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Allen P.K. Keese

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## The Civil Law Enforcement of Contractual Covenants

ALLEN P. K. KEESEE\*

### I. INTRODUCTION

A standard component of virtually all international loan agreements is the package of "negative covenants" to which the lender requires the borrower to obligate itself. Typically, these covenants require the borrower not to merge, liquidate, file for receivership or bankruptcy, cease doing business, enter new lines of business, encumber any of its assets, or in any way dispose of any substantial portion of them, execute cross-guaranties, make loans to third parties, incur long-term debt in excess of specified amounts or enter into long-term leases, management agreements, or profit-sharing arrangements.<sup>1</sup>

\* Counsel, Overseas Private Investment Corporation, Washington, D.C.; B.A., Yale University, 1968; J.D., Harvard University, 1972; Associate, Simpson, Thacher, and Bartlett, New York, 1972-1975; General Editor, *COMMERCIAL LAWS OF THE MIDDLE EAST*, Oceana Publications, 1980.

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1. The various restrictions explored in this article can be found in the standard project loan agreement forms used by the Overseas Private Investment Corporation, the Export-Import Bank of the United States, the International Finance Corporation and Citibank, N.A., among others.

While the substance of the restrictions is essentially the same in each of the four standard forms cited, it is interesting to note the variations of language, degree of detail, and attempted completeness among the forms in use by the four institutions. The following paragraphs represent, in part, the respective sections forbidding encumbrance of borrower assets:

(I) *Citibank*: So long as any debt under this facility shall remain unpaid Borrower(s) will not without the prior written consent of Lender . . . mortgage, pledge or in any way encumber any of its assets except for purchase money liens on equipment purchased and [other specified liens].

(II) *Eximbank*: Until all of the indebtedness under this Agreement and the Notes has been paid in full, the Borrower covenants and agrees that, except as the Lenders may otherwise consent in writing, it will not . . . create or permit the creation (except as required by the Guarantor as a condition of issuing its guarantee in this Agreement) of any mortgage, pledge, lien, or other encumbrance, on any of its properties, whether now owned or hereafter acquired. . . .

It is this body of covenants in particular, which, granting the difficulty of drafting against the random hazards presented by management fallibility and the vagaries of the marketplace, seeks to at least preclude the borrower from purposefully engaging in any course of action which could impair its earnings capability or divert its revenues into third party "pockets" inaccessible to the lender. It is because of this prophylactic, as opposed to remedial, orientation that negative covenants can justly be regarded as the most important loan documentation component in the post-disbursement phase of a financing—more important than even financial reporting provisions (essentially "post mortem" devices) and collateral security arrangements (essentially "last resort" remedies).

Negative covenants assume particularly great importance in transnational, as opposed to uni-jurisdictional, loan transactions. This is so not simply because the quantum of risks varies as between domestic

(III) *IFC*: Unless IFC shall otherwise agree, the Company shall not:

(g) Create or permit to exist any lien on any assets of the Company except:

- (i) the liens to be created as security for any indebtedness included in the Financial Plan but only if such lien or liens shall secure *pro rata*, under agreements in form and substance satisfactory to IFC, the Loan and any other indebtedness hereunder;
- (ii) any tax or other statutory lien, provided that such lien shall be discharged within thirty days after final adjudication; and
- (iii) any lien on commercial goods to secure a debt, incurred in the ordinary course of business, maturing not more than one year after the date on which it is originally incurred and to be paid out of the proceeds of sale of such commercial goods.

(IV) *OPIC*: The Company shall not directly or indirectly create, assume or permit to exist any mortgage or lien on, vendor's lien or title retention agreement with respect to, or other security interest in, any property or assets of or contracted to be sold to the Company whether now owned (or leased) or hereafter acquired (or leased), or in any proceeds, income or profits therefrom, provided that the foregoing restrictions shall not apply to:

- (a) Liens for taxes and assessments which are not otherwise required to be paid by the terms of this agreement; and
- (b) Contractual or statutory liens terminating prior to the date of completion of project construction in favor of equipment suppliers and materialmen in only the goods sold by them for the Project to secure only the purchase price thereof, and in favor of contractors and mechanics in only the facilities for the Project constructed by them to secure only payments and fees for such construction services.

and international investments (a differential which should be reflected in the lender's pricing formulation), but primarily because the type of lending risk encountered in the international arena differs materially from that encountered in domestic financings. In domestic investment situations, for example, the principal sources of uncertainty are arguably the relatively familiar marketplace and competitive model risks—both controllable, at least in theory, by careful borrower selection. The international lender, *per contra*, is often concerned with the substantial physical and cultural distances that separate lender and borrower, by the political uncertainties inherent in cross-border financing, and perhaps most importantly, by the lender's ultimate dependence on an at best unfamiliar, and at worst hostile, legal system as the instrument of enforcement of its contractual rights. Under these circumstances, where care in borrower selection clearly must be reinforced by vigilance in asset control, negative covenants assume a heightened importance.

This importance is recognized, in a sense, by the virtually invariable inclusion of covenant violations as an event of default. Yet, in the process of negotiating and drafting the terms of foreign investment financings, the means of enforcement of negative covenants are rarely adjusted or structured to meet the specific requirements of the particular financing to be effected. Similarly, they rarely reflect the demands of the jurisdiction where the loan documentation will have to be enforced. On the contrary, it appears that negative covenant enforcement mechanisms are generally perceived as static, assumed "givens," rather than as dynamic "variables" similar to mandatory prepayment triggers, financial tests, and collateralization options.

The mechanism that lenders based in common law jurisdictions appear to look to in the final analysis for enforcement of their negative covenants is the threat to institute actions against the borrower for injunctive relief and/or damages. In some cases, lenders may also rely on actions against the other party to the violative transaction for interference with contractual rights. Generally, the options of actual acceleration, action on the debt, and foreclosure are regarded as last resort measures which ideally will not have to be utilized.

Such an approach might be acceptable outside common law jurisdictions if all enforcement jurisdictions were governed by those same substantive and procedural legal principles which obtain in the lender's common law jurisdiction and which are reflected in its loan documentation. In actuality, however, the common law holds sway in a

relatively small number of nations as compared to the number of countries which, as detailed in Part II of this paper, have adopted what may justifiably be referred to as the leading legal system in the world, the civil law system.<sup>2</sup> In that civil law principles are not

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2. The origins and distinguishing characteristics of the civil law system have been described thusly by three leading commentators:

If we leave aside the great systems of Hindu and Islamic law, the modern world may be divided into two broad groups of legal systems—the common-law countries which comprise the English-speaking world and territories which have formed part of the British Empire and Commonwealth; and the civilian countries which include continental Europe and many other—even Oriental—states which have, with westernisation, adopted occidental codes of law, like Japan and Turkey. To a greater or less degree, civilian systems stem from Roman law; or rather from revived Roman law.

For Roman law, in world history, had two leases of life and influence. In the first, of course, it was the living law of Rome and the Roman Empire, an existence which may be said finally to have come to an end with the compilation by the Emperor Justinian (A.D. 527-565) of the Code and Digest which contain the essential legacy of the imperial legislation and juristic writing respectively of Rome's past. Its second life began with the use and study of Justinian's works in the Italian universities of the eleventh century A.D., which spread thereafter throughout Europe (even, to an extent, into medieval England), influencing the development of juridical terminology to the period of codification, which really starts with the French Code Napoleon of A.D. 1804.

