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LAW AND PRACTICE OF INTERNATIONAL FINANCE

INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION

By

Philip R Wood
BA (Cape Town), MA (Oxon)

Solicitor of the Supreme Court

Visiting Professor, Queen Mary
& Westfield College,
University of London

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SERIES SUMMARY

Comparative Financial Law

This work classifies and provides a snap-shot summary of financial law in nearly all the jurisdictions of the world – more than 300 of them. There are also chapters on the conflict of laws governing financial contracts and on jurisdiction on a comparative basis, as well as a comparative study of money transfers and payment systems. The book contains the texts of European conventions on contractual applicable law and on jurisdiction.

Principles of International Insolvency

An advanced study of substantive bankruptcy law in the major jurisdictions of the world in the context of international financial transactions. The work contains a classification of global jurisdictions and comparative studies of the law of preferences, of trusts and custodianship, of the impact of insolvency on contracts, of judicial reorganisation proceedings, of the liabilities of corporate directors and shareholders on insolvency, of lender liability, the conflict of laws of insolvency, and the law and practice of private restructuring agreements and work-outs.

International Loans, Bonds and Securities Regulation

This work covers term loan agreements, loan syndications, loan transfers and participations, bond issues (as well as convertible issues and issues of eurocommercial paper and medium term notes) and includes a survey of the duties of syndicate agents and the review of bond trustees and bondholder representation on a comparative basis. There are several chapters on international securities regulation together with a summary of bank regulation and chapters on legal opinions. There are outline summaries of documents, precedents and advice on negotiation.

Comparative Law of Security and Guarantees

This work contains an international and comparative survey of the law of security, including floating and universal business charges, security over contracts and receivables, charge-backs, security over investment securities including those held by custodians such as Euroclear, a comparative study of ship and aircraft finance, and a review of guarantees, standby letters of credit, comfort letters and the like. There are check-lists, summaries and precedents.

Title Finance, Derivatives, Securitisations, Set-off and Netting

This work comprises a review of title finance, including finance leases and sale and repurchase agreements, chapters on the techniques of securitisation as well as country notes, a comparative study of set-off and netting including a summary of the netting laws of the world's major jurisdictions, and finally a review of swaps and derivatives. The work contains summaries of documents.

Project Finance, Subordinated Debt, and State Loans

This work contains a review of the techniques and structures for project finance internationally, chapters on subordinated debt including mezzanine finance and subordinated capital issues, and a detailed review of the law and practice of state loans, sovereign immunity, state insolvency, state rescheduling agreements, state succession, state recognition and lending to international organisations. There are extensive outlines of project finance documentation, and check-lists and precedents in relation to subordinated debt and state loans.

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investor. In addition there are specific exemptions under the Financial Services Act 1986 which were promulgated for the avoidance of doubt, especially since some lawyers feared that some bank loans may technically be "debentures" which are investments regulated by that Act.

Securities regulation is discussed generally in chapters 14 to 21, and bank loans and participations at para 16–24 *et seq*.

CHAPTER 8

BOND ISSUES: GENERAL PRINCIPLES

Comparison of bond issues and syndicated loan agreements

Main differences

8–1 Bond issues are issues of transferable debt securities by a borrower to investors who may be limited in number or to the public at large in return for a subscription price.

International issues are issues of bonds to international investors. The chief differences with issues of debentures in a domestic market are that international bonds are negotiable bearer instruments, not registered, and, since they are issued to sophisticated investors, they can usually be issued without compliance with rules for the prescribed contents and filing of prospectuses.

These chapters are concerned only with international bonds, not domestic issues.

8–2 Some of the key differences between bond issues and loan agreements are:

1. **Transferability** Bonds must be easily transferable and must usually be negotiable. Banks do not usually trade in loans.
2. **Character of investors** Syndicated bank loans are made by sophisticated institutions, well able to analyse the credit risks involved. Bond investors may ultimately be the public at large who are not in a position to assess credit risks or the value of the securities. The law has therefore intervened to protect the public, e.g. by prospectus disclosure requirements. But in practice most international bondholders are also sophisticated institutions – insurance companies, banks, governments, large corporates, pension funds, investment funds. Hence international bonds usually benefit from "sophisticated investors" exemptions in relation to prospectus requirements.
3. **Number and anonymity of investors** International investors in bonds

are numerous and often anonymous because the bonds are bearer instruments. One result is that it is difficult to organise bondholders to approve modifications, to waive defaults or to agree a restructuring plan in the event of financial difficulties. Provisions in a trust deed or in corporate legislation whereby bondholders can vote on proposals affecting the bonds ameliorate this obstacle, but in practice modifications are much more difficult than is the case with bank loans where only a few banks need to be consulted. As a consequence, the covenants and events of default in bonds are much less rigorous than in syndicated loan agreements.

4. **Issue mechanics** Syndicated bank loans can make provision for a revolving credit, a standby facility, multicurrency options, complex project security arrangements and the like. They are a highly flexible form of financing which can be tailored to meet the needs of a particular transaction. Bond issues, on the other hand, do not enjoy this flexibility. The bonds must be sold to the market when there is a suitable "window". The issue mechanics can be cumbersome by reason of the marketing arrangements, the need for a formal offering circular, the desirability of listing and the impact of securities regulation. But these disadvantages can be mitigated in the case of debt issue programmes employing framework agreements and in practice the procedures in other cases are streamlined.

Detailed comparison

8–3 The following are some detailed similarities and differences between bonds and syndicated credits. Obviously the contractual variety is immense and this short review limits itself to typical terms only. The clauses mentioned below are explained elsewhere in this work.

Disclosure requirements Syndicated loans are usually exempt from prescribed disclosure and prospectus registration requirements. Bonds issued outside the United States can be structured so as to be exempt from disclosure and prospectus registration requirements. There are stock exchange disclosure requirements if the bonds are listed.

Information memoranda for syndicated loans are informal and not detailed. Bond issue offering circulars are sometimes more formal – usually because of stock exchange requirements – but short forms are used in the case of established issuers who are subject to stock exchange continuing disclosure requirements so that the information is already publicly available.

High disclosure standards apply in both cases, but contracting-out by managers is usual, again in both cases.

