# THE REPRESENTATION OF BONDHOLDERS IN INTERNATIONAL LOAN CONTRACTS

MARIO MATTEUCCI
*Secretary-General, International Institute for the Unification of Private Law, Rome, Italy.*

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I

IN RECENT years, recurring storms have troubled the financial world market and considerably increased the risk involved in capital investments abroad; this has brought into the foreground the problem of protecting the bondholders of international loans.

By international loans we mean loans issued by states, public agencies and corporations in a foreign market through the offer of bonds to the public.

It is anticipated, with a return to normal international relations, that such types of loan may again develop; hence we propose to determine whether, and to what extent, it may be possible to create permanent representation of bondholders in international loans. Such representation would evidently be useful both to the bondholders and to the debtor groups; the former would be provided an efficient means of protecting their common interests, while the latter would be in position to deal with a qualified agency, and to reach agreements with it concerning eventual amendments to the clauses of loans, in relation to exceptional circumstances. Bondholders' representation would also help to restore that much to be desired confidence in international financial relations, which has been badly shaken by the prevailing system of unilateral amendments.

As to the manner of forming such a representation, only one way seems open to us: to insert special clauses into the deed of issue (that is, into the contract with the issuing house, or general bond). These clauses, reproduced in the document, would become binding on the bondholders, at the moment the bond is purchased.

For the above purposes, other solutions are juridically and practically unworkable. The same holds true for another system, quite often employed: to found, after the loan has been issued, groups of bondholders, in the form of civil companies or associations. The same is true of permanent committees

created for the protection or defense of the bondholders of foreign loans. Both systems lack something essential: they have no legal power to make their decisions binding on all parties, unless all the bondholders have adhered to them—and this, in most cases, cannot be obtained.

For the above purposes, a third system, inaugurated by some states must also be considered unworkable: to constitute an *ex lege* representation of all bondholders, operating through meetings modeled on the meetings of shareholders' companies. Even if it is admitted that such a system of legislatively regulated representation can be applied to international loans (in the present state of legislation it generally applies only to loans of companies or bodies whose seat is in the issuing state)—even so, the main object, which is to create a single representation, internationally efficient, would not be secured. And in point of fact, in the rather frequent case of a loan issued at the same moment in several states, it would be necessary to have a different representation for each of the issuing states.[1] In any case, a solution of this kind presupposes legislative reform, both in the states which have already passed laws on this subject, having only interior loans in view, and in those states—the majority—which have not made any provisions on the subject.

Our inquiry thus relates to one single type of representation, the one created by virtue of the loan contract. The problem before us is to establish, in the first place, whether it be lawful to constitute such a representation, and in the second place, within what bounds the powers of representation should be confined, in relation to the principles of public policy, both in the state under whose law the loan contract has been made, and in the other states within whose jurisdiction differences might arise respecting the validity of said clauses in the loan contract.

As instances of the system of collective representation in question, practically applied, we shall consider the clauses of three international loans which have regulated the subject, namely the six per cent loan of the Republic of Peru of 1927 (article V, § 15), the Belgian Conversion Loan of 1936 (clause XVIII), and the Czechoslovakian State Loan of 1922 (article 15).[2]

While examining this problem, however, we also intend to examine any developments that such a system might possibly have—outside of pre-

[1] Extremely embarrassing situations would result from thus fractioning the representation of bondholders, in the case of discordant and clashing resolutions by the different groups of bondholders.

[2] From a collection of documents made by the League of Nations Committee for the Study of International Loans, Doc. I. L. 17, Annex to the Memorandum by A. P. Fachiri, at p. 15.

ceding applications—with the object of fulfilling its purposes in a more systematic and complete manner.

II

The first point of our inquiry will be to establish whether it is lawful, as a general principle, to create by contract collective representation of all bondholders in an international loan.