J. THOMAS, *Roman Law*, in *AN INTRODUCTION TO LEGAL SYSTEMS* 1 (J. Derrett ed. 1968).

A [major world legal system] to which French law belongs may be called the Roman-Germanic family. This group includes those countries in which legal science has developed on the basis of Roman Law . . . .

The law has evolved, primarily for historical reasons, as an essentially *private* law, as a means of regulating the private relationships between individual citizens; later other branches of law were developed, but less perfectly, according to the principles of *de droit civil* which today still remains the main branch of legal science . . . . The Roman-Germanic family of law originated in Europe. It was formed by the efforts of the European universities which, from the 12th century and on the basis of the compilations of the Emperor Justinian evolved and developed a juridical science common to all and adapted to the conditions of the modern world.

R. DAVID & J. BRIERLY, *MAJOR LEGAL SYSTEMS IN THE WORLD TODAY* 14 (1968).

Two points of difference are usually emphasized in comparing the civil and the common laws. First, in the civil law, large areas of private law are codified. Codification is not typical of the common law. Second, the civil law was strongly and variously influenced by the Roman law. The Roman influence on the common law was far less profound and in no way pervasive.

A. VON MEHREN & J. GORDLEY, *THE CIVIL LAW SYSTEM* 3 (2d ed. 1977).

identical with common law principles, there would appear to be a *prima facie* question as to whether lender reliance on common law covenant enforcement mechanisms in civil law jurisdictions is advisable.

Starting from the premises discussed in Parts III and IV that underlying legal principles are substantially similar in the many civil law jurisdictions around the world and that it is reasonable to represent them by one well-chosen "model" civil law jurisdiction, this paper argues, in Part V, that the common law jurisdiction approach of attempting to prevent negative covenant violations through the deterrent effect of the threat of litigation is an ineffective approach in civil law jurisdictions. Part V, for example, lays major emphasis upon: (1) the difficulties of invoking injunctive relief or of bringing damage actions for breach of contract; (2) the fact that in a civil law jurisdiction the lender's threat to litigate is in essence little more than the threat to invoke the ultimate remedies of acceleration, suit on the debt (or possibly bankruptcy), or foreclosure; (3) the fact that the pursuit of these remedies is hardly consistent with the lender's pay-back interest since it places the lender in the position of being able to enforce its negative covenants only by the exercise of prerogatives which cause the firm serious operational—and probably financial—disruption, i.e., precisely the effect the occurrence of which the covenants were intended to preclude; and (4) the fact that such a result seriously undermines the credibility of litigation as a deterrent to covenant violations. Part VI then describes in detail four enforcement mechanisms of proven effectiveness in civil law jurisdictions, and provides summary accounts of civil law principles fundamental to the operation of these mechanisms.

Finally, it should be noted that implicit in the foregoing analysis is the premise that given the large number of nations which are civil law jurisdictions, the common law-based lender who does not make some attempt to adopt its loan documentation by the incorporation of effective covenant enforcement mechanisms is taking a serious risk that the most vital post-disbursement feature of its documentation—the negative covenants—will be all but unenforceable, a condition which can only have the most adverse implications for repayment prospects.

## II. THE CIVIL LAW AND THE CODES NAPOLEON

Two points should be made at the outset. First, there is ample reason for a common law attorney to delve into civil law issues in

view of the widespread influence of the civil law in the world today. As previously mentioned, the number of countries classifiable as civil jurisdictions far exceeds the number of nations in the common law orbit. Indeed, civil law jurisdictions make up one of the four great "families" of law in the world<sup>3</sup> and include nations comprising all of Western Europe, except Great Britain and Ireland; all of Africa, except Liberia and the ex-British colonies, but including Egypt; all of Latin America; all of the Middle East, except the Arabian Peninsula states; and Thailand, Indonesia, and Japan.<sup>4</sup>

Second, despite the great social, cultural, and political variations among the many countries which have adopted the civil law system, it is eminently feasible to study civil law principles applicable to virtually all of those countries because, generally speaking, those principles had a common origin in—albeit indirect in some cases—and those legal systems continued in many cases to be strongly influenced by, the French Codes Napoleon enacted in the first decade of the nineteenth century.<sup>5</sup> One knowledgeable commentator has asserted that "the French Civil Code is the most pervasive single phenomenon of the entire world of the system known as the civil law."<sup>6</sup>

3. R. DAVID & H. DE VRIES, *THE FRENCH LEGAL SYSTEM* 14 (1958).

4. For detailed descriptions of various civil law jurisdictions, see R. SCHLESINGER, *COMPARATIVE LAW* 251-69 (3rd ed. 1970).

5. The Napoleonic Codes include the Civil Code of 1809; the Civil Procedure Code of 1806; the Commercial Code of 1807; the Penal Code of 1811; and the Criminal Procedure Code of 1811. See generally M. AMOS & F. WALTON, *INTRODUCTION TO FRENCH LAW* 18 (2d. ed. 1963); David & de Vries, *supra* note 3, at 13 (All subsequent references herein to the Napoleonic or French Codes will be to the three non-criminal codes).

6. J. CRABB, *THE FRENCH CIVIL CODE* 5-6 (1977). Crabb further states:

The French Empire of Napoleon annexed outright the entire Low Countries (the present "Benelux") and large parts of Germany, Italy and Switzerland, to all of which the Civil Code was applied (leaving aside from discussion transAdriatic territories known as "Illyria" that were also annexed). In addition the Code was adopted in some client states or protectorates, this occurring in Poland and some German states which had not been annexed to France itself. Upon recovering independence these countries, with minor exceptions, did not summarily throw out the Civil Code as part of the law imposed by a foreign conqueror under whom they had languished. Rather they seem to have judged it on its own merits, found it superior to their earlier systems of law, and retained it, with whatever modification they wished, as an ongoing basis of legal system. The German and Swiss areas ultimately did depart to join different movements of their own national laws which subsequently resulted in each establishing its own system of codification independently of the Napoleonic model. But otherwise the scheme of the French Civil Code extended later into some other European countries

A second commentator has noted, with respect to the substantial coincidence of principles among civil code "families" and to the hegemony of the French codes in particular, that

[t]here is almost no private-law code in force in any civilian country today which is not substantially copied from, or in its structure or some of its provisions to some extent influenced by the codes of France, Germany or Switzerland. The German Civil Code of 1896 (effective date Jan. 1, 1900) was in turn somewhat, although not too strongly, influenced by provisions of the French Code; and the Swiss Code of 1907 . . . did not escape the influence of the German and French codes.<sup>7</sup>

Similarly, despite the fact that the current Italian Civil and Civil Procedure Codes were issued in 1942 and were modeled to a certain extent on opposite-number German codes, the Italian codes are indisputably French in terms of underlying legal principles, in that they represent not wholesale replacements, but merely reformations of the Italian Civil, Commercial, and Civil Procedure Codes of 1865, which in turn, were based squarely on the respective French Codes. Moreover, the Italian Commercial Code of 1882, which was "particularly influential" in the legislation of Latin America and which formed the basis for the commercial law sections of the 1942 Italian Civil Code, was modeled, albeit with certain changes, on the French Commercial Code of 1807.<sup>8</sup>

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and areas which it had not entered at the time of the original Napoleonic impulse.