8–4 **Documentation** For syndicated loans, the marketing documents are informal, e.g. telexes to prospective participants and an information memorandum. For bonds, the marketing documents are more elaborate, e.g. formal invitational telexes, subscription agreement, (sometimes) underwriting and selling agreements, and a formal offering circular. But many of the documents are standardised and the documentation can be further reduced by the use of master forms covering future issues under debt issue programmes.

Syndicated loans are evidenced by a loan agreement. For bonds there are a trust deed or fiscal agency agreement and paying agency agreements. The issue is evidenced by bonds which are security printed, because they are bearer securities.

8–5 **Advance of funds** Syndicated loans are made on request by the borrower during a commitment period which allows multiple drawdowns and flexibility of timing.

Bonds are issued in a single advance. Two or more instalments are possible but cumbersome. Market conditions limit flexibility on timing. But the use of master agreements enhances the ability of the issuer to issue bonds quickly at intervals.

For syndicated loans, revolving and standby credits are available. Bonds can approximate to this by "tap" issues. As mentioned, under dealer programmes the issue mechanics can be reduced to the minimum in the case of pre-standardised framework documentation. For example, the procedures can be limited to an exchange of telexes followed by an issue of notes by the agent on behalf of the issuer.

8–6 **Currency conversion** Loans can be converted into other currencies periodically. For bonds, periodic currency conversion is impracticable.

Interest Loan interest is usually floating. The borrower can select different interest periods. Bonds have fixed or floating interest rates. The interest periods for floating rate notes are fixed and the issuer has no right of interest period selection.

Default interest on loans usually is at an increased penalty rate, but this is not the practice for bonds.

8–7 **Repayment** For loans, anything may be agreed, e.g. bullet, instalments, or variable according to project cash flows. For bonds, there is limited flexibility – the redemption is usually bullet or by fixed instalments. Sometimes there is a purchase fund.

Voluntary prepayment For loans, full or partial prepayments on interest payment dates are usually allowed. Prepayment premiums are unusual. In bonds, prepayments are usually not permitted. Sliding scale premiums on voluntary prepayments have been seen, but are rare in the eurobond market. As in the case of loans, prepayments are invariably allowed without premium if a withholding tax is imposed.

For loans, prepayments are made pro rata between the banks. For bonds, prepaid bonds are selected by lot so that chance decides if a bondholder is prepaid.

8–8 **Margin protections** Loans have increased costs protection but this is not so in floating rate notes. Both have tax grossing-up, but the tax grossing-up in bonds is more protective of the issuer.

Loan agreements contain an illegality clause, but bonds do not.

8–9 **Payments and equality** Payment of loans is made through an agent bank who is agent of the lenders. Payment of bonds is made against presentation of bonds and coupons at paying agents (choice of several). Paying agents are agents of the *issuer*. In practice bonds are usually held by custodians for the bondholders (Euroclear or Cedel) and it is the custodians who present them for payment.

Loan agreements contain a pro rata sharing clause but there is no pro rata sharing in bonds. The pari passu clause primarily insists on pro rata payment on insolvency which is the law in any event, but might possibly require non-discrimination before actual insolvency. However, if a trustee is appointed, the trustee generally distributes pro rata after a default, but the double-dipping effect of a pro rata sharing clause is not available.

There is a set-off clause in loans, but not in bonds.

8–10 **Warranties** Loan agreements contain elaborate warranties. Breaches are an event of default entitling the banks to suspend drawdowns, to cancel the commitments and to accelerate. Evergreen warranties, which must be continuously true, are common. In bonds, the only warranties are in the subscription agreement with the managers entitling them to cancel issue. Breach of warranty is not an event of default in bonds, so there is no acceleration for breach of warranty unless rescission is available as matter of law, e.g. for misrepresentation.

8–11 **Covenants** Loan agreements contain detailed information requirements, a negative pledge, a pari passu clause, an anti-disposal clause, and controls on changes of business. Financial ratios are common. There are often other covenants relating to the maintenance of exchange control consents, the

maintenance of corporate status, and other matters. Project and secured credits bristle with covenants.

In bonds, information requirements are laconic, such as the provision of accounts or as required by the listing undertaking with the stock exchange. The negative pledge is very limited but a pari passu clause is standard. Sometimes an anti-disposal clause is an event of default. Usually there are no other covenants. The trust deed, if any, may contain reporting requirements and covenants as to the maintenance of exchange controls, corporate status, etc.

8–12 **Events of default** In loans, the defaults can be elaborated. A material adverse change clause is common. Breach of warranty is a default.

In bonds, the defaults are less stringent; there are less of them and longer grace periods. A material adverse change clause is very rare. Breach of warranty in the subscription agreement is not an express default.

In loans, accelerations require a majority bank consent but banks can individually suspend drawdowns on a default. Usually individual enforcement rights for sums unpaid are preserved. In bonds, acceleration and enforcement by individual holders is typical, but if there is a trustee then, by virtue of a no-action clause, only the trustee can accelerate and enforce, subject to ultimate bondholder control.

8–13 **Modification** In loans, unanimity is usually required for changes to the financial terms. Majority bank waivers are required for non-financial matters. In bonds, individual bondholder consent is required unless there is a provision in the bonds or a trust deed or under corporate law for bondholder meetings. These usually allow changes to the financial terms by specified majority resolutions.

Transfer Loans are assignable, sometimes subject to restrictions, e.g. borrower consent and no extra costs to be thereby incurred. Novations are usually contractually sanctioned. Bonds are negotiable and so are freely transferable.

8–14 **Prescription** There is no express provision in loan agreements. Hence the statutory limitation periods apply, e.g. six to 12 years.

In bonds there is a contractual cancellation of unpresented claims at the expiry of the stated period. The statutory periods may be contractually shortened.

Governing law, forum, waiver of immunity These are standard in both loans and bonds.

Marketing and distribution of bonds

Main methods of marketing and distribution

8–15 Broadly, the marketing method varies according to (a) the need or otherwise to test market response by a preliminary prospectus, and (b) the identity and range of the proposed investors, e.g. private, sophisticated or public. The main techniques may be summarised as follows:

1. **Private placements** A manager or group of managers subscribe for the whole issue and place the issue with selected private clients or even a single private investor. These issues are not usually listed, but may be.