As may be gathered from the clauses of the three international loans quoted above, collective representation may be obtained in two ways: (a) by appointing a third party as the representative of all bondholders (the Peruvian Loan confers this representation upon "financial agents," who are empowered to conclude agreements, within certain limits, in the bondholders' name), or (b) by authorizing a meeting of bondholders (generally called following a request by the debtor state, or an initiative of the loan trustee) to deliberate, with certain *quorums* and majorities, on questions concerning the bondholders' rights—the decisions taken to be binding on all bondholders (Belgian and Czechoslovakian Loans). The two systems may also be conceived as coexisting, that is, representation to be conferred on a third party, whose powers should be limited by the powers of the meeting, the latter to be recognized as the only body entitled to deliberate on certain subjects.

Having to ascertain whether one or the other type of representation is compatible with the different legislations, it is necessary, as a preliminary step, to establish which legal rules apply to this subject.

Now, representation of the first and of the second types cannot be measured by the same standards. As to the first type (representation conferred on a third party) it seems self-evident that we must have recourse to the rules on mandates. The clause of the Peruvian Loan says so explicitly:

"The Republic accepts that financial agents, or one of them, or their successors, *acting as the bondholders' representatives* for one or all the series of the loan circulating at a given moment, *may represent* said bondholders and may conclude agreements with the Republic concerning the present agreement, or in view of its completion, in accordance with paragraph 1 of art. IX of the present agreement. It accepts that financial agents may *promote and pursue in their own name and in the interest of said bondholders, any legal action or trial*, whatever its cause, with the object of obtaining the execution of obligations or undertakings contracted by the Republic and defined or provided for in said bonds, in addition to the present agreements or any other agreement concluded in view of the present agreement or in order to complete it. They will not be required to submit the bonds themselves to any court

or any other body, and they will not have to prove their mandate or the powers conferred upon them by said bondholders."

The typical element of this representation resides in its irrevocable character. The clause we have just quoted also states that:

"The holder of a bond of any series of the loan will be presumed, by his acceptance, *to have irrevocably conferred said powers* on the financial agents operating each by himself, or together in accord, and also on their respective successors."

Our inquiry must then seek to determine whether an irrevocable mandate can be reconciled with the principles of public policy in the various legal systems.

As far as representation of the second type is concerned, we meet with a certain difficulty in defining the legal principles on whose basis the validity of what are usually called "majority clauses" should be judged. The problem does not arise in those legislations which have already recognized the lawfulness and efficiency of majority clauses, either through explicit statutory provisions or through the decisions of courts. In such a case, it will only be necessary to establish the relation between provisions regulating legal representation in cases contemplated therein, and the hypothesis with which we are dealing.

When, on the contrary, the institution of the bondholders' meeting, based on the majority principle, has not been approved by law or by judicial decision, not even in the case of bonds issued for an internal loan, what principles should we start from, to establish whether such an institution is compatible with public policy?

Let us remark, first of all, that a clear doctrine has not yet been formed, concerning the definition of the *nomen juris* and the nature of the relation created when these bondholders' groups are founded.

In France, doctrine and jurisprudence have often had to deal with this question, and they wavered between the concept of *société civile* according to article 1832 of the Civil Code, and the concept of *association* according to the Law of July 1st, 1901[3], until the Law of October 30th, 1935, conferred legal personality on bondholders' groups formed according to the latter law.

It seems to us that it is not necessary, for our research, to give a rigorous legal definition of the relation called into being by the clauses which create collective representation. On the contrary, we believe it is sufficient to as-

[3] Such trends of doctrine and jurisprudence are summed up by Escarra in Traité théorique et pratique de l'organisation des obligataires (1922) 25 ff.

certain whether the principle which makes the decisions of the majority of creditors binding on all the creditors, whenever founded on an agreement by contract, is inconsistent with public policy in the various legislations. This may be ascertained by considering other types of groups based on common interests, within which the majority clause has established itself.

Having stated these general concepts, we shall now make a brief survey of the various legislations, both as regards the conferring of mandates on a third party, and as to the majority clause.

*1. Conferring a Mandate On Third Parties In Loan Contracts*

As we have already said, this question must be solved on the basis of the principles regulating mandates. That a mandate may be validly conferred for purposes concerning loans and the relations between bondholders and the debtor, is unquestionable, since all legislations admit that patrimonial relations can be the object of a mandate.