The Civil Code followed the French flag around the world as France developed the bulk of its colonial empire in the nineteenth century. These colonies upon becoming independent retained the Civil Code and other French legal institutions as the bases of their modern legal systems. The Civil Code has also made appearance in parts of the world that were never touched by French sovereignty. Latin American countries, in seeking as the basis of legal system something more modern than the Spanish law which they had inherited, leaned heavily on the guidance and framework of the French Civil Code. Parts of the Arab world which had experienced British rather than French colonialism, after achieving independence constructed their modern legal systems on French models rather than to continue with law based on English style. Non-European societies which were never subjected to European colonialism ultimately replaced their traditional legal systems with modern law, and in so doing in varying degrees borrowed, adapted or at least studied the French Civil Code.

*Id.*

7. Schlesinger, *supra* note 4, at 383-84.

8. M. CAPPELLETTI, J. MERRYMAN & J. PERILLO, *THE ITALIAN LEGAL SYSTEM* 46-47 (1967). "Both the French and German codifications . . . have strongly influenced the legal development of unified Italy." *Id.* at 52.



With respect to Latin America, the French Commercial Code of 1807, with minor amendments, including the incorporation of the "Ordinances of Bilbao," became the Spanish Commercial Code of 1829,<sup>9</sup> and in that form, was copied widely throughout Latin America.<sup>10</sup> The influence of the French Civil Code throughout the area has also been pervasive.<sup>11</sup> Similarly,

throughout the vast area of North and West Africa as well as the Near East (except in Turkey [ , ] Israel [ , ] Saudi Arabia and South Yemen) French influence has been stronger than that of any other legal system . . . . In the [Middle East,] especially in the law of obligations and in the area of commercial law, civil law influence—traditionally of the French variety—has become predominant. French influence remains particularly strong in Lebanon and Iran . . . [W]hile the Code Napoleon is no longer blindly followed, it is still the most potent source of western influence upon draftsmen of private law codes in the Arab world.<sup>12</sup>

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9. B. KOZOLCHYK & O. TORREALBA, *CURSO DE DERECHO MERCANTIL* 106 (1974).

10. "It is generally acknowledged that the Latin American countries took their codes from the French." Gutierrez, *El Desarrollo de un Sistema Juridico*, 5 *REVISTA JUDICIAL* 65 (1977) (quoting E. NOVOA, *EL DERECHO COMO OBSTACULO AL CAMBIO SOCIAL* 18 (1975)).

11. Limpens, *Territorial Expansion of the Code*, in *THE CODE NAPOLEON AND THE COMMON LAW WORLD* 92 (B. Schwartz ed. 1956). Note particularly Limpens' comments on the legal systems of Chile and Argentina, both of whose Codes and jurisprudence have been, and remain, highly influential throughout Latin America:

[With respect] to Latin America, we find that the codes developed there during the nineteenth century were all more or less inspired by the French example.

The Dominican Republic Code of 1825 and the Bolivian Code of 1831 were copied virtually verbatim from the French Code. The . . . Chilean Code of 1865 established by the great jurist Arches Bello, . . . in spite of its incontestable originality, also belonged to the French family. Its arrangement is practically the same and many passages are literally borrowed from the French Code. This code was . . . so remarkable that it was copied by some countries (Ecuador and Colombia, 1861 and 1873 respectively) and taken as a model in others (Uruguay and Argentina, 1867 and 1869).

As for the Argentinian Code of 1869 . . . , a threefold source is generally attributed to it: the *Escobo* of Freytas for the first three books, Aubry and Rau and the *Code Napoleon* for the last three, [and] Garcia Goyenna and the Chilean Code for the remainder. As much directly as indirectly (through the Chilean conduit), the French influence is here again important if not preponderant. *Id.* at 99-100.

12. SCHLESINGER, *supra* note 2, at 262-63. See also A. LIEBESNY, *THE LAW OF THE NEAR AND MIDDLE EAST* 71-116 (1975). "In the former French North African territories, the influence of French law has been profound." *Id.* at 111.

Finally, it should be noted that virtually all of the nations of former French West Africa have either retained in force the French codes in effect on their respective dates of independence, or have replaced those codes with modernized versions differing from their French predecessors in organization and text, but remaining conceptually true to their original counterpart.<sup>13</sup>

In assessing the full significance of the shared Napoleonic origin of virtually all civil law systems, it should also be recognized that in the civil law, although prior decisions and judgments are not, as a rule, ignored by judges in subsequent cases, the principle of *stare decisis* is not formally recognized. Prior case law and legal precedent are considerably less important than in the common law. Rather, the prime evaluative standards applied to the facts of a given civil law case and invoked as the basis of the "reasoned" judgment required by virtually all civil law procedure codes are the principles set forth in the codes themselves. It can reasonably be argued that by virtue of their common origins and the relative infrequency of code revisions, these codified principles tend to correlate more from country to country than do principles derived from case law, which principles are free to permute in each discrete common law jurisdiction in whichever directions the courts choose to take them. This greater consistency of legal principles across civil law, as opposed to common law, boundaries then, combined with the common origin of the civil law codes cited above, makes it reasonable to contend that the study of "civil law principles" in general constitutes in fact the study of the legal principles basic to scores of nations around the world.

### III. METHODOLOGY, MODELING AND CORRELATIONS

Precisely because such a multiplicity of civil law jurisdictions does exist, it is not practical to attempt to review each country's codified and statutory provisions as they bear on negative covenant enforcement and to provide precise country-specific remedial formulations. Rather, the approach to be taken in this paper is: (1) to attempt to demonstrate that in addition to the common origin of code principles noted in Part II, there is, even today, a substantial correspondence among civil law jurisdictions of underlying legal principals in general, and of principles in the negative covenant area specifically; (2) to select one civil law jurisdiction and establish that it is indeed repre-

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13. See J. SALACUSE, AN INTRODUCTION TO LAW IN FRENCH-SPEAKING AFRICA 121 (1969) (discussing the law of the Ivory Coast).

sentative of civil law systems in general; and (3) to base the discussion of specific covenant enforcement problems and specific solutions on the codes and statutes of that model jurisdiction.

The threshold question, then, is whether "modeling" is legitimate at all, no matter how apt the model, when the legal systems of a wide variety of disparate nations are the items to which the model is being applied. A defensible answer is that where the legal systems sought to be represented are the civil law systems descended from the Napoleonic Codes, the exercise is reasonable. This conclusion can be defended not only by reference to the common origin of the code systems of civil law nations described above, but also to the high degree of correlation among the underlying legal principles subsisting today in the respective codes of civil law nations. This correlation appears to obtain whether the civil code system in question developed directly from the French model or indirectly from the French codes via German or Swiss models.

This linkage of underlying principles is perhaps most effectively illustrated by presenting examples from the civil, commercial, and civil procedure codes of three nations widely disparate in culture, language, geography, and colonial experience: Costa Rica, the Ivory Coast, and Thailand. These nations have virtually nothing in common other than the origin of their respective civil, commercial, and procedural codes. The similarities of both code language and underlying principle which will be noted in this comparative analysis, however, should support the validity of the modeling technique.

### *Costa Rica*

The first code enacted in Costa Rica was the General Code of 1841, which included sub-codes on penal, procedural, and civil law matters.<sup>14</sup> The Code's origins have been described as follows:

The Civil Code was, for the most part copied from the French [although in] some areas it departed from the original, such as, for example, in matters of marriage and divorce, where principles of common law were adopted, and in matters of testamentary succession, where Spanish law was followed.<sup>15</sup>

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14. Gutierrez, *supra* note 10, at 65.

