84></sup>, (h) attachment or restraint of the Collateral, or the issuance of any order of any court or other legal process against the same,<sup><85></sup> [☺ (i) any change in the financial condition or business of Applicant<sup><86></sup> that, in the [variants: determination or commercially reasonable opinion]<sup><87></sup> of Issuing Bank, [☺ would be likely to]<sup><88></sup> materially and adversely affect[s] the ability of Applicant to perform its obligations under this Agreement]], and (j) the occurrence of any of the above events

with respect to any person or entity that has heretofore or hereafter guaranteed or provided any Collateral security for any of the obligations.

**76. Events of Default:** This section essentially lists all the circumstances that could trigger an Event of Default by the MFI. The most obvious triggers are the MFI's failure to make a payment or to perform an obligation under the agreement, but other triggers include misrepresentations; dissolution, insolvency, or bankruptcy; and attachment or seizure of the Collateral. Once an Event of Default exists (and as long as it continues), the Issuing Bank may terminate its obligations and declare the full Letter of Credit amount (and any other amounts owed to the Issuing Bank by the MFI) immediately due and payable and pursue other remedies, such as foreclosure on the cash collateral, set off, or litigation. Because of this possibility, the MFI should negotiate to keep this list as short and as narrow as possible, while the Issuing Bank typically tries to make it as expansive as it can.

**77. Failure to Pay:** Failure to pay an amount due is a special kind of default known as a "payment default." MFIs frequently ask for the agreement to specify a grace period for payment defaults and certain other defaults. The MFI may support this request by reminding the Issuing Bank that a hair-trigger (extremely sensitive) event of default in the agreement would entitle Issuing Banks or lenders under other instruments to exercise their own rights under cross-default clauses. The Issuing Bank may, however, consider that no grace period should apply to the MFI's reimbursement obligation upon a drawing on the Letter of Credit, because the intent of the parties is that such obligation be immediately satisfied by application of the cash collateral. In such case, the parties may agree to apply different grace periods to different payment obligations, for example, applying no grace period to reimbursement by the MFI, pursuant to Section 2, of amounts drawn under the Letter of Credit, but permitting a 5-day grace period with respect to "all other obligations." Grace periods do not typically relieve the MFI from being charged penalty interest on the overdue amount, although an Issuing Bank may permit 15 days to cure a payment default before it would commence charging penalty interest.

78. **Optional Language:** The MFI should resist the inclusion in the “failure to pay” clause of language allowing the Issuing Bank to declare an Event of Default on the basis of the MFI’s breach of obligations toward third parties, including the Issuing Bank’s affiliates. Any cross-default provision—a provision where a default by the MFI on another loan or obligation is treated as a default under the Reimbursement Agreement—should be set out separately, with appropriate negotiated safeguards (such as threshold amounts and limitations on the relevant types of agreements or events of default).<sup>†</sup>

79. **Optional Language:** Grace periods may run from the date the MFI is given notice of the breach (☺) or from the date of the breach itself (☹), in this case, the missed payment. Issuing Banks will strongly resist the imposition upon themselves of a notice requirement. They will expect the MFI to know when it has missed a payment. The MFI will obviously prefer a grace period that runs from the date of the breach (☺) than no grace period at all (☹).

80. **Negotiation Point:** There are a number of other ways an MFI might negotiate a more favorable payment default clause, such as the one above. The MFI might try to negotiate a threshold amount, below which no payment default shall occur. The MFI might seek exclusions, or “carve outs,” such as for payments that the MFI has failed to make as a result of illegality, *force majeure*, unavailability of a currency, inadvertence, or administrative error.

81. **Failure to Perform/Observe Covenants:** This is a fairly standard Event of Default in many different types of financial agreements. Especially in common law jurisdictions, Issuing Banks should be reminded during negotiations that courts may sometimes refuse to enforce a default remedy if the court views the breach as trivial or technical, or if the party in default promptly cures the default with no prejudice to the Issuing Bank.

<sup>†</sup> For further discussion of cross-defaults, see Section 10.1(e) and accompanying annotations in the Model Loan Agreement (CGAP 2006).