The various legislations do not take an equally uniform attitude concerning the irrevocability of mandates.

Some legal systems consider it an essential character of the mandate, that it should be revocable; hence they declare the irrevocability clause to be null, or at the utmost they attribute limited effects to it (obligation, of the mandator, to make good damages derived from repeal of the mandate). On the contrary, other systems admit that mandates may be irrevocable, either when the irrevocability clause has been explicitly agreed upon, or when it is derived from a determined obligatory relation, existing between the mandator and the mandatory, or between the mandator and a third party.

Thus: when the mandate has been conferred, not only in the interest of the mandator, but also in the interest of the mandatory or of a third party; when it forms an integrating element of synallagmatic relations, in which the exercise of certain powers of representation is the means of attaining a common interest.

In the case under consideration, the irrevocability of the mandate (in respect of the legislations which admit it) should be justified by considering that it would be conferred in the interest of a third party (the debtor) and also considering that, as it has been conferred collectively by a number of mandators, a real plurilateral contract, in the form of a mandate, would arise, binding on each of the mandators in respect of one another, as so many contracting parties.

*2. Validity of Majority Clauses under the Various Legislations*

For this aspect of our research, it is necessary to divide legislations into three groups, according to the following standards: (a) legislations in which majority clauses have been explictly recognized as valid by judicial decisions; (b) legislations which have regulated bondholders' committees by statutory rules, on the basis of the majority principle; (c) legislations in which this subject has not been the object either of legislative regulations or of pronouncements by courts.

Great Britain, the United States of America, and Canada belong to the first group.

Among the legislations which have already regulated by law permanent bondholders' representation, we cite the five states which have founded an organic system of collective representation, acting through committees whose deliberations are in accordance with the majority principle. These states are Belgium, France, Germany, Italy, the Netherlands, and Switzerland. In some other states, provisions apply which are less complete—as far as our inquiry is concerned—but show, nevertheless, a favorable attitude towards the majority system.

Concerning the legislations of this second group, it seems to us self-evident that the institution of the bondholders' meeting, deliberating on a majority basis, having been the object of legislative treatment, can no longer be considered as contrary to public policy. It remains to be seen whether, side by side with the groups established by law, other groups may not exist, based on the clauses of the loan contract—above all in the case of loans remaining outside the law itself. We think the query can be answered in the affirmative; this results from the laws quoted above. Article 20 of the German law,[4] and the corresponding article 30 of the Swiss law,[5] when they proclaim the nullity of loan clauses insofar as they suppress or restrict the powers conferred upon bondholders by the law, implicitly admit that—for the same loans contemplated by the law—regulations under the contracts may coexist, although subject to some limitations. Article 16 of the Dutch law[6] explicitly contemplates this coexistence. As to the French and Italian laws, although we have not yet found any interpretative decisions, we believe it is possible to deduce, from the provisions of the said laws and their reports, the opinion that the legislator sought to facilitate for bondholders the formation of groups under majority law, rather than

[4] Law of Dec. 4, 1899.

[5] Revised Code of Obligations (1936) art. 1180.

[6] Law of May 31, 1934, as amended by Law of Sept. 13, 1935.

to impose upon them a rigid and formal discipline. Hence there should be no obstacles to the voluntary and conventional formation of such groups.

As for the Belgian law, commentators also hold the opinion that it does not prevent the formation of representation under the contract.

The laws of Mexico and Chile explicitly provide for representation based on the contract.

As to the third group of legislations: we must put to ourselves, respecting each legal system, the following query: Is there any principle of public policy forbidding a number of individuals, entitled to rights connected by a common interest and tending to a single end, to limit by their own act the exercise of said rights, by conferring upon a majority the power of modifying them, in a manner binding upon all of them, when this is necessary in the common interest? It is a question of seeing whether such a limitation of the rights of individuals, justified by practical needs, may be reconciled with the general principles of the various legislations.