15. A. CORDOBA, *HISTORIA DEL DERECHO* 380-81 (1929). See also F. ACUNA, *HISTORIA DEL DERECHO* 225 (1978). "The first part [of the General Code], the civil code, has its roots in the French Code." *Id.*

The Civil Code currently in force in Costa Rica was issued in 1887 and took effect on January 1, 1888. Like its predecessor, it was based on the Napoleonic Civil Code and the analyses thereof published by the well-known French commentators Aubry and Rau.<sup>16</sup>

*Per contra*, the procedural provisions of the General Code were based on the Spanish *Ley de Enjuiciamiento Civil*, which in turn reflected not French, but rather "medieval Spanish procedures."<sup>17</sup> Through extensive revision during the late 1800's, in 1933, and most recently in 1937, however, the Civil Procedure Code has evolved into a code which in its trial, attachment, execution, and appeals procedures, as well as in its summary proceedings provisions, closely resembles the French procedure code.

The first Costa Rican Commercial Code was promulgated in 1853 and was a direct copy of the Spanish Commercial Code of 1829, which, in turn, was a minimally-altered adaptation of the French Commercial Code of 1807. The Code has since been amended, e.g., by the bankruptcy laws of 1865 and 1907, the bill of exchange law of 1902, and various legislation relating to the organization of *sociedades anonimas*, sales by merchants, and banking practices. Indeed, in 1964, an entirely new edition was promulgated. Nevertheless, only minimal changes in principle or concept, as opposed to organization and operational detail, have been effected from the original 1853 edition.<sup>18</sup>

### *Ivory Coast*

The Ivory Coast, upon its independence in 1960, retained in force the civil, commercial, and civil procedure codes applicable on that date to *La France Outre-Mer* (French-administered territories beyond the borders of metropolitan France). These codes were essentially identical to the codes then in force in France proper, except for the colonial codes' non-inclusion of the amendments to French bankruptcy law effected by the French law of May 20, 1955.<sup>19</sup> In 1972, the Ivory Coast enacted a new Civil Procedure Code<sup>20</sup> not markedly different from the amended version of the French Procedure Code of 1806 which had theretofore been in effect.

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16. Acuña, *supra* note 15, at 227.

17. *Id.* at 225.

18. Kozolchik & Torrealba, *supra* note 9, at 106; Acuña, *supra* note 15, at 229.

19. Salacuse, *supra* note 13, at 118.

20. Loi No. 72-833, du 21 decembre 1972.

### *Thailand*

The relevant codes currently in force in Thailand are the Civil and Commercial Code, the first two books of which were issued in 1925 and which was completed in 1935, and the Civil Procedure Code B.E. 2477, issued in 1935. Both codes draw upon German, Swiss, and Japanese models, as well as on the French codes,<sup>21</sup> but the codification commission's chief draftsman, M. Rene Guyon, was French,<sup>22</sup> and its attorneys were almost all French and Belgian.<sup>23</sup> Perhaps in consequence of these staffing factors, while Thai civil procedure, both in matters of evidence and of conduct of litigation, closely parallels English civil procedure, the Thai Civil and Commercial Code, except in its omission of the traditional French "merchant/non-merchant" bifurcation and in certain aspects of bankruptcy law, does not deviate markedly from its counterpart French codes in terms of underlying legal principles.<sup>24</sup>

### *Comparative Correlations*

While the degrees of correlation among the three above code systems vary, each of them exhibits a marked linkage to the other systems in virtually all areas of major commercial importance.

As a consequence of a shared, relatively direct descent from the French Civil, Commercial, and Civil Procedure Codes, the respective codes of Costa Rica and the Ivory Coast exhibit substantial correlation in commercial matters. For example, Costa Rican Commercial Code Articles 727, 800, and 803,<sup>25</sup> on the one hand, and

21. Hicking, *The Legal System of Thailand*, 2 HONG KONG L.J. 10 (1972).

22. *Id.* at 9.

23. U.S. DEP'T OF DEFENSE, COUNTRY LAW STUDY FOR THAILAND 6 (1971).

24. See also Kraichitti, *The Legal System in Thailand*, 7 WASHBURN L.J. 239, 241 (1968).

[E]xcept in certain branches of Thai law such as bills of exchange and bankruptcy, where English influence was and is still strong, Thailand for its general law reform turned to the continental tradition of codification in which the leading principles of Roman jurisprudence prevailed in logical form and with scientific arrangement.

*Id.* at 241.

25. Quotations from the Costa Rican codes are the author's translations from the following Spanish-language editions: CODIGO CIVIL [C. CIV.] (A. Vincenzi ed. 1978); CODIGO DE COMMERCIO [C. COM.] (N. Valle & H. Zurcher eds. 1978); and CODIGO DE PROCEDIMIENTOS CIVILES [C. PR. CIV.] (A. Vincenzi ed. 1976).

Ivorian Commercial Code Sections 110 and 183,<sup>26</sup> together with Article 1 of the Decree of October 31, 1935, setting forth the formal requirements for bills, notes, and checks, respectively, are virtually identical. To take one illustration, Article 727 prescribes that a valid bill of exchange must state on its face: (a) its denomination as a bill of exchange; (b) an unconditional order to pay a sum certain; (c) the name of the drawee; (d) the due date; (e) the place of payment; (f) the name of the payee; (g) the bill's date and place of issue; and (h) the signature of the drawer. Section 110 sets forth identical requirements, virtually verbatim.

In the important area of basic contract law, there are numerous code sections which are close parallels. Compare, for example, Costa Rica Civil Code Article 629 and Ivorian Civil Code Section 1101. Article 629 states:

An obligation has for its object to give, to do or to refrain from doing something, and may refer to all things which are traded in commerce including future interests, such as in crops not yet grown.

Section 1101 states:

A contract is an agreement by which one or several persons obligate themselves to one or several other persons to give, to do or not to do something.

Costa Rica Civil Code Article 627 and Ivorian Civil Code Section 1108 contain virtually identical provisions. Article 627 states:

In order to be valid, an obligation [must include] the following essential [elements]:

1. capacity of those who contract;
2. as an object, a thing certain and possible which serves as the subject matter of the obligation; and
3. just cause.

Section 1108 states:

Four conditions are essential to the validity of an agreement:

1. the consent of the party who obligates himself;
2. his capacity to contract;
3. a definite object which forms the subject matter of the obligation; and
4. a licit cause for the obligation.

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26. See generally CODE CIVIL, JURIS CLASSEUR DE LA FRANCE D'OUTRE MER (1948); CODE DE COMMERCE, JURIS CLASSEUR DE LA FRANCE D'OUTRE MER (1948).

Other examples of the close correlation among the provisions of the respective Costa Rican and Ivorian codes are Costa Rica Civil Code Article 633 and 700 and Ivorian Civil Code Sections 1234 and 1142. These provisions state respectively, in notably similar language, the principle that any nonperformance is remedial in damages, and also articulate the means through which obligations are extinguished.

A number of commercially significant provisions appear in virtually identical language not only in the Costa Rican and Ivorian codes, but also in the Thai codes.<sup>27</sup> Examples, which again are far from a complete list of such correlations, are the Thai Civil and Commercial Code sections which, respectively: (i) define the formal requirements of bills, notes, and checks;<sup>28</sup> (ii) set forth permissible forms of business organizations;<sup>29</sup> and (iii) impose joint and unlimited liability on any limited partner who participates in the management of a limited partnership.<sup>30</sup>

Similarly, there are correlations limited to Costa Rica-Thailand,<sup>31</sup> and others found only between Ivorian and Thai code provisions.<sup>32</sup> In any event, while all civil, commercial, and civil procedure codes will differ from each other to one degree or another,<sup>33</sup> and while it is

27. THE CIVIL AND COMMERCIAL CODE B.E. 2468 (Int'l Trans. Center ed., Bangkok) (hereinafter cited as Thai CIV. AND COM. C.).