**Negotiation Point:** The MFI may be able to argue successfully that, with respect to at least some covenant breaches, it ought to have the opportunity to cure. A good starting point is a 30-day grace period for less serious covenant breaches. On the other hand, some covenant breaches by the MFI, such as breach of a financial covenant (which may exist for some time before the borrower's financial reports reveal the breach), are such that the MFI should become aware of the breach much sooner than the Issuing Bank (hence, the Issuing Bank is likely to argue that no further grace period should be provided because an MFI will have time to remedy these breaches before an Issuing Bank even becomes aware of them). (Note, however, that Section 14 does not include any financial covenants. Given that the issuance of the Letter of Credit is fully cash collateralized by the MFI, such covenants are unnecessary and should be resisted.)

**82. Breach of a Representation or Warranty:** This is also a fairly standard Event of Default in many different types of financial agreements. **BEWARE!** The agreement may specify that the representations and warranties be deemed repeated each time the Local Bank draws on the Letter of Credit. See Section 15 (last sentence) and Annotation 75. MFIs, of course, should attempt to keep this language narrow and, if possible, add a materiality requirement as suggested above with the addition of the words "in a material respect." The word "material" is difficult, if not impossible, to quantify, but generally refers to an effect or change that is more than insignificant (from an Issuing Bank's point of view).

**83. Insolvency/Bankruptcy:** These provisions (clauses (d), (e) and (f)) address the insolvency of the MFI. The MFI should ask for an opportunity to terminate or stay the involuntary bankruptcy or insolvency proceedings rather than have an Event of Default be triggered merely by the institution of such proceedings. Ninety days may be a good starting point, but the MFI should make sure that the time allotted is sufficient for the MFI to prove its case and successfully move the court to act in its favor. In jurisdictions where courts move slowly, the MFI should negotiate a longer time period than ninety days.

**84. Government Seizure:** The MFI should ask for language giving it an opportunity to appeal. Language like "after the Applicant has exhausted all remedies and



appeals” is important to ensure that the MFI is given the opportunity to obtain the necessary authorizations before the Issuing Bank declares an event of default.

**85. Attachment of Collateral Property:** This covenant protects the Issuing Bank against the creation of other liens on the Collateral securing the MFI’s obligations under the Reimbursement Agreement, as well as against the exercise of certain legal remedies against such Collateral by third parties.

**86. Material Adverse Change:** Issuing Banks seek to protect themselves against material adverse changes to the circumstances of the MFI through material adverse change or MAC clauses. **BEWARE!** Such clauses present a danger to the MFI, because the Issuing Bank can theoretically declare an event of default based on its own subjective opinion that a MAC has occurred. For a discussion of MAC clauses, see Annotation 70. The MFI should negotiate strenuously against the inclusion of a MAC clause.

**87. Optional Language:** Although MFIs may seek some comfort if the law of the governing jurisdiction requires that the Issuing Bank’s determination of a material adverse change be made in “good faith,” it is preferable for the agreement to clearly state that any determination made by the Issuing Bank be made “in a good faith, commercially reasonable manner.” If the MFI can negotiate such a standard in the agreement, the MFI should link this provision to that standard by using the word “determination” in this clause.

**88. Negotiation Point:** Some Issuing Banks use vague language referring to changes that, in the reasonable opinion of the Issuing Bank, “might have” or “could have” a material adverse effect on the MFI. The MFI should resist such broad language here and elsewhere, in favor of language referring to changes that “would likely have” or “are reasonably likely to have” such an effect.

17. Remedies<sup><89></sup>. If any Event of Default shall have occurred and be continuing, the amount of the Letter of Credit as well as any or all obligations shall, at Issuing Bank’s option, become

due and payable immediately without presentment, demand, protest, or notice of any kind, all of which are hereby expressly waived by Applicant; provided, however, that in the event of an actual or deemed entry of an Event of Default under Section 16(d), (e), or (f), the amount of the Letter of Credit and all obligations shall automatically become due and payable without presentment, demand, protest, or notice of any kind, all of which are hereby expressly waived by Applicant. In addition to the remedies described in the immediately preceding sentence, if any Event of Default shall have occurred and be continuing, Issuing Bank may exercise, in respect of the Collateral, all the rights and remedies of a secured party on default under the Uniform Commercial Code as in effect in the State of New York<sup><90></sup>. Applicant shall pay Issuing Bank on demand all costs and expenses (including reasonable attorneys' fees and legal expenses) related or incidental to the custody, preservation, or sale of, or collection from, or other realization upon, the Collateral or related or incidental to the establishment, preservation, or enforcement of Issuing Bank's rights in respect of the Collateral. Issuing Bank may, in its discretion, hold the proceeds of the Collateral as additional collateral under this Agreement or then or at any time later apply the proceeds to the payment of the costs and expenses referred to above and the obligations, whether or not then due, as Issuing Bank may determine in its discretion. Issuing Bank shall pay any surplus to Applicant or to whomever may be lawfully entitled to receive the surplus and Applicant shall be liable for any deficiency.