8–16 2. **Preliminary prospectus offerings** The purpose of this method is to test the market before the managers fix the interest rate and any discount (or premium) on subscription. The managers contact a group of selected financial institutions with brief details of the issue and the issuer and an indication of the likely issue terms. The managers also send out a preliminary prospectus which omits the issue terms and is stated to be subject to amendments – the "red herring" or "pathfinder" prospectus. In the light of the response, the managers agree the interest rate with the issuer, arrange for the issue to be underwritten and then offer the bonds to the interested financial institutions. These institutions hold the bonds themselves or in due course on-sell to their clients or to the public, if permitted by securities regulation.

   This is the traditional method followed in the case of an international eurobond offering and US and Canadian domestic offerings. But many eurobond issues are now "bought" deals: the managers dispense with the preliminary prospectus, buy the entire issue themselves and then on-sell to dealers.

3. **Impact day offerings** In this case the managers fix the issue terms with the issuer and announce the offering by public advertisement on an impact day. The public can apply on application forms for the securities within a stated period. The disadvantage of this method is that the managers are not able to fix the issue terms in the light of an initial market response and must hope the terms they decide on will attract sufficient investor interest. This is the method used for UK domestic offerings. It has never been used for eurobonds.

Many permutations of these three basic methods are possible in the various capital markets.

London eurobond issues: structure

8–17 The following describes the marketing techniques for a London eurobond issue.

The classical London eurobond structure involves the establishment of a hierarchy of three groups: (a) the **managers** (between three and, say, 12) who arrange the issue; (b) the **underwriters** comprising a larger group of financial institutions who agree to underwrite the issue in case investors do not subscribe; and (c) the **selling group**, comprising professional dealers in securities who place the bonds with their clients.

Often, there may only be two groups (managers and underwriters) or, more commonly nowadays, even only one (the managers). Administratively one lead manager is usually charged with organising the issue and preparing the documentation.

London eurobond issues: documents

8–18 The principal documents for a eurobond issue would include:

The **prospectus** or **offering circular** giving information about the issue and the issuer and furnished to the selling group.

A **subscription agreement** between the managers and the issuer setting out the terms upon which the managers agree to purchase or procure purchasers for the bonds: see the form in the Appendix. These terms may be summed up as follows:

- **Subscription** The issuer agrees to issue and the managers agree to subscribe for, or procure subscribers for, the bonds in return for a commission, and subject to listing, execution of the documents, and the warranties remaining true until the issue is made. In English practice, the liability of the managers is joint and several, i.e. each manager is liable to subscribe the whole issue if the selling group, the underwriters and the other managers all fail. In US practice, the commitments of the managers (usually called underwriters) are several.
- **Warranties** The issuer gives warranties on the lines of those in term loan agreements – see para 3–1 *et seq*. But there is a more elaborate warranty as to the accuracy of the offering circular. These warranties are given only to the managers – not investors. Breach is not an express event of default in the bonds.
- **Market disruption** The managers are permitted at their discretion to terminate the agreement at any time prior to closing in the event of market disruption. The usual clause allows this "if, in the opinion of the managers, there shall have been such a change in national or international financial, political or economic conditions or currency exchange rates or exchange controls as would in their view be likely

to prejudice materially the success of the offering and distribution of the bonds or dealings in the bonds in the secondary market". Since the time between signature and closing is often no more than a few days, this clause is rarely used and it is probably not worth spending too much time on it, especially as all parties have a commercial interest to complete the issue, unless there really is a good reason to "pull" it.

- **Miscellaneous** The agreement contains miscellaneous clauses as to expenses, stabilisation, compliance with securities regulation, jurisdiction, waiver of immunity and governing law.

Underwriting agreements between the managers and the underwriters setting out the terms upon which the underwriters agree to underwrite the issue in specified proportions in return for a commission.

8–19 **Selling agreements** between the managers and the selling group members setting out the terms upon which members of the selling group agree to sell the bonds. The main purpose of this agreement is to throw the onus upon selling group members to comply with securities regulation and it therefore contains elaborate selling restrictions, e.g. not sell the bonds into, or deliver the offering circular or other invitational material into, jurisdictions where the distribution would be unlawful, in particular the United States.

A managers' agreement between the managers delegating the organisation of the issue to the lead manager and providing for the division of the management commission and the underwriting shares. The London market has a standard form agreement developed by a market association which is deemed to be signed when the subscription agreement is signed.

8–20 **A trust deed** (if there is a trustee) between a financial institution as trustee and the issuer whereby the trustee is appointed trustee for the bondholders to protect their interests.

A fiscal agency agreement (or, where there is a trustee, **a paying agency agreement**) between the issuer and a bank whereby the issuer appoints a fiscal or paying agent and sub-paying agents (always banks) in various international centres to make payments to the bondholders.

A global bond, pending printing of the definitive bonds.

The **bonds** themselves issued by the issuer and containing the terms of the loan.

Issue procedures

8–21 The traditional procedure is as follows. The lead manager arranges for the documents to be prepared. On the "launch", the lead manager sends an invitational telex to prospective underwriters and selling group members (if there are any) setting out brief terms of the issue (except the subscription price and coupon) and (in the case of a first-time issuer) a summary of the issuer's business and accounts. The lead manager sends the preliminary offering circular to the same people. The managers and issuer then agree the interest coupon and subscription price (i.e. par, discount or premium) and the underwriters agree to underwrite. Following this agreement, the subscription agreement is signed by issuer and managers. The managers are now legally committed. The final prospectus is despatched to buyers. The selling group members or other buyers settle how many bonds they are prepared to buy. The trust deed/fiscal agency and paying agency agreements are signed. The listing is confirmed by the stock exchange. At the closing, the issuer delivers the conditions precedent documentation and delivers the global bond to a common depository (custodian) for the clearing system (either Euroclear or Cedel) and the selling group members or other buyers of the bonds pay the lead manager the subscription price and the lead manager transfers the proceeds of subscription to the issuer. The common depository may be used as agent to pay the issuer against receipt of the global bond. In due course the definitive bonds are issued when printed.

The whole procedure usually takes between a week and three weeks.

Nowadays, most issues are "bought" deals. There are no underwriters and no formal selling group. The issue is announced to the market via a dealers screen, at which time the terms are fixed, and telexes are then despatched. The managers agree with the issuer to subscribe the whole issue themselves and they sell the bonds to their clients and other dealers.