28. Thai CIV. AND COM. C. §§ 909, 983, 988 (correlating to the Costa Rican articles and Ivorian sections cited above).

29. Thai CIV. AND COM. C. §§ 1013, 1064 (correlating to Costa Rica C. COM. art. 17 and Ivory Coast COM. C. § 19).

30. Thai CIV. AND COM. C. § 1088 (correlating to Costa Rica C. COM. art. 65 and Ivory Coast COM. C. §§ 27, 28).

31. For example, Costa Rica C. COM. art. 34 states: "Agreements by which the unlimited joint and several responsibilities of the partners are eliminated or reduced are absolutely void and shall have no legal effect in prejudice of third parties." Thai CIV. AND COM. C. § 1053 states: "No restriction of the power of a member of a non-registered partnership to bind the other partners can have effect with respect to third persons."

32. The prime example here is the substantial correlation between Ivory Coast CIV. C. §§ 1582 *et seq.* and §§ 453 *et seq.*, which set forth the rules of the respective jurisdictions governing contracts of sale. Compare Costa Rica C. CIV. arts. 1603 and 1605 with Thai CIV. AND COM. C. §§ 461, 472, and 486 (stating, respectively, the duties of seller and buyer).

33. There is a notable lack of correlation, for example, among the three jurisdictions' bankruptcy provisions (Costa Rica C. COM. art. 1831 *et seq.*; Ivory Coast COM. C. §§ 437 *et seq.*; and Thai Bankruptcy Act B.E. § 2483) and execution procedures (Costa Rica C. CIV. art. 424 provides for the *juicio ejecutivo*, or summary proceeding, in the case of execution based on certain "executory documents," and, analogously, Ivory Coast CIV. PR. C. § 334 provides that all orders, judgments, and *actes authentiques* may form the basis of execution provided that they bear the executory formula, that is, a clause, described in

not a certainty that negative covenant enforcement mechanisms that work in one civil law jurisdiction will work in all others, the substantial correlation between Costa Rican codes, on the one hand, and the codes of two other civil law jurisdictions—the Ivory Coast and Thailand, chosen essentially at random—does suggest that such mechanisms as are effective in Costa Rica would, in all probability, be effective in a substantial number of other civil law jurisdictions also.

Several independent analytical procedures tend to confirm this conclusion and establish that the same legal principles which are basic to the enforcement procedures described in Part VI are indeed intrinsic to the codes of other civil law jurisdictions. First, a review of the Thai and Ivorian codes discloses that the correlation with the Costa Rica codes in the commercial law areas discussed above extends to the principles of law most relevant to covenant enforcement. As will be detailed in Parts V and VI, below, prominent among these enforcement-related principles are: (a) relative lack of capacity as a basis for the voidability of juristic acts; (b) the availability of the so-called *accion pauliana* for attacking transactions inimical to creditor interests; and (c) the application and effect of the liquidated damages, or penalty, clause.<sup>34</sup> Second, correspondence and memoranda received from attorneys in Guatemala, Honduras, El Salvador, Nicaragua, and Panama indicate that the same difficulties of attempting to deter covenant violation by the threat of litigation would rise, and that the same civil law-oriented enforcement mechanisms would be effective, in those five jurisdictions as in Costa Rica.<sup>35</sup> Third, the correlation noted above among the Costa Rican, Ivorian, and Thai codes on enforcement mechanism principles has been found to extend to the codes of two other major civil law jurisdictions chosen for re-

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Civ. Pr. C. § 259, which may be inscribed upon the executory copies of court judgments or *actes en la forme authentique* (a category that includes all documents drawn up in notarial form); *contra*, Thai Civ. Pr. C. arts. 253 *et seq.* and 271 *et seq.* (relating to pre- and post-judgment execution; emphasizes not particular categories of “executory” documents, but rather the showing by the applicant of a need to conserve obligor property and his possession of a valid order or judgment).

34. See discussion *infra*. Correlation with each of these concepts is found: (a) with respect to lack of capacity among Costa Rica C. Civ. art. 836, Ivory Coast Civ. C. §§ 1108 and 1989, and Thai Civ. AND COM. C. §§ 823 and 1164; (b) with respect to the *accion pauliana*, among Costa Rica C. Civ. art. 848, Ivory Coast Civ. C. § 1167, and Thai Civ. AND COM. C. §§ 237-240; and (c) with respect to the penalty clause, Costa Rica C. COM. arts. 426-28, Ivory Coast Civ. C. §§ 1226-33, and Thai Civ. AND COM. §§ 379-83.

35. Correspondence and memoranda in author's files.



view on an essentially "spot-check," or random, basis—Egypt and Spain.<sup>36</sup> There appears, then, a reasonable basis for concluding that the negative covenant enforcement mechanisms discussed with respect to Costa Rica would be effective in a substantial number of other civil law jurisdictions.

#### IV. THE COSTA RICAN MODEL

Costa Rica is the model jurisdiction to be used to illustrate the implementation of the civil law enforcement mechanisms for two primary reasons. First, the enforcement mechanisms under consideration were initially developed and applied in connection with two actual loan workout<sup>37</sup> and restructuring situations which occurred in Costa Rica during 1978 and 1979. Hence, it is certain that with respect to Costa Rica, the enforcement mechanisms described are valid and effective. The second basis for reliance on Costa Rica as a model is that in several important respects, Costa Rica is better qualified than a number of other nations as an apt representative of the "typical" civil law jurisdiction. For example, the codes currently in force in Costa Rica are not mere copies of the Napoleonic Codes, but rather are what may be termed "third generation" codes—the reformed, revised, and indigenized descendants of received Spanish codes which were themselves permutations from the French originals. Thus, the Costa Rican codes do not represent an atypically "pure" or "turnkey" version of the Napoleonic Codes, as do, for example, those of the Dominican Republic or even France itself, but rather represent a typically "indigenized" variant of the original French codes.

Moreover, Costa Rica qualifies as a model jurisdiction by the very fact that its codes were derived from the French, rather than the German, side of the civil law family. The French Codes, as noted above, not only antedate the German codes, but have been more

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36. PERROTT, FARMER & SIMS MARSHALL, *THE EGYPTIAN CIVIL CODE* (Cairo 1952); and S. WALTON & N. DE LEON, *THE SPANISH CIVIL CODE* (Havana 1899). With respect, for example, to: (a) relative lack of capacity as a basis for contract voidability, see Egyptian Civil Code Articles, 105, 141, and Spanish Civil Code Article 1259; (b) the availability of the *accion pauliana*, see Egyptian Civil Code Articles 5, 104, and Spanish Civil Code Articles 1291 (3), 1292, 1298; (c) to the penalty or liquidated damages clause, see Egyptian Civil Code Article 223 and Spanish Civil Code Article 1152.