**89. Purpose:** This section describes the remedies that the Issuing Bank can exercise against the MFI and the Collateral if an Event of Default occurs (for instance, failure on the part of the MFI to reimburse the Issuing Bank for a drawing under the Letter of Credit pursuant to Section 2(a), or a breach of any of the covenants in the Reimbursement Agreement). First, following an Event of Default, the Issuing Bank can require the MFI to *immediately* pay the Issuing Bank the amount of the Letter of Credit, even if no drawing has occurred. Thus, it is very important that the MFI carefully review and observe the Reimbursement Agreement to ensure that none of the covenants or other provisions is likely to be breached (consciously or inadvertently) before expiration of the Agreement. Second, the Issuing Bank may exercise its rights as a secured party in the Collateral. In practice, this means that the Issuing Bank can foreclose on the Account (or set off its obligation to return the deposit to the MFI) to satisfy the MFI's obligation to pay the accelerated amounts.

**90. Negotiation Point:** The MFI may want to negotiate a short notice period (e.g., 3 business days) before the Issuing Bank forecloses on the Collateral. On the other hand, the MFI should keep in mind that during the period between occurrences of an Event of Default and the Issuing Bank's foreclosures on the Collateral, interest will accrue at a penalty rate (see Annotation 10).

18. Set off<sup><91></sup>. If any Event of Default shall occur and be continuing, Issuing Bank may set off and apply any Collateral against any and all of the obligations, irrespective of whether or not Issuing Bank shall have made any demand under this Agreement and although such Collateral or obligations may be unmatured or contingent<sup><92></sup>. Issuing Bank's rights under this Section are in addition to other rights and remedies (including other rights of set off) that Issuing Bank may have under this agreement or applicable law.

**91. Purpose.** The right of set off is simply the right of a party (here, the Issuing Bank) to reduce the amount of an obligation to another party (here, the Issuing Bank's obligation to return the funds deposited in the Account to the MFI) by the amount of that other party's obligation to the first party (here, the MFI's obligation to reimburse the Issuing Bank for drawings under the Letter of Credit)—in effect, it is the Issuing Bank's right to net out mutual obligations between the parties. Depending on the jurisdiction, the right may be a common law right (having evolved from court decisions), it may be a statutory right, or it may not exist at all. As indicated in Annotation 50, the Issuing Bank may rely exclusively on its set-off rights to secure the MFI's obligations, or it may create a security interest in the Account containing the proceeds of the MFI's hard currency loan.

**92. Negotiation Point:** In some instances, the set-off provision may contain broader language allowing the Issuing Bank to offset the MFI's obligations against other deposits with the Issuing Bank and/or other obligations of the Issuing Bank to the MFI. The impact of such a provision depends on the MFI's other relationships with the Issuing Bank: Does the MFI have other deposits at the Issuing Bank? Does the Issuing Bank owe the MFI money under other contracts or transactions? Does the MFI expect that the Issuing Bank will owe it money in the future? If so,

will the Issuing Bank’s set-off rights over these other deposits and obligations interfere with the MFI’s ability to respect its obligations under the relevant transactions or reduce their economic benefits to the MFI? The MFI should carefully consider these questions and, where appropriate, require that other transactions be excluded from the Issuing Bank’s right of set off under this provision and applicable law. If such limitations are agreed, the MFI should request that any other provisions allowing the Issuing Bank to apply the MFI’s deposits or accounts against the Obligations be similarly limited—see, e.g., Annotation 12.

19. Waiver of Immunity<sup><93></sup>. Applicant acknowledges that this Agreement is, and the Letter of Credit will be, entered into for commercial purposes and, to the extent that Applicant now or later acquires any immunity from jurisdiction of any court or from any legal process with respect to itself or its property, Applicant now irrevocably waives its immunity with respect to the obligations [☺ to the fullest extent permitted by applicable law]<sup><94></sup>.