Let us first of all remark that a first limitation of individual rights as respects collective interests occurs in company contracts, where the will of the majority is superimposed on the will of each member. This principle is so widespread that it is unnecessary to illustrate it.

Another legal institution in which the majority principle has prevailed is co-ownership; in this case also, for the best enjoyment of common property, the decisions of the majority of owners are binding upon the dissident minority. We find this principle applied in the legislations which admit collective property in flats in apartment houses; this situation has some analogy with the case we are examining. For, in the former instance, distinct and separate ownership overlap, together with the existence of a common property of those parts of the building which are necessarily common to all, or which are adapted to common use by the different owners. Hence: rights that are distinct, but connected by a common interest.

The common ownership of ships is also subject to majority law in some countries.

Furthermore, under the urge of increasing economic needs, groups of individuals and bodies are being formed today for the protection of common interests in the economic field. These groups are different from companies. I allude to the organizations (*consorzi*) of landowners, for the purpose of land reclamation, exploitation of watercourses, et cetera and to the different kinds of financial syndicates, often organized in meetings, endowed, by explicit agreement, with the power to deliberate on the majority basis, either concerning amendments to the syndicate's contract, or in a consultative capacity, or for some other purpose.

Finally, we cite another typical form of the subordination of individual rights to the decision of given majorities, in an institution which is widespread in the commercial field, the preventive composition (*concordat préventif*). This institution, although justified by the debtor's exceptional situation, is closely akin to the case with which we are dealing.

It should not be forgotten that some legislations have shown a trend towards statutory organization of bondholders' groups, on the model of what has already been done in the above-mentioned countries.

From this complex of institutions in which the majority principle has acted to limit individual rights, we think the conclusion can be drawn that majority clauses inserted in loan contracts and freely accepted by subscribers to the loan by the act of buying bonds, find no obstacle in the principles of public policy of the various legislations. On the contrary, they are in harmony with the principles regulating certain kindred institutions mentioned above.

Having solved the preliminary question, and found that the formation of collective representation may be admitted in principle—it must now be seen whether such a representation, in its constitution and in the manner of its functioning, should be subject to some rules not to be departed from, or whether the parties' will should be paramount in these matters.

As regards the conferring of mandates on a third party in loan contracts, we must go back to the rules regulating the form of mandates. Now, in the case under consideration, we are dealing with a written instrument, surrounded by all the guarantees of publicity, and we believe that no cases of formal nullity can arise. It will rather be necessary that the clause conferring the mandate should specify its contents and limits.

As to committees, the present query is mainly concerned with those legislations where statutory regulation of bondholders' collective representation already exists.

Let us now examine these legislations, keeping in mind that they generally do not apply to loans issued by states or other foreign bodies. Only the French law is excepted; its provisions also apply to bonds, issued, exposed, put on the market, or introduced on the French market by means of an offer to the public, by companies whose seat is abroad, and to the bonds of loans issued by foreign public bodies.

When the provisions are analyzed from this point of view, we observe that they deal with the following main points: (1) Initiative to convene meetings; (2) Provisions for the publicity required in order to convene them; (3) Those entitled to be present at meetings; (4) Majority or *quorum* required to deliberate; (5) Judicial homologation of deliberations.

As to the provisions dealing with points (1) and (2), we think that after examining the legislations in question, the conclusion will be reached that such provisions are not concerned with public policy, not even for the issue of bonds falling within the sphere to which the laws themselves apply. Even less, therefore, could they function as limits of public policy in an absolute sense. All those clauses will therefore be lawful which, to regulate the procedure for calling bondholders' meetings, will make it possible for all the interested parties to participate, through a minimum of publicity suited to the purpose.

Concerning point (4), we remark that the legislations providing for a permanent representation of bondholders, make the validity of deliberations dependent, in all cases, on the approval of determined majorities and in some cases on the participation of a fixed *quorum* of bonds, of the total amount of bonds in circulation. Some legislations further provide for compulsory judicial homologation.