37. The term "work-out" refers to the process of negotiation, payback re-scheduling, and in most cases, allocations of collateral engaged in by, on the one hand, a borrower (together with its guarantors and/or affiliates, if any) who has defaulted under a loan agreement, and on the other hand, its (their) creditor.

widely received by other nations. Costa Rica's French-inspired codes, thus, have more in common with the codes of that large block of Latin American, Middle Eastern, and ex-French/Belgian African nations whose legal systems were primarily influenced by the Napoleonic Codes, than do the codes of such nations as Switzerland, Greece, Turkey, South Korea, and Japan, the codes of which were more heavily influenced by the German codes.<sup>38</sup>

Finally, despite the fact that the major influence on the Costa Rican codes has been indisputably French, the current Costa Rica Commercial Code does reflect the influence of the Italian Civil Code of 1942 and the German Commercial Code of 1900.<sup>39</sup> Hence, conclusions based on an analysis of Costa Rican law should have substantial validity even for German- and Italian-influenced jurisdictions.

#### V. THE ENFORCEMENT PROBLEM

As givens, then, are the importance of negative covenants, the substantial number of nations which subscribe to civil law principles, the pervasive influence of the French codes in, and the consequent high degree of correlation among, the codes in force in the various civil law jurisdictions, and the probable applicability of enforcement mechanisms effective in Costa Rica in a substantial number of other civil law jurisdictions. It remains to be demonstrated precisely why the "litigation deterrent" relied upon for covenant enforcement in common law jurisdictions is an ineffective enforcement mechanism in civil law countries. The following section will, therefore, discuss in detail four principal factors which render common law negative covenant enforcement procedures ineffective in civil law jurisdictions and which necessitate the development of covenant enforcement mechanisms specifically adapted to civil law systems.

#### *Injunction versus Embargo*

The first enforcement problem arises from the fact that the laws of Costa Rica, taken as representative of civil law statutes in general, do not provide for injunctive relief. That is, whereas in a common law jurisdiction, if a lender learned of a borrower's intent to grant a

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38. Schlesinger, *supra* note 4, at 260, 384.

39. Interview with H. Zurcher, principal code draftsman. For a description of the development of the German commercial code, *see* von Mehren, *supra* note 2, at 73-74, and of codified Italian commercial law, *see* Cappelletti, *supra* note 8, at 222-28. Note that the Italian Civil Code of 1942 was the successor to both the Civil Code of 1865 and the Commercial Code of 1882.

mortgage, execute a cross-guaranty, merge, dispose of assets, or take on excessive additional debt, it could, if such an act were barred by the lender's negative covenants, move a court to enjoin the borrower from violating its contractual obligations.<sup>40</sup> This remedy is not, however, available under Costa Rican law. There, the best one can do is to threaten to attach, or "embargo," borrower property if a prospective covenant violation is actually effected or an existing violation not cured.

Under Civil Procedure Code Article 172,<sup>41</sup> a creditor may be granted pre-judgment (or "conservatory") attachment (an *embargo preventivo*) of his debtor's assets on a showing that such action is

40. See, e.g., N.Y. CIV. PRAC. LAW §§ 6301, 6312, and 6313 (McKinney).  
 § 6301 states in part:

Grounds for preliminary injunction may be granted in any action where it appears that the defendant threatens or is about to do, or is doing or procuring or suffering to be done, an act in violation of the plaintiff's rights respecting the subject of the action, and tending to render the judgment ineffectual, or in any action where the plaintiff has demanded and would be entitled to a judgment restraining the defendant from the commission or continuance of an act, which, if committed or continued during the pendency of the action, would produce injury to the plaintiff. A temporary restraining order may be granted pending a hearing for a preliminary injunction where it appears that immediate and irreparable injury, loss or damage will result unless the defendant is restrained before the hearing can be had.

§ 6312 states:

Motion papers; undertaking . . . (b) Undertaking. Except as provided in section 2512, prior to the granting of a preliminary injunction, the plaintiff shall give an undertaking in an amount to be fixed by the court, that the plaintiff, if it is finally determined that he was not entitled to an injunction, will pay to the defendant all damages and costs which may be sustained by reason of the injunction . . . .

§ 6313 states:

Temporary restraining order. (a) Generally. If, on a motion for a preliminary injunction, the plaintiff shall show that immediate and irreparable injury, loss or damages will result unless the defendant is restrained before a hearing can be had, a temporary restraining order may be granted without notice. Upon granting a temporary restraining order, the court shall set the hearing for the preliminary injunction at the earliest possible time. . . . (c) Undertaking. Prior to the granting of a temporary restraining order the court may, in its discretion, require the plaintiff to give an undertaking in an amount to be fixed by the court, containing terms similar to those set forth in subdivision (b) of rule 6312, and subject to the exception set forth therein.

41. C. Pr. Civ., art. 172 states: "In order to prevent the debtor from hiding or embezzling his property and nullifying thereby the result of any action, the creditor may demand conservatory attachment."

necessary to ensure that any ultimate judgment the creditor may obtain can be satisfied. The disadvantage of the embargo is that it is not a direct constraint on borrower action, as would be a judicial order to refrain from violating a particular negative covenant. Rather, it is only a prospective constraint, a threat to in future obtain an order for the sale of the attached property if the violation is carried through or not cured. Although, in theory, the attachment threat should carry some weight, in practice, it is of little value for two particular reasons. First, most debtor assets of any value will already have been mortgaged to collateralize the lender's loan. Second, in order to obtain even partial repayment from attachment proceeds, the lender would be compelled to sell the mortgaged or attached assets at auction, thereby incurring the risk of disruption of the borrower's operations and earnings capability. The necessity of running this risk can operate as a substantial disincentive to actual lender use of the embargo remedy—a fact of life of which most civil law jurisdiction borrowers are far from unaware.

Attachment is also available on a post-judgment basis<sup>42</sup> but, again, is of little use to the creditor. Unless the debtor deposits security for the amount due,<sup>43</sup> the embargoed property is sold at auction,<sup>44</sup> with proceeds to the judgment creditor. The creditor, as noted above, however, is already likely to have a forecloseable lien on any borrower property of value and, again, is unlikely to be enthusiastic about attempting to enforce negative covenants through potentially costly suits leading to borrower property sales likely to be disruptive of borrower operations, detrimental to borrower credit standing with suppliers, and altogether negative in its impact on borrower repayment capabilities.

### *Cost Factors*

A second constraint on lender efforts to achieve covenant enforcement through the threat of litigation is the cost of obtaining an *em-*

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42. C. PR. CIV., art. 437 states: "If the plaintiff establishes his personal capacity and if the document he files is executory, the judge decrees execution and orders the attachment of property in sufficient amount to cover the sum payable plus fifty percent for interest and costs."

43. C. PR. CIV., art. 449.

44. C. PR. CIV., art. 465 states:

If the order of auction is agreed to by the parties or judicially confirmed, or if in its place a surety for its results is given, then if the attached property is money, the claimed principle, interest, and costs shall immediately be paid to the plaintiff.

*bargo preventivo* or of instituting any other litigation whose deterrent effect the lender would normally look to for covenant enforcement under a common law regime. The high cost of instituting litigation stems from: (i) the fact that the plaintiff may be required to post indemnification and court cost bonds, unless he is entitled to bring his action as a summary proceeding; and (ii) the requirement of paying substantial legal fees, whether or not the action is brought on a summary basis.