**93. Purpose:** Some legal entities, like governments and government officials, are granted different levels of immunity (sometimes only temporary or partial) from lawsuits. Different countries have different rules about who gets immunity and under what conditions, but often, immunity from lawsuits can be waived by the beneficiary of such immunity. This section is meant to ensure that the Issuing Bank will still have a legal remedy against the MFI even if the MFI were immune from lawsuits presently or were to somehow benefit from an immunity law in the future.

**94. Negotiating Point:** Although the Issuing Bank may ask the MFI to waive any and all of its immunity from lawsuits, the law in the MFI’s home jurisdiction may not permit the MFI to waive certain types of immunity. The MFI may attempt to negotiate a limitation on the waiver such as the phrase “to the fullest extent permitted by applicable law” to acknowledge this possibility.

20. Notices; Interpretation; Severability<sup><95></sup>. Notices shall be effective, if to Applicant, when sent to its address indicated below the signature line and, if to Issuing Bank,

when received at \_\_\_\_\_, or as to either, such other address as either may notify the other in writing. If this Agreement is signed by two or more persons or entities, (i) each such person or entity shall be deemed an “Applicant” hereunder, (ii) each Applicant shall be jointly and severally liable for all the Obligations hereunder<sup><96></sup>, and (iii) notices from Issuing Bank in connection with this Agreement or the Letter of Credit to either Applicant and notices from, or the consent of, either Applicant in connection with this Agreement or the Letter of Credit shall be sufficient to bind all Applicants. Headings are included only for convenience and are not interpretative. The term “including” means “including without limitation.” If any provision of this Agreement is held illegal or unenforceable, the validity of the remaining provisions shall not be affected<sup><97></sup>.

**95. Notices:** This section sets forth the addresses and contacts of record for all exchanges of documents, information, and negotiations under this agreement, as well as the method by which information may be transmitted or delivered.

**96. Joint and Several Liability:** Joint and several liability is a legal term of art that refers to the method of apportioning money damages in a civil suit between two or more defendants. This term is only relevant in this Section of the Agreement if more than one MFI signs as an “Applicant.” If there are multiple MFI Applicants, and if more than one MFI fails to live up to its obligations under the Agreement, the Issuing Bank can potentially sue (in a civil, not a criminal case) just one of the MFIs for *all* of the money damages the Issuing Bank suffered even though the particular MFI sued may have been only *partially* responsible for those damages. If the Issuing Bank is successful in its law suit, it is up to the MFIs to apportion the damages more equitably among themselves, either through a negotiated settlement or another lawsuit.

**97. Severability:** This clause allows the parties to ignore any specific provision in the agreement that is illegal or unenforceable and enables them to continue to observe all other provisions, rather than invalidating the entire agreement if one or more provisions are illegal or unenforceable.

21. Successors and Assigns<sup><98></sup>. This Agreement shall be binding upon and inure to the benefit of Applicant and Issuing Bank and their respective successors and permitted assigns. Applicant shall not voluntarily transfer or otherwise assign any of its obligations under this Agreement. Issuing Bank may transfer or otherwise assign its rights and obligations under this Agreement, in whole or in part, and shall be forever relieved from any liability with respect to the portion of Issuing Bank's rights or obligations transferred or assigned. Applicant acknowledges that information pertaining to Applicant as it relates to this Agreement or the Letter of Credit may be disclosed to (actual or potential) transferees or assignees. This Agreement shall not be construed to confer any right or benefit upon any person or entity other than Applicant and Issuing Bank and their respective successors and permitted assigns.

**98. Successors and Assigns:** This clause binds any successors in interest to the MFI or to the Issuing Bank to the terms of the agreement ("successors in interest" are institutions or individuals that may take over the interests of the MFI or the Issuing Bank through a sale, acquisition, merger, or other transfer of the rights and responsibilities under an agreement). This is especially helpful to the Issuing Bank in situations where the control and/or ownership of the MFI may be in question, or where the MFI has historically changed ownership frequently. Note, however, that an assignment by the Issuing Bank may subject the MFI to additional tax risk, unless Section 5 appropriately excludes such additional taxes. See Annotation 22.