Stabilisation

8–22 The managers are usually authorised by the issuer and underwriters to stabilise the bonds. Stabilisation is a procedure whereby the managers over-allot or under-allot to limit or create demand during the initial distribution of the bonds. Stabilisation is generally regarded as necessary to maintain an orderly distribution – otherwise the price might fluctuate wildly according to speculative dealings not related to the quality of the paper. For example, dealers wishing to make a quick profit on the selling commission will push up the price by their demands and the price may then collapse as they dump the bonds in the market. Stabilisation may conflict with rules as to market-rigging, insider trading and short-selling and accordingly has to be specially

exempted by securities regulation (it is so exempted in the UK and US, subject to very detailed conditions).

Listing of bonds

Stock exchanges

8–23 Bonds which are intended to reach a large number of investors are generally listed on a stock exchange. For eurobond issues the most common stock exchanges are the London and Luxembourg stock exchanges. Other stock exchanges include Singapore, Frankfurt and Zurich depending on the target investor market. New York is not available for eurobond issues because SEC requirements make this impracticable.

Advantages of listing

8–24 The main advantage of listing is access to investors: listing enlarges the number of investors to whom the bonds can be sold. For example, many institutions such as pension funds, insurance companies and banks are for prudential reasons prohibited by law, official guidelines or their own self-imposed policies from investing in unlisted securities. Sometimes exchange controls may limit investment in unlisted securities but allow the holding of listed portfolios. Hence, listing greatly improves marketability.

A secondary advantage is that the stock exchange quotes the current price of the bonds based on prices at which the securities have changed hands so that investors benefit from a reasonably objective assessment of the current price. In practice very little trading of eurobonds is effected on stock exchanges since most dealings are carried out in the "over the counter" market, i.e. between dealers on behalf of their clients.

Disadvantages of listing

8–25 There are some disadvantages of a listing. The issuer must comply with the stock exchange disclosure requirements. The issuer must usually enter into a listing undertaking or its equivalent with the stock exchange whereby (inter alia) it commits itself to produce continuing information and to notify events which may lead to a false market in the securities, e.g. adverse changes which are not public knowledge and which may significantly affect the issuer's ability to meet its obligations. A stock exchange's listing require-

ments may change during the currency of securities and impose more onerous disclosure obligations. The issuer may be limited by the terms of the subscription agreement from de-listing or listing elsewhere. Listing may impede a rapid issue to take advantage of a "window" in the market. This is because stock exchange authorities may require listing particulars (offering circular, constitutional documents, issue documents, authorising resolutions etc.) to be submitted in advance of the issue of the securities, so that they can check them, although European stock exchanges often streamline their requirements so as to reduce this disadvantage in the case of euro issues.

Most stock exchanges require a paying agent to be located within the jurisdiction (not so in London or Luxembourg). Finally, the stock exchange may require a trustee to represent the bondholders and to monitor the issue (not so in London or Luxembourg).

Tax considerations for bonds

8–26 The ability of an issuer to make a bond issue and the structure of the bond issue are vitally affected by tax considerations. The two basic tax requirements are as follows:

1. The issuer must be able to pay interest free of withholding tax to investors. Investors are not willing to invest in bonds where the interest is reduced by taxation at source so that for every 100 of interest they receive only, say, 70. Bonds invariably contain a grossing-up clause which would make it prohibitively expensive to pay the interest plus the amount equal to tax. For grossing-up clauses, see para 4–160 *et seq*.

   If there is a withholding tax at source, then it may be possible to avoid the tax by structuring the issue differently. For example, the issuer could arrange for the bonds to be issued by an overseas finance vehicle located in a jurisdiction which does not impose a withholding tax. The parent guarantees the issue. The finance vehicle issuer on-lends the proceeds of the issue to the parent. All this increases the cost because a finance subsidiary must be set up and administered in accordance with local corporate law, and nominee directors must be appointed, paid and protected. Various tax haven states compete for the market by proffering the lowest common denominator of corporate formality and disclosure; they can be thwarted only by tax penalties by other states imposed on the parent to whom the proceeds are on-lent. The local jurisdiction might require a small taxable profit to be made locally which will necessitate a spread between the bond interest and the on-lending interest: their object is effectively to charge a small fee

for the service, levied in the form of tax. In the past, both the Netherlands Antilles and the Netherlands were useful tax havens for this purpose by reason of a satisfactory network of double taxation treaties, but many developed countries have dismantled withholding taxes on eurobond issues so that their business enterprises can borrow in the international capital markets. Alternatively, it may be possible to use the bearer depository receipt structure discussed at para 9–27 *et seq.*

2. The issuer must be able to deduct interest payments for the purposes of determining liability to tax on its income. If the issue is by a finance subsidiary, the company to which the proceeds are on-lent must be able to deduct the interest on the on-lending. The rules depend upon the jurisdiction.

8–27 In the United States the US Tax Equity and Fiscal Responsibility Act of 1982, as amended (TEFRA), is designed to discourage the avoidance of US tax by the holding of anonymous bearer instruments. It does this by imposing tax sanctions on an issuer (e.g. an excise tax and denial of interest deduction) and on the holders of bonds, unless the bond is in registered form. Hence, if it is desired that the securities should ultimately be available in the secondary market to US investors, then the bond should provide for a registered option so that a US tax-paying investor can exchange his bearer bond for a registered bond. There are detailed protections for off-shore issues of eurobonds to protect issuers from unwittingly being exposed to tax sanctions if a US person buys a bearer bond. For the detail, see chapter 21.

In the United Kingdom, interest payments by a UK company on eurobonds can qualify for exemption from deduction of UK tax at source under s 124 of the Income and Corporation Tax Act 1988 if the bond is a *bearer* security quoted on a recognised stock exchange.

Negotiability of bonds

Meaning of negotiability

8–28 International debt instruments must be freely transferable. In practice they are usually negotiable, e.g. bearer bonds transferable by delivery, certificates of deposit or promissory notes. If they are non-negotiable they will commonly be transferable only by written instrument: the name of the holder is noted in a register maintained by registration agents of the issuer.

Negotiability must be distinguished from mere transferability or assignability. The main characteristic of negotiability is that the holder in due course acquires the property in the instrument and all rights under it free of any defects in title of a prior holder or defences available to the issuer against a prior holder. See below.