As to provisions concerning the *quorum* of bonds to be represented, and those concerning qualified majorities, we do not believe that their character as public policy rules can be affirmed in an absolute manner. This opinion of ours is supported by the following considerations:

First of all, both the *quorum* and the majority may vary, according to the laws themselves, as the latter provide for less severe conditions in the case of second and third meetings.

In the second place, it must not be forgotten that while the severity of the above provisions is justified in the case of an *ex lege* collective representation, that is, when the limitation on individual rights is imposed by statute, without having been stipulated in the loan contracts, the same cannot be said in cases where said limitation is freely desired by bondholders, who on subscribing to the loan have accepted all its conditions.

A limit to the independence of the parties may however be found in the obligation of respecting the majority principle. This principle may be considered common to all legislations in cases of collegial deliberations, so that it acquires the status of a public policy norm in an absolute sense. To admit that a minority may be empowered to decide in a manner binding on the dissenting majority, would be repugnant to the above principle, which has been consecrated by legislation, where companies and preventive composition or bankruptcy composition are concerned.

Finally, in the case of homologation by the judicial authority, such a proceeding evidently cannot apply to decisions taken by meetings which have been formed and have deliberated according to standards different from those laid down by the law. For the object of homologation is mainly

to ascertain the exact observance of the conditions prescribed by the law. In some countries, where the judicial authority has no such special competence, requests for homologation, were they submitted, would be declared unacceptable.

III

Having now to examine the sphere of the collective representation's powers, in relation to the individual rights of each single bondholder, we believe it is necessary to state clearly, first of all, the nature of the powers normally conferred on the bondholders' collective representation, whether they be exercised by third parties, as representatives, or by the bondholders themselves.

Where international loans are concerned, the clauses of the three loans we have quoted from confer very ample powers on representatives and meetings. The Peruvian Loan provides that the bondholders' representatives:

"May conclude agreements with the Republic concerning the present agreement, or with the object of completing it according to paragraph 1 of article IV of the present agreement; they may undertake and carry out, in their own name and in the interest of said bondholders, any legal action or trial, whatever be its cause, with the object of securing the execution of the obligations or undertakings assumed by the Republic, as defined and provided for in the above-mentioned deeds."

The Czechoslovakian Loan provides that the meeting may be convened to secure "the bondholders' adhesion to the exercise of their rights, or their decision concerning any proposals which might be made to them by the Czechoslovak Government." Finally the Belgian Loan lays down that a meeting may be convened with the object of "obtaining an opinion or a decision from bondholders, concerning any proposal which might be made to them by the Government, or concerning any other question." It may be seen that this last clause provides for the meeting's intervention in a double capacity: consultative (this function to be exercised mainly in interpreting the loan's clauses) and in a dispositive capacity.

To ascertain whether these clauses can be harmonized with the principles of public policy, we shall examine separately the case of representation by third parties and the case of bondholders' meetings.

As to representatives appointed in the loan contracts, we shall refer to the rules governing mandates, according to the method followed so far.

Concerning the contents of mandates, it may be stated that modern law now proceeds from the principle that mandates are generally admitted for

legal acts, whatever be their type. Rare exceptions occur in some legislations, concerning matters not considered in the case we are examining (family relations and successions).

Considering then, in relation to this principle, that the subjects which may fall under the powers of bondholders' representatives are all of a patrimonial character, we may conclude that none of these subjects is of such a nature that it cannot become the object of a mandate. It should be added that for some acts—particularly those which exceed the field of mere administration and imply the disposal of bondholders' rights—it would be well if the mandate contained a specified statement of the mandatory's powers, in order to avoid that exceptions should be raised concerning the mandate's limits.

We also believe that we can affirm the legitimacy of such representation clauses, as they confer on the representative the right to appear in court in the bondholders' interest, in actions connected with the object of representation. Nearly all legislations admit that the members of a community may confer a mandate or a charge on a third party, whether he be a member or not, so that he may appear in court in the name of the others, as their representative.

We shall see later according to what standards a line can be drawn between the action of collective representation and the individual action of single bondholders.