22. Modification; No Waiver. None of the terms of this Agreement may be waived or amended except in a writing signed by the party against whose interest the term is waived or amended<sup><99></sup>. Forbearance, failure, or delay by Issuing Bank in the exercise of a remedy shall not constitute a waiver, nor shall any exercise or partial exercise of any remedy preclude any further exercise of that or any other remedy. Any waiver or consent by Issuing Bank shall be effective only in the specific instance and for the specific purpose for which it is given and shall not be deemed, regardless of frequency given, to be a further or continuing waiver or consent<sup><100></sup>.

**99. Modification:** In most jurisdictions, a written agreement that expressly states it can be modified only in writing cannot be modified orally. Under New York law, a written agreement that includes a clause stating that it cannot be

changed orally, as above, cannot be changed by an agreement unless that agreement is in writing and is signed by the party against whom enforcement of the change is sought.

**100. No Waiver:** These clauses establish that, even if the Issuing Bank does not seek to enforce a right or remedy under this agreement immediately, or does not completely exercise such a right or remedy, it does not give up that right or the ability to seek that remedy later.

23. **Other Agreements; Remedies Cumulative; Delivery by Facsimile.** This Agreement (and any controlling agreement described in the preceding sentence) constitutes the entire agreement between the parties concerning Issuing Bank's issuance of a letter or letters of credit for Applicant's account and supersedes all prior or simultaneous agreements, written or oral<sup><101></sup>. All rights and remedies of Issuing Bank under this Agreement and other documents delivered in connection with this Agreement are cumulative and in addition to any other right or remedy under this Agreement, the Letter of Credit, or applicable law<sup><102></sup>. Delivery of a signed signature page to this Agreement by facsimile transmission shall be effective as, and shall constitute physical delivery of, a signed original counterpart of this Agreement<sup><103></sup>.

**101. Other Agreements/Integration:** An "integration" or "merger" clause is meant to preclude disputes over whether the agreement is the final expression of the parties' agreement on its subject matter by establishing that this agreement is final and includes all the terms the parties agreed to include. This clause establishes that this written agreement is and should be understood to be the final agreement of the MFI and the Issuing Bank. Without this clause, in the event of a dispute over the content of this agreement, New York's parol evidence rule would apply to a Reimbursement Agreement (governed by New York law). This rule would normally forbid a fact finder from considering evidence of the subject matter of the agreement—like a conversation or letter between the Issuing Bank and MFI dated before the agreement was executed—if that evidence is not consistent with the Reimbursement Agreement. However, an exception to this rule exists when the written Reimbursement Agreement does not appear to reflect the entire agreement

of the parties (for example, if the parties forgot to include a provision that they had previously agreed to include). In that case, extrinsic evidence that is consistent with the loan agreement may be admissible to explain ambiguities or omissions.

**102. Remedies Cumulative:** This clause is simply asserting that the Issuing Bank has the right to choose among different remedies available to it under the Reimbursement Agreement, the Letter of Credit itself, or applicable law. The enumeration of certain rights in this agreement, for example, does not preclude the existence or exercise of others. Thus, the Issuing Bank will insist that it be free to choose its remedies.

**103. Delivery by Fax/Counterparts:** A counterpart is an original, signed copy. This clause enables multiple copies of the agreement to be signed by different parties with the signature pages then put together to form a single agreement. This provision is especially helpful in situations where the parties are geographically separated and is also helpful to ensure that the signing progresses quickly. It also may be called the “separability” clause. Copies of the entire executed agreement should be maintained by the MFI and by the MFI’s counsel.

24. **Termination; Surviving Provisions.** This Agreement shall be terminated only upon payment in full to Issuing Bank of all obligations hereunder. Restrictive provisions in this Agreement, such as indemnity, tax, immunity, and jurisdiction provisions shall survive termination of this Agreement<sup><104></sup>. If the Letter of Credit is issued in favor of any bank or other financial or commercial entity in support of an undertaking issued by such bank or entity on behalf of Applicant or Issuing Bank, Applicant shall remain liable under this Agreement (even after expiry of the Letter of Credit) for amounts paid and expenses incurred by Issuing Bank with respect to the Letter of Credit or the undertaking until Issuing Bank is released by such other bank or entity<sup><105></sup>.