Article 425 of the Civil Procedure Code lists by category a series of executory instruments (*titulos ejecutivos*)<sup>45</sup> which are deemed to embody explicit and unconditional payment obligations. Prominent in the executory document category are notes, all duly drawn public documents,<sup>46</sup> court judgments,<sup>47</sup> and mortgages.<sup>48</sup>

45. C. PR. CIV., art. 425 states:

Execution will not be ordered except on the basis of executory instruments. Executory instruments are:

1. A court order for execution of a judgment;
2. The certified copy of a public writing duly issued, or, as the case may be, a certification, which the Public Registrar's office is obliged to provide of such copy or whose registration is pending;
3. The certification of an entry in the Public Registry, provided that it is stated therein that the certified inscriptions have not been cancelled or modified by any other entry;
4. A private document acknowledged before a competent judicial authority, or declared as acknowledged, in default of appearance by the party;
5. A confession of judgment made by a party or which is made by the court in the absence of such party;
6. Certification of non-appealable orders or judgments which establish against a third person or against a party the obligation to pay a sum certain, where such obligation does not arise from the same action as the action to enforce;
7. Any type of document to which specific legislation accords executory force.

46. A public document is defined by C. CIV., art. 733 as follows:

A public writing is an instrument granted before a notary public. It is effective without witnesses, whether inscribed in a protocol book or in certified copies or certifications, unless the law provides to the contrary or one of the parties so requests or it is deemed necessary or convenient, in which case the number of witnesses shall not be more than two, provided that the law does not provide otherwise.

The notary must be legally authorized to exercise his functions, in accordance with the relevant law.

The witnesses must be adults, be of good reputation, know how to read and write and be under no legal impediment.

47. C. PR. CIV., art. 425.

48. *Id.*

The primary benefit of evidencing an obligation by a *título ejecutivo* is that, subject to one exceptional circumstance to be discussed below, any action brought on the basis of such a document is entitled to be adjudicated by a summary proceeding, or *juicio ejecutivo*. The summary procedures provided by a *juicio ejecutivo* include: (i) the limitation of the period allowed the defendant to answer and to compile his evidence to a total of ten days, versus fifteen to thirty days in an ordinary procedure, or *juicio ordinario*; and (ii) the limitation of the period for the presentation of evidence to the same period as provided for evidence compilation, versus an additional ten days for answer and specification of evidence, and up to forty more days for the presentation of evidence in an ordinary action.<sup>49</sup>

The *juicio ordinario* is not only more time consuming than the *juicio ejecutivo*, but entails for the creditor, if he requests the imposition of an *embargo preventivo*, the obligation to post a bond to guarantee the respondent against any damages the latter may suffer by reason of an attachment which is deemed in the hearing on the merits to have been unjustified. The amount of the bond is set at either twenty percent (cash) or fifty percent (securities) of the value for which the embargo is sought.<sup>50</sup> The creditor, moreover, is required to file his action on the merits within thirty days after the effective date of the embargo.<sup>51</sup> If he fails to do so, the embargo is lifted and his bond is forfeited.<sup>52</sup> If the creditor does proceed with the action on the merits within the prescribed time limit, he may be ordered, unless he is suing on the basis of an executory instrument, to post an additional twenty-five percent of the value of his action

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49. C. PR. CIV., arts. 231, 290, 440, and 441.

50. C. PR. CIV., art. 173 states:

If the creditor does not file an executory document, he must guaranty direct and consequential damages resulting from the attachment and specify clearly what type of satisfaction he demands from the defendant and the cause or instrument on which his claim is based. The guaranty must consist of the deposit of cash or securities, as ordered by the judge. If in cash, the deposit must be twenty percent of the amount for which the attachment is sought [and] if in securities, fifty percent. . . .

51. C. PR. CIV., art. 175.

52. C. PR. CIV., art. 176 states:

If the claim on the merits is not presented within the prescribed term, or is dismissed by a non-appealable judgment, the attachment is lifted and the applicant is required to pay direct and indirect damages. In both cases the deposit of the money made by the applicant will be

to guarantee payment of certain litigation expenses, including court costs and the respondent's counsel's fees.<sup>53</sup>

The damages guaranty will only be returned to the creditor upon the institution of the suit on the merits if the action is based on an executory document; if not so grounded, the deposit is retained by the court. *In toto*, then, the cost of attaching debtor property and suing on the merits on the basis of a non-executory instrument can theoretically range from twenty to seventy-five percent. While the latter amount is rarely, if ever, exacted in practice, even damage and cost bonds which together total twenty to twenty-five percent of the value of the action are sufficiently high, especially in view of the relative difficulty, resulting from the non-observance of a *stare decisis* rule and the characteristic lack of detailed fact exposition in judgments, of predicting the outcome of civil law litigation, to give pause to all plaintiffs except those with the greatest confidence in their claims.

One may reasonably ask why, since a lender would presumably always require its debtor to execute a *titulo ejecutivo* as evidence of the obligation concerned, it would ever be necessary to forego the *juicio ejecutivo*. The answer is that even if the operative document falls in one of the six *titulo ejecutivo* categories prescribed by Article 425, the debtor may still be able to argue that certain of the document's terms render it non-executory. If the court accepts this argument, the document's enforceability must be determined through an ordinary proceeding. This prospect has disturbing implications in the covenant enforcement area.

Violation of a negative covenant which is a term of an executory document will assuredly be actionable in summary proceedings if no more is needed to establish the violation than proof of the occurrence

forfeited at once to the owner of the attached property as liquidated damages, but this in no way diminishes the right of the injured party to demand the balance of the actual damages caused by the attachment.

53. C. Pr. Civ., art. 192 states:

The applicant as well as the respondent has the right to demand, reciprocally, the guaranty of costs in order to assure the payment of any which may be taxed [to the other party]. This rule is applicable to all types of actions, except actions which are executive or universal.

. . . .

The guaranty of costs shall be 25% of the estimated amount set forth in the claim . . . . If the applicant has obtained a conservatory attachment in order to guaranty the results of the action, it is within the discretion of the judge to exempt the defendant from the guaranty or reduce its amount.

of an easily verifiable breach. Such breaches would include, for example, the unauthorized grant of a mortgage or pledge, the execution of a cross-guaranty, or the execution of a loan agreement or lease in excess of covenant-stipulated maximums. The greater the degree, however, to which establishing the fact of a covenant violation entails proof of the infringement of an essentially subjective standard—i.e., whether a transfer by the borrower involved “substantially all,” or a “substantial portion of,” its assets, or whether a lease on an operating, supply, management, or profit-sharing agreement is “within the ordinary course of business”—the greater the risk that recourse to the *juicio ejecutivo* may be foreclosed by a borrower claim that a fact issue exists as to whether the standard in question was indeed infringed. If the borrower succeeds in his claim, the lender—even if his action is based upon a document which would otherwise be executory—will be required to proceed via a *juicio ordinario*. Hence, for certain covenant violations, there is no sure way to guarantee that enforcement can be sought by summary proceedings. The possibility that covenant enforcement may have to be sought through a non-summary procedure renders the litigation option still less attractive to the lender, makes it less credible as a deterrent, and reduces even more the creditor’s ability to rely on the threat of litigation as a covenant enforcement mechanism.

In addition to exposing the creditor to demands for the deposit of substantial indemnity and court cost guaranties, the enforcement of covenants through “after-the-fact-of-violation” litigation—whether or not it is brought on a summary basis—is costly in terms of the counsel fees that must be paid. While, in theory, these expenses would be absorbed by the borrower if the lender prevailed on the merits, the borrower may well have committed the very negative covenant violation that precipitated the suit precisely because it was in dire need of liquid assets. Assuming that most assets of any significant value would already be mortgaged to the lender, the debtor in the typical covenant violation situation would in effect be “judgment proof.” This circumstance renders creditor legal fee recovery at best problematic. This factor, coupled with the fact that in Costa Rica and many other civil law jurisdictions, counsel fees are set by law and are, by United States standards, quite high, operates, like the prospect of having to proceed through a *juicio ordinario*, to make the litigation option even less attractive to the lender. The threat of litigation hence becomes still less credible a deterrent through which to seek covenant enforcement.