English law of negotiability

8–29 As regards English law, there are only two ways in which an instrument can acquire the characteristic of negotiability: by statute or by mercantile usage in the English mercantile world. An instrument cannot become negotiable by agreement between the parties or by custom which is not general.

As to statute, the Bills of Exchange Act 1882 recognises the negotiability of bills of exchange, promissory notes and cheques. But the requirements set out in the Act as to certainty of amount and unconditionality will almost never be satisfied by bearer bonds in the form encountered in international bond issues. Thus an instrument with a floating rate of interest or a currency indemnity is uncertain. If it has events of default, it is conditional.

As to mercantile usage, it has been firmly established in England and indeed in many other jurisdictions that a debt instrument may become negotiable if the financial community treats it as such. Thus in *Goodwin v Robarts* (1876) 1 App Cas 476 scrip issued by the Russian Government was held to be negotiable because merchants in England so regarded it. On the other hand in *Picker v London and County Banking Co* (1887) 18 QBD 515, CA, bonds issued by the Prussian Government were treated as negotiable in Prussia but not in England, and it was held that they were not negotiable. The London certificate of deposit acquired negotiability by custom in England in 1966. Others are various forms of bearer depository receipts and bearer participation certificates. The custom need not be long-standing since the test is the frequency of transaction. However, outside the Bills of Exchange Act 1882, only *bearer* instruments have been treated as negotiable: registered or nominative instruments do not qualify.

8–30 The law shows a benign disregard for theories defining rigid attributes necessary to qualify a bearer document as negotiable. In *Edelstein v Schuler* [1902] 2 KB 144 (following the leading case of *Bechuanaland Exploration Co v London Trading Bank* [1898] 2 QB 658) Bingham J said:

> "In my opinion, the time has passed when the negotiability of bearer bonds, whether government bonds or trading bonds, foreign or English, can be called into question in our courts. The existence of usage has so often been proved and its convenience is so obvious that it might be taken now to be part of the law."

In *London Joint Stock Bank v Simmons* [1892] AC 201, Lord Macnaghten said:

> "In a matter of this sort, it is not, I think, desirable to set up refined distinctions which are not understood or are uniformly and persistently ignored in the daily practice of the Stock Exchange."

Bearer and registered bonds compared

8–31 A comparison of some of the differences between a bearer negotiable bond and a registered non-negotiable bond will indicate some of the reasons that registered instruments are inconvenient in the international markets.

Notification to issuer Under the laws of some jurisdictions, the sale of a debt is *invalid* on the bankruptcy of the *seller* and as against execution creditors of the seller if the debtor has not been notified, often in prescribed form, e.g. France, Luxembourg, Italy, Japan, S Korea. Hence the debt still belongs to the seller and goes to his creditors on his insolvency.

In other countries, notification is desirable (e.g. for priorities), but does not affect validity on the bankruptcy of the seller, e.g. England, most US states, Germany.

In England, if notice is not given, the transferor must be joined in any action against the debtor, although the debtor can waive this. The holder of a negotiable bond can sue in his own name.

Anonymity Bearer bonds preserve anonymity, a feature desired by some international investors.

8–32 **Transfer** A bearer bond is transferable by delivery. A registered bond requires the filing of an instrument of transfer together with the bond certificate with the registration authority, possibly in a distant country. Payments are made to those on the register on a record date, e.g. 15 days before the interest payment or redemption date to enable the issuer to prepare and post the payment orders for interest to the registered holder: this gap is inconvenient. On the other hand bearer bonds carry with them the risk of theft or fraud. This risk is greatly reduced by depositing the bonds with custodians

8–33 **Title** The purchaser of a bearer bond who becomes a holder in due course can acquire a better title than the person he took it from. This enhances certainty and hence marketability. In the case of a non-negotiable registered bond, a transferee acquires no title if he takes a transfer from a thief who has stolen the original certificate and forged the owner's signature on the

transfer: *Barton v London & North Western Railway* (1889) 24 QBD 77, CA.

8–34 **Priorities** The purchaser who becomes a holder in due course of a negotiable bond will normally take free of other interests, e.g. the claim of a third party to whom the bond has been hypothecated or the claim of a beneficiary for whom the bond is held in trust. The position of the purchaser of a registered bond is less secure. The English priority rules are complex but in broad terms the purchaser of a registered instrument will take free of these earlier competing interests only if he is not on actual or constructive notice of the prior interest and secures registration first: see, e.g. *Fry v Smellie* [1912] 3 KB 282, CA; *Peat v Clayton* [1906] 1 Ch 659, and generally on the subject *Colonial Bank v Cady* (1890) 15 App Cas 267, HL.

8–35 **Set-offs and other defences of issuer** In principle the transferee of a registered bond is subject to rights of set-off which the issuer could claim and which arise out of most claims contracted before the issuer has notice of the transfer. However, it is usually provided that registered debentures are to be transferable free from any claims which the issuer could set up against the original or any intermediate holder and in England such a provision is effective: *Re Blakely Ordnance Co* (1867) LR 3 Ch App 154. Negotiable bonds are in any event free of this difficulty: see Wood, *English and International Set-off* (1989) Sweet & Maxwell, para 12–68 *et seq*. The possibility of unknown set-offs would inhibit marketability.

Governing law of negotiability

8–36 In conflict of laws, negotiable instruments tend to be treated like chattels and are not governed by the rules which apply to ordinary assignments of claims. They are like chattels because, in contrast to an ordinary debt signified by a mark in a book, the whole claim is represented by a tangible document which has to be produced to be paid. Further the essence of negotiability is certainty and predictability which requires simple hard and fast rules so that a purchaser can know which law he has to look to see whether he gets good title. Generally, therefore, apart perhaps from the legal effect of transfers between the immediate parties, negotiability and its consequences tend to be determined according to the law of the place where the negotiation takes place, namely, where the instrument is at the time of delivery: see Dicey Rule 193; s 216 of the US Conflicts Restatement; *Lloyds Bank v Chartered Bank of India* [1929] 1 KB 40, CA. The rationale, originating from pre-telex days, is that this is the law which the holder would be

most likely to consult in the case of questions. The Rome Convention on Applicable Law of 1980 does not apply to negotiable instruments to the extent that the obligations arise out of their negotiable character: Art 1(2)(c).