**104. Termination:** The obligations of the MFI under the Reimbursement Agreement will terminate when it has repaid the Issuing Bank in full for any draw-downs by the Local Bank on the Letter of Credit. The Letter of Credit typically will



have a fixed termination date after which no more drawdowns by the Local Bank are permitted. (In a few rare cases, a Beneficiary may be able to draw upon a Letter of Credit after the fixed termination date has passed. See Annotation 2.) The Reimbursement Agreement ought to terminate on the same date as the Letter of Credit to the extent that the MFI's obligation to repay the Issuing Bank has been fulfilled.

**105. Surviving Provisions:** This clause states that the provisions relating to indemnification, the payment of taxes, immunity, and jurisdiction will last even after the obligations under the Reimbursement Agreement have been completely repaid.

25. Governing Law; Governing Guidelines<sup><106></sup>. (a) This Agreement and the rights and obligations of Applicant and Issuing Bank hereunder shall be governed by and subject to the laws of the state of New York and applicable U.S. federal laws. (b) Applicant agrees that Issuing Bank may issue any Letter of Credit subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, International Chamber of Commerce Publication No. 500 (the "UCP") or the International Standby Practices, International Chamber of Commerce No. 590 (the "ISP")<sup><107></sup> [© *optional language*: excluding ISP Rule 5.09 *or* but the rules of ISP shall not apply to the rights and obligations of the Issuing Bank and the Applicant with respect to each other]<sup><108></sup> or, at Issuing Bank's option, such later revision thereof in effect at the time of issuance of the Letter of Credit<sup><109></sup>. The UCP or the ISP, as applicable, shall serve, in the absence of proof to the contrary, as evidence of general banking usage with respect to the subject matter thereof. (c) Applicant agrees that for matters not addressed by the UCP or the ISP, each Letter of Credit shall be subject to and governed by the laws of the State of New York and applicable U.S. federal laws. If, at Applicant's request, a Letter of Credit expressly chooses a state or country law other than New York, U.S.A., or is silent with respect to UCP, ISP, or governing law, Issuing Bank shall not be liable for any payment, cost, expense, or loss resulting from any action or inaction taken by Issuing Bank if such action or inaction is justified under UCP, ISP, New York law, or the law governing the Letter of Credit.

106. **Governing Law:** An important purpose of this clause is to afford predictability as to which country's (or state's) law will apply in case a dispute erupts between the parties. If the agreement contains no express choice of law, a court may look to a number of factors to determine the applicable law, which can affect the substantive outcome of the dispute.

107. **More on Governing Law and/or Governing Guidelines:** The Issuing Bank's desire for convenience and predictability as to the applicable law usually leads the Issuing Bank to select the law of the Issuing Bank's own jurisdiction, the law of New York or England (whose commercial law is well established), or, in the case of letters of credit in particular, two sets of international standards regarding letter-of-credit transactions (the Uniform Customs and Practice for Documentary Credits ("UCP") or the International Standby Practices ("ISP98")). See Introduction, above, for more information. Issuing Banks may perceive certain dangers in applying the law of the MFI's country of operation, such as possible future moratoriums, interest limitations, exchange controls, or rules voiding repayment obligations deemed "odious." Of course, the parties will negotiate the actual choice of law to be used.

108. **BEWARE!** One of the rules of ISP98, Rule 5.09, would effectively shorten the period of time that the MFI has to sue the Issuing Bank for paying the Local Bank even though the Local Bank presented noncomplying documents along with its draft. The default under the UCC is that the MFI has one year to sue the Issuing Bank for wrongful honor of the Letter of Credit. ISP98 Rule 5.09 would require the MFI to give the Issuing Bank notice of a wrongful honor under the Letter of Credit within seven days, otherwise the MFI would be precluded from making such a claim at a later date. The MFI should strongly insist that ISP98 Rule 5.09 not apply to this transaction. One approach would be to simply exclude Rule 5.09's application explicitly. Another, broader approach would be to preclude ISP98's application to the rights and obligations that the MFI and the Issuing Bank owe one another. See also Annotation 33.

109. **Negotiating Point:** This last clause would permit the Issuing Bank to apply future revisions of the UCP or ISP98 to this Agreement regardless of the con-

tent of such revisions. Though neither set of rules may change very much during the term of the Letter of Credit or of this Agreement, the MFI may wish to avoid an open-ended commitment to abide by all future changes in these voluntary standards regardless of the substance of such changes.