As to the powers of meetings, we shall sum up, first of all, the provisions in the common interest of bondholders, on which meetings may be called to give their opinion:

(1) Provisions having the effect of imposing on bondholders new obligations (particularly, further payments of capital);

(2) Provisions seeking to modify the bondholders' legal situation (for instance, by deciding the conversion of the bonds into other instruments);

(3) Provisions limiting the bondholders' rights: (a) as to capital, (b) as to interest, (c) as to guarantees;

(4) Other provisions to be adopted as a consequence of the debtor's initiatives.

May meetings freely confer such powers, or should they undergo some limitation, not to be dispensed with? The answer to this query should also be obtained through a double inquiry: in the first place, the problem should be considered in relation to the general principles of law; secondly, in its relation to those special rules which, in some legislations, govern the representation of bondholders.

In legal organizations which do not regulate this subject by special

provisions, we believe that the answer may be drawn from a general principle: that, in the case of contracts and in the patrimonial sphere, the will of the parties is paramount. If general principles recognize the renunciation of a right as valid, when it is freely willed, we do not see why a contract should be considered unlawful or contrary to public policy when its purpose is to limit or to regulate the exercise of that same right, making it subordinate to the decision of a majority. The rules of positive law—which in some legislations have limited the majority's power—in some of the institutions we have mentioned (collective ownership, companies, et cetera) have drawn their inspiration from the objective of respecting individual rights, as far as this may be reconciled with the necessity of managing common property. But where the will of the contracting parties themselves has decided to set limits to the exercise of their own rights, the object of such protection, in our opinion, is lacking.

But out of the preceding considerations, another consequence may be drawn. If the meeting's powers are founded on the contract, the contents and limits of these powers should be sought for in the contract, and it will be the judge's task to interpret, in each case, the intention of the contracting parties, as it results from the clauses of the contract.

British jurisprudence, which has often made pronouncements on the subject of majority clauses, has set no definite limitations to the subjects which may be the object of the majority's decision. Palmer, in summing up the jurisprudence on this point, has remarked that "the powers of the meeting depend entirely on the true construction of the provisions in question."[7]

Having now to examine the legislations which have already made legislative provisions on this subject, we may remark that, while some legislations do not definitely limit the majority's powers, others lay down limitations or definitely enumerate the subjects which may be the object of deliberation, or point out those which should be excluded.

From these provisions it might be deduced that the loan contract's clauses conflict with public policy limits when they attempt to suppress or to restrict the meeting's powers, and not when they extend those powers —excluding the prohibitions we have stated above.

It remains to be seen whether these limits of public policy have a general scope (i.e., whether they can be referred also to loans outside the sphere to which the law applies) or whether their scope is merely a special one. In the absence of interpretative elements, which might enable us to solve the question, and in order to avoid a solution derived from a purely sub-

[7] Palmer's Company Law (18th ed. 1948) 329.

jective opinion, we think that it would be prudent, in any case, to take into account, when the loan clauses are laid down, certain limits which may be considered common to the legislations we have examined, namely: (1) bondholders should not be obliged to sustain new burdens; (2) no condition of inequality should be established between bondholders of the same issue.

We have our doubts on the opinion, held by some authors,[8] that provisions within the meeting's powers should not include the renunciation of a part of the credit's capital, represented by the nominal value of the bonds. For in point of fact there is no practical difference between this hypothesis and reduction of the rate of interest which—according to these authors—ought to be included in the meeting's powers. On the other hand, it has been remarked that some of the legislations we have examined grant the meeting power to decide in favor of a partial renouncement of credit, when this measure is necessary to avoid total loss.

As to the exercise of judicial action, we do not think a clear line can be drawn between collective and individual action. This distinction, which is already difficult in the case of companies, is much more complex in the case we are dealing with, where no entity exists, distinct from the persons of the individual bondholders. Hence we may say, in a general manner, that the bondholder retains the full exercise of actions derived from his bond, insofar as he has not invested the meeting with this right.

[8] See Escarra, *op. cit.*, at p. 268.