Clearing systems

8–37 Most negotiable eurobonds are deposited with one of two custodians known as Euroclear or Cedel located in Brussels and Luxembourg respectively.

The main objects of these custodians are to safeguard the bonds, to collect payments, and, most importantly, to facilitate transfers: if all the bonds are with same custodian or there are special arrangements between custodians (which there are between Euroclear and Cedel), there is no need to deliver the physical bond on a transfer. All that is necessary is for the custodian to debit the seller's account and to credit the buyer's account. The bonds stay where they are in some vault somewhere. To achieve the maximum reduction of paperwork, the bonds must be fungible, i.e. of the same issue so that one bond is identical to another and there is no need to transfer specific bonds. Without this facility, trading in bonds would come to a halt and the paperwork would crush the market.

8–38 In practice, there are tiers of custodians. A bondholder may deposit with his bank which deposits with Euroclear or Cedel which deposits with a local custodian in the country of the currency which deposits with a local clearing system, perhaps. Sales and pledges of the bond by the bondholder are replaced by sales or pledges of intangible claims against the head custodian: these intangible claims may be proprietary claims or debt claims. The legal technology is considered in another work in this series on financial law, in a section dealing with security over investment securities located with custodians. That section also describes Euroclear and Cedel in more detail. The asset dealt with is not the bond, but a claim against a custodian.

In addition, many securities are now dematerialised, i.e. not represented by any paper, for example government domestic currency debt securities (US Treasuries, UK Gilts). They are transferred or pledged by entry in the register maintained by or on behalf of the issuer.

The result of those remarkable developments is that the mountain of case law on negotiability is rapidly becoming of historical interest. But it must not be forgotten that negotiability was vital in the development of financial law to free the law from the shackles of obsolete rules inhibiting the transfer

of intangible claims. Unhappily this development is by no means complete: para 8–31.

Terms of bonds

8–39 This section summarises the terms commonly found in international bonds. For a form, see the Appendix.

Face of bond

The face of the bond states that, the issuer, for value received, promises to pay to the bearer the amount of the bond and to pay interest at the prescribed rate in accordance with the detailed terms and conditions endorsed on the back of the bond.

Attached to fixed rate bonds are coupons, each for an interest payment in a fixed amount. Coupons are detachable and separately negotiable.

Incorporation of fiscal agency agreement/trust deed

8–40 The bonds state that they are issued subject to and with the benefit of the specified fiscal agency agreement (or trust deed if there is one) available for inspection at any of the paying agents and that the bondholders and couponholders are bound by and deemed to have notice of their terms.

There is no objection in English law to binding a bondholder to terms by reference, but firstly this term should not be misrepresented in any offering material even if the bondholders had a right of inspection, and secondly one must bear in mind the varying international position on surprise clauses incorporated by reference (bus and laundry ticket cases) and the attitude to unfair contract terms and terms imposed by standard contracts.

Rules are found in most, if not all, of the developed jurisdictions whereby exculpation clauses and harsh provisions in contracts with parties of little sophistication or weak bargaining power are subjected to close judicial scrutiny and may be nullified. Many of these are now encapsulated in consumer statutes or apply only to contracts involving consumers, but this is not always the case. The contracts particularly under attack are standard terms of business imposed on a party who had neither the bargaining power nor the sophistication to resist their terms. In such a case it could not be said

that freedom of contract exists. In many countries, the courts limited the impact of these clauses by covert means, e.g. that a party is not bound by surprise terms contained by reference in his contract which he could not expect, e.g. an exclusion clause in a laundry ticket or bus ticket, and by rules whereby exclusion clauses are construed strictly against the party relying on them, e.g. by insisting that negligence or liability for a fundamental breach which goes to the root of the contract cannot be excluded except by very clear words, perhaps drawn to the attention of the other party.

For example, in Germany the Act for the Control of the Law of General Conditions of Business of April 1, 1977 contains a number of rules applying to standard terms even if they are between merchants so that the Act is not exclusively concerned with consumer protection. The British Unfair Contract Terms Act 1977 is to the same effect and there is a provision in s 27 which limits the ability to contract out in an international setting. In Austria Art 839 of the ABGB renders void any contract prohibited by law or in conflict with good morals, and a new provision (Art 879 para 3) provides that collateral agreements contained in general conditions of business or contractual forms are also void if, in view of all of the circumstances of the case, they are "grossly" disadvantageous to one of the parties. There is also a provision striking down unusual surprise clauses: see Art 864A. Both the French and Italian courts as well as the Swiss courts, have policed exemption clauses and sometimes invalidated them. The same tendencies are to be found in the United States: see ss 203, 206, 211 of the Restatement of Contracts (2nd). See also Art 36 of the Swedish Contract Acts of 1976. For a general review, on which the above paragraph is based, see Zweigert/Kötz, vol 2 chapter 1.

Attacks are more likely to happen in relation to bonds which are bought by members of the public, as opposed to sophisticated investors (the usual purchasers of bonds) who are well able to look after themselves.

As to conflict of laws, validity is normally governed by the governing law of the bond, and an "unfair" contract would usually only be capable of being struck down if it is within a public policy exemption or violates a mandatory rule of the forum. Conflicts of law are discussed in another work in this series on financial law.

In any event, the best policy is that any unusual or adverse terms should be reflected in the bonds themselves.

Form and transfer

8–41 The bonds state that they are issued in bearer form and that title thereto will pass by delivery. In other words, they are negotiable. See para 8–28 *et seq*.

Covenants

8–42 Detailed covenants are rare. The reason is that it would be impracticable for the issuer to negotiate modifications of over-rigid covenants with numerous bondholders if circumstances changed. More extensive covenants may be found if the bond is constituted by a trust deed since a representative is available to monitor the covenants on behalf of the bondholders.

Pari passu clause This usually states:

> "The Bonds are unsecured obligations of the Issuer and rank at least pari passu, without any preference amongst themselves, with all other outstanding, unsecured and unsubordinated obligations of the Issuer, present and future."

This statement contains two limbs: pari passu equality between bonds, and pari passu status with other unsecured debts.

For the effect of the pari passu clause generally, see para 3–27.