26. **Jurisdiction; Service of Process.** Applicant now irrevocably submits to the nonexclusive jurisdiction of any state or federal court sitting in New York, New York, for itself, and in respect of any of its property and, if a law other than New York, U.S.A., has been chosen to govern the Letter of Credit, Applicant also now irrevocably submits to the nonexclusive jurisdiction of any state or federal court sitting in such jurisdiction. Applicant agrees not to bring any action or proceeding against Issuing Bank in any jurisdiction not described in the immediately preceding sentence. Applicant irrevocably waives any objection to venue or any claim of inconvenience<sup><110></sup>. Applicant agrees that any service of process or other notice of legal process may be served upon it by mail or hand delivery if sent to, at \_\_\_\_\_ which Applicant now designates its authorized agent for the service of process in the courts in the State of New York<sup><111></sup>. (If no authorized agent is designated in the space provided above, Applicant agrees that process shall be deemed served if sent to its address given for notices under this Agreement). Applicant agrees that nothing in this Agreement shall affect Issuing Bank's right to serve process in any other manner permitted by law or to commence legal proceedings or otherwise proceed against Applicant in any other jurisdiction. Applicant agrees that final judgment against it in any action or proceeding shall be enforceable in any other jurisdiction within or outside the United States of America by suit on the judgment, a certified copy of which shall be conclusive evidence of the judgment.

**110. Jurisdiction:** If the agreement provides for submission to a foreign jurisdiction (such as a state of the United States), the agreement may provide that the Issuing Bank may also bring and enforce a proceeding in the local jurisdiction, or any other jurisdiction where the MFI or any of its property may be found.

**111. Agent for Service of Process:** An MFI would typically hire a company (there are several that provide this as a standard service) to receive legal notices on the MFI's behalf in a jurisdiction like New York—this is what is meant by an

“agent for service of process.” Such an agent would then transmit those legal notices to the MFI. In this case, the MFI will likely already have an agent for service of process in that particular jurisdiction, because the hard currency loan agreement will typically require the appointment of such an agent.

27. JURY TRIAL WAIVER<sup><112></sup>. APPLICANT AND ISSUING BANK EACH IRREVOCABLY WAIVES ITS RIGHT TO A JURY TRIAL OF ANY CLAIM, COUNTERCLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT, THE LETTER OF CREDIT, OR ANY DEALINGS WITH ONE ANOTHER RELATING TO THE SUBJECT MATTER OF THIS AGREEMENT.

**112. Waiver of Jury Trial:** It is common for the Issuing Bank to seek to require that the MFI waives any right it might have to jury trials in the Reimbursement Agreement. This clause assumes that the agreement is enforceable in a jurisdiction that provides a right to a trial by jury, such as New York. If the agreement is to be enforced in a jurisdiction that does not provide for a right to trial by jury, this section is unnecessary. Counsel should be consulted as to the enforceability of such waivers in the relevant jurisdictions, and as to whether a waiver in any particular form is more likely to be enforced.

Very truly yours,

Applicant: \_\_\_\_\_

(Company Name)

By: (Authorized Signer):

\_\_\_\_\_

(Signature)

\_\_\_\_\_

(Print Name)

\_\_\_\_\_

(Title)

Address: \_\_\_\_\_  
\_\_\_\_\_

Co-Applicant (if any):  
\_\_\_\_\_

By (Authorized Signer):  
\_\_\_\_\_

(Signature)

\_\_\_\_\_  
(Print Name)

\_\_\_\_\_  
(Title)

Address: \_\_\_\_\_  
\_\_\_\_\_

(For Issuing Bank Use Only)

Approvals to Issue

## *Reference*

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Consultative Group to Assist the Poor. 2006. *Commercial Loan Agreements: A Guidebook for Microfinance Institutions*. Washington, D.C.: CGAP.

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The Consultative Group to Assist the Poor (CGAP) is a global resource center for microfinance standards, operational tools, training, and advisory services. Our 33 members—including bilateral, multilateral, and private donors—are committed to building more inclusive financial systems for the poor. For more information about CGAP or microfinance, visit [www.cgap.org](http://www.cgap.org).