The inter-bond equality provision contracts out of any rule there may be that bonds rank according to the date of their creation: such a rule would be unusual but might apply, e.g. to a secured bond and also applies to formalised securities in some Spanish-influenced jurisdictions. The statement may also constitute a covenant that the issuer will not discriminate between bondholders although it is not clear if this applies only on competition between creditors, i.e. actual insolvency, even though not yet judicially ordered. It may prevent compromises whereby more favourable terms are made available to some but not all the bondholders. Listing codes and the general law may in any event require bondholders to be treated equally.

8–43 **Negative pledge** Most bonds will contain a negative pledge. For negative pledges, see para 3–10 *et seq*.

Negative pledges in bonds are traditionally without teeth: usually they only prohibit the grant of security for *comparable securities*, e.g. listed external debt of more than one year maturity. The issuer can secure non-listed debt, e.g. bank borrowings. These negative pledges are not designed to prevent the subordination of the bondholders by the creation of security by the issuer in favour of other creditors, but rather to prevent the issue of comparable secured debt whose existence might prejudice the relative value of the unsecured bonds and thereby directly affect bondholders' interests: investors might be more likely to purchase the secured bond. Hence the negative pledge is primarily intended to provide market support for the price of the bonds. But the romantic "same paper, same treatment" motive is also present. As a control on the grant of security by the issuer, the bond negative pledge is useless.

Information There is usually an obligation upon the issuer to furnish annual accounts for inspection at the offices of paying agents. This is also usually a listing requirement.

Interest

8–44 The following are some examples of the usual methods of fixing the interest rate:

Fixed rate A fixed interest rate bond states that the bond bears interest at the specified rate per annum payable annually in arrears on a specified date. Bonds cease to bear interest from their due date for redemption, unless not paid on due presentation. Interest stops on the due date for redemption because, if not so provided and if the holder delayed presentation, interest would continue to run: *Fowler v Midland Electricity Corporation* [1917] 1 Ch 526 and 656, CA. The clause encourages diligence by bondholders.

Unlike bank loans, there is usually no provision for an increased rate of default interest to discourage delayed payment.

8–45 **Floating rate** Floating rate bonds (generally called notes) are common because of their appeal to bank investors who are not willing to take the risk of a fixed rate.

The issuer appoints a bank as reference agent to fix the rate periodically, usually every three or six months, by reference to a market rate: this is usually the London interbank offered rate (LIBOR) because of its international acceptability, although local IBORS, e.g. in Hong Kong or Singapore, have been used, primarily for floating rate certificates of deposit. The rate should be one which would be acceptable to the investors for whom the notes are designed. The rate is announced in the financial press periodically after each fixing. Unlike loan agreements the issuer cannot select interest periods: bondholders desire certainty and the minimum of fuss.

There is no increased cost clause: for these, see para 4–5.

8–46 **Zero coupon (deep discount bonds)** These are bonds which do not carry any interest at all but are issued at a deep discount, e.g. 30 per cent below par. The return to the investor is the capital appreciation realised on sale or redemption. One advantage is an improved cash flow for the issuer – the issuer does not have to pay interest which is effectively "rolled-up" until final redemption. The investor's tax position may be improved since it may not be liable to pay income tax on the discount so that the earnings

are free of tax, at least until redemption. But this depends upon the tax laws in the jurisdiction of the investor and the issuer. The other main questions are (i) whether the issuer will obtain tax relief on the accrued discounts over the life of the security, (ii) whether the investor is taxed on disposal or redemption as though it had received income equal to the accrued discount, and (iii) whether any capital gains will be charged on the discount.

If the bonds become prematurely due, e.g. the issuer redeems voluntarily when a tax law change imposes a withholding tax on interest on the bonds or if an event of default occurs, the investor receives compound returns up to the redemption date equal to the proportion of the return he would have received if the bonds had remained outstanding until final redemption.

Other questions are whether, in the event of the insolvent liquidation of the issuer, the usual prohibition on interest running in a liquidation will apply to the discount element and whether any borrowing limits would apply to the full principal amount, i.e. by treating the discount as capital.

Swaps The interest on the bond is often the subject of an interest swap. Swaps are reviewed in another volume in this series on financial law.

Redemption

8–47 The terms of repayment ("redemption" in bondese) are diverse. The following are some examples:

Bullet The bonds are repayable in one instalment.

Instalments The bonds are repayable by fixed periodic instalments. Normally the bonds for redemption are selected by drawings by lot by the fiscal agent. The bondholder is exposed to the whims of fortune.

Purchase fund The issuer is required to appoint a purchase agent who, by the terms of the bonds, must endeavour to purchase bonds during specified periods up to a specified total amount at a stated maximum price, normally par. The purchaser need not buy at par but can buy at below market prices. A purchase fund theoretically gives willing bondholders an opportunity to be "redeemed" and also, perhaps more importantly, provides market support for the bond: the demand created by the purchase agent theoretically pushes up the price. The disadvantage is that the "redemption" can be at less than par and, in practice, it is

difficult to enforce impartiality in the purchase of bonds by the purchase agent. Purchase funds are now rare in the eurobond market.

8–48 **Perpetual bonds** A perpetual bond is one which is not redeemable by the issuer except upon default or if a withholding tax is imposed. Corporate irredeemables have been known in domestic markets for many years and in England statutory recognition is now given to them by company legislation, even if they are secured, i.e. the objection to clogs on the equity of redemption of mortgaged assets does not apply.

The defaults are generally limited to non-payment and winding-up.

Perpetuals are usually subordinated to all other creditors of the issuer. One purpose of a perpetual is to approximate the bond to preference share capital while preserving its status as debt. The reason may be that interest is tax deductible but preference dividends are not, but the effect of equity is required, e.g. for bank capital adequacy purposes. Subordinations are discussed in another work in this series.

8–49 **Early voluntary redemption** Investors generally prefer that issuers should not be able to voluntarily redeem the bond before its maturity because this results in a loss of the investment, e.g. the higher interest rate on the bonds if market rates are lower.

If a voluntary prepayment right is conceded, then a premium may be payable on a sliding scale commencing at, say, 105 per cent in the early years and dropping by, say, $\frac{1}{2}$ per cent for each subsequent semi-annual period. Prepayments and sliding scales are now unusual in the eurobond market. In England a prepayment premium is not a void penalty unless it is unfair or unconscionable or is payable on a default: see *Multiservice Bookbinding v Marden* [1978] 2 All ER 489 (a mortgage loan).

The bond generally provides that the bonds prepaid are selected by lot and for the application of prepayments towards any redemption instalments in inverse order, i.e. the compulsory redemption instalments continue in the full amount notwithstanding the early prepayment until the bonds are fully redeemed. Thus the life of the issue is shortened. Bank loan practice is the same.

Normally it will be clear from the language of the bond that an issuer does not have a right of early redemption if no express right is conferred by the bond. It was held in *Hooper v Western Counties and South Wales Telephone Co Ltd* (1892) 68 LT 78 that debentures are not redeemable before the stated fixed date unless otherwise provided. An Australian court has delivered a similar opinion in relation to a loan: *Hyde Management Services (Pty) Ltd v FAI Insurances* (1983) 144 CLR 541.

In the absence of an express provision as to application of partial pre-

payments towards instalments in inverse order, the issuer could probably not choose which instalments to apply the redemption amount against but must continue to pay in accordance with the fixed redemption terms of the bonds so that the prepayment shortens the life of the issue: but this depends on the terms of the bonds and any applicable rules as to rights of appropriation.

8–50 **Early redemption for tax** Almost invariably an issuer can voluntarily redeem the bonds if a withholding tax is imposed which gives rise to an obligation upon the issuer to pay additional amounts under the grossing-up clause in the bond. If this were not the case, the issuer would theoretically be subject to potentially unlimited liabilities at the hands of the tax legislature. Redemption in such a case must generally be on interest payment dates, in whole, and at par. Hence no discrimination between bondholders is permitted. This right of redemption is not usually allowed in issues by sovereign states since they control their own tax laws.

8–51 **Purchase of bonds by issuer** Unlike share capital, there are generally no legal restrictions on an issuer purchasing its own debt and even re-issuing it. In some jurisdictions, the acquisition of the debt instrument by the debtor may cause the debt to be extinguished automatically. In England the Companies Act 1985 allows debentures purchased by a company to be reissued with the original priority if they are secured.

Some bonds allow the issuer (or its subsidiaries) to purchase its own bonds provided:

- If made by tender, the tender is available to all bondholders alike (to prevent discrimination).
- The purchased bonds are cancelled. They must not be reissued or resold. Reissues would, for example, potentially run into securities regulation problems.
- Purchased bonds are credited towards any subsequent compulsory redemption instalments.

A purchase is therefore similar to a prepayment except that (i) the transaction requires a willing seller, (ii) the issuer need not purchase at par, and (iii) no prepayment premium is payable.

Payments

8–52 **Bearer bonds** Payments on bearer bonds are made against surrender of the bonds or coupons at the specified offices of the specified paying agent. Generally it is a custodian or sub-custodian who collects.

Payment is generally made either by cheque drawn on or by transfer to an account maintained by the payee with a bank in the country of the currency.

Payment is generally expressed to be subject to all applicable laws or regulations at the place of payment – meaning the office where the bond or coupon is presented. Hence, if taxes or exchange controls are imposed in one place, the bondholders can present their bonds at another paying agent. For the impact of exchange controls and illegality at the place of payment, see the relevant chapters in another work in this series.

The amount of any missing, unmatured coupon must be deducted from a payment of principal and is payable against surrender of the missing coupon. The reason is that the coupon is a bearer instrument and so can subsequently be presented for payment notwithstanding that the bond itself had been prepaid prior to the maturity of that coupon. Floating rate coupons are void if separated from the note.

8–53 **Paying agents** Generally the issuer can change the paying agents and appoint additional paying agents. Bonds normally require that the issuer maintain paying agents in a convenient jurisdiction for bondholders and also in the country where the bonds are listed (if the local stock exchange so requires, which it usually does). It is often not the case that a paying agent is maintained in the country of the currency; a paying agent in the US for US dollar issues would cause problems under US securities regulations which seek to prevent unregistered issues from coming to rest in the primary distribution in the US. For more detail on fiscal and paying agents, see para 10–9.

Prescription

8–54 A prescription clause in a bearer bond having a registered option provides that the bonds and coupons become void unless presented for payment within periods of usually 10 years and five years respectively of the due date (assuming the issuer places the funds with the fiscal agent).

Statutory periods Without a prescription clause, if a bondholder omitted to present a bond or coupon for payment, either through inadvertence or because of some disability, the issuer's liability to pay and the continuance of the covenants in the bond could endure almost indefinitely, subject only to the various statutes of limitation.

Contractual alterations It is usually not possible to extend the limitation period by private contract. However local laws vary as to whether contractual shortenings are permitted. In France, England and Germany there is no objection. However local stock exchanges may prescribe a minimum period in order to prevent issuers from fixing unduly short limitation periods to the prejudice of bondholders.

Events of default

8–55 Events of default are discussed generally at para 3–37 *et seq.*

In the case of bonds, the events of default are generally less stringent than those appearing in term loan agreements. The reasons are: the terms of the bonds are generally longer than medium-term loan agreements so there may be greater changes of circumstances; it is less easy to arrange modifications or waivers of non-material defaults than is the case with bank loans (and which are often impossible if there is no provision for meetings of bondholders or no trustee); and complex events of default requiring the exercise of judgment, e.g. as to materiality or those which require monitoring such as financial ratios, are not appropriate in the case of scattered bondholders even where there is a trustee. Trustees are generally unwilling to take on too wide a discretion.

The events of default normally included are non-payment, non-compliance, cross-default, insolvency, bankruptcy, dissolution, creditors' processes and sometimes substantial disposals.

Acceleration and enforcement If there is no trustee, then each bondholder can accelerate and enforce his own bond. For the position where there is a trustee, see para 10–21. If there is a trustee, the bonds will generally refer in outline terms to the no-action clause, the ability of the trustee to waive breaches, approve non-material modifications and approve mergers and transfers of the undertaking of an issuer in certain cases, meetings of bondholders and the ability of bondholders' resolutions to modify the bonds; and the indemnity in favour of the trustee. This is to avoid surprise clauses which might entitle the bondholder to claim he was not bound: see para 8–40.

Miscellaneous

8–56 **Notices** Notices are stated to be valid if published in a specified leading financial newspaper.

Governing law, forum and waiver of immunity These matters are briefly summarised in chapter 5.