Legal fees for the enforcement of loan documentation are, it should be noted, payable in addition to: (i) the notarial fees which the lender in all probability has already paid for the inscription of the documentation in a notary's protocol book; and (ii) the registral and stamp fees payable for the inscription of mortgages in the appropriate public register. Costa Rican notarial fees are set by Law No. 39 of January 5, 1943 (*La Ley Organica del Notarial*), as amended. Protocolization qualifies an instrument as a "public document,"<sup>54</sup> which status, as explained above, entitles the holder to proceed through a *juicio ejecutivo* with the attendant benefits of summary procedure and exemption from liability for the posting of indemnity or court cost bonds.<sup>55</sup> Registration, as will be discussed in Part VI, below, renders the document in question effective against third parties. Both notarial and registral fees are calculable as percentages of the value of the instrument or action concerned. The notarial and registral fees for a real property mortgage (*hipoteca*) or chattel mortgage (*prenda*) total approximately five percent; if the financing is unsecured,<sup>56</sup> the fees applicable to the loan agreement total approximately one percent.<sup>57</sup> For typical loan documentation enforcement proceedings, the legal fees are formidable, ranging, for example, from approximately two and one half percent of the value of the action for proving a bankruptcy claim, to more than ten percent for full prosecution of a *juicio ordinario* for, e.g., the collection of a money debt.<sup>58</sup> Moreover, the fees are not, as in some jurisdictions (e.g., Nigeria), statutory maximums, but are amounts specified by law whose

54. See note 46 *supra*.

55. See note 45 *supra*.

56. If the financing is secured, all salient terms of the loan agreement (repayment dates, interest rates, prepayment provisions, affirmative and negative covenants, and events of default) should and, in the normal course, would be included in the mortgage which is registered and which would be the document upon which any collection action in Costa Rica would be based.

57. Specifically, the fee is colons 5012.50 for the first one million colons of face value, plus .36% of any excess, plus: (a) for a *hipoteca*, municipal stamps of .1%, hospital stamps of .2%, and registral fees of .3%, if the term is less than six years and .4% otherwise; (b) for a *prenda*, fiscal stamps of .4%, *timbres obreros* (labor stamps) of .4%, and a registral fee of .1%; if the *prenda* is set forth in the same document as a *hipoteca* or protocolized loan agreement on which all applicable fees have been paid, the .4% fiscal stamp charge is waived; (c) for a protocolized loan agreement, .4% fiscal stamps but, since the agreement is non-registrable, no registral fee.

58. Law 1128, art. 1 provides, in paragraphs A and B, that the fee for ordinary actions shall graduate from 25% down to 15% for amounts from one to 250,000 colons, and shall be 10% for amounts above that figure (the *accion*

reduction is generally either illegal, or if legal, vigorously resisted by the local bar.

### *Proof of Damages*

In addition to the lack of injunctive relief and the high legal costs involved, litigation is a poor deterrent to negative covenant violation because of the steps the lender must take in order to establish the quantum of damage he has suffered. There is no doubt of the lender's right to sue in damages for breach of contract.<sup>59</sup> The lender can, however, only comply with code-specified standards of proof as to the amount of damages if he accelerates the loan and prosecutes a collection or foreclosure action through the stages of judgment and levy on borrower assets, if any, to judicial sale. Estimates of damages are not admissible. Only when the amount of the actual proceeds of the sale are known will the lender have satisfactorily established whether there is in fact any shortfall between amount due and amount collected, which figure is the only recognized measure of damages.<sup>60</sup> Hence, the lender again is placed in the position of being able to enforce negative covenants only through the initiation of a legal action which is not only expensive to prosecute, but which in many instances, will impact adversely on the borrower's ability to repay the underlying obligation. Additionally, and perhaps most importantly, it should be noted that in a lending, as opposed to a

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*pauliana* discussed *infra* is an "ordinary action"); in paragraph D, that in any other type of action, including collection or foreclosure actions based on *titulos ejecutivos* (i.e., *juicios ejecutivos*), the fee is one-half of that chargeable in a *juicio ordinario*; in paragraph C (covering *juicios universales*), that fees for filing a bankruptcy petition are the same as those for a collection action, and that fees for legalizing a claim in bankruptcy are one-fourth of those for instituting a *juicio ordinario*. To fully appreciate the high cost of prosecuting a bankruptcy action, it should be noted that pursuant to C. Civ. art. 826 and C. Com. art. 883, in addition to the foregoing legal fees, a fee of 5% of all amounts actually distributed must be paid to the court-appointed receiver; and in paragraph I, that the fee for bringing ancillary actions (*actos perjudiciales*), such as the petition for an *embargo preventivo*, is to be determined by the agreement of the parties.

59. "In bilateral contracts there is always implicit the condition subsequent of non-performance. In this case the party which has performed may demand either performance of the agreement or compensation in direct and indirect damages." C. Civ., art. 692. Although the explicit wording indicates otherwise, this section is interpreted as meaning that the party who has performed may, in the event of the other party's non-performance, request either cancellation and damages, or performance and damages.

60. See, e.g., C. Civ., art. 208(5), which cannot be complied with absent actual damage.

construction or sales contract context, there would not be any "damage" unless the borrower had failed to repay, or judicial sale proceeds had failed to cover, all or part of the amount due. Yet, if the borrower lacked the funds to pay, or the auctionable assets to cover, amounts due under the loan agreement, it is unlikely that it would have the funds or assets with which to respond in damages. Hence, for a lender, a damage suit in the most likely covenant violation fact situation would hardly be an efficacious remedy.

### *Registral Law and Acciones Paulianas*

Even if the lender is prepared to rely on the litigation deterrent for covenant enforcement despite the lack of injunctive relief, the high bonding and legal costs, and the difficulties of proving damages, he will probably find that he is able to make out a cause of action against the borrower only and not against any third party who may have benefited from the violation. Recourse against the borrower, however, is likely to be of minimal utility since, as previously noted, the borrower may well have committed the negative covenant violation precisely because of its severely-eroded financial position. Thus, the borrower may be virtually judgment proof by the time the lender is in a position to initiate litigation.

The probable inability of the lender to bring suit against any third party benefiting from a covenant violation, and the lender's consequent inability to effectively deter third parties from participating in a negative covenant violation by threat of litigation, derives from two factors. First, two of four Code provisions relevant to the problem of interference with contractual rights are available only in the context of a bankruptcy proceeding and are directed toward voiding the violative act rather than toward obtaining damages from the third party. Second, while the remaining two provisions require a clear showing of intent on the third party's part to harm or prejudice the lender, relevant principles of Costa Rican registral law<sup>61</sup> interpose substantial obstacles to the making of that showing.

The relevant provisions are Civil Code Articles 848, 901, 905, and 1045. The first three articles provide for the annulment of certain debtor transactions, while Article 1045 establishes a basis for bringing

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61. Registral law consists primarily in C. Crv., arts. 448-79, the Regulations issued pursuant to C. Crv., art. 458, and C. Com., arts. 19, 20, 22, and 27. For a detailed description of the civil law registral system and the "principle of publicity," see Schlesinger, *supra* note 4, at 464-78.

an action directly against the parties to such transactions. Articles 901 and 905 list a series of acts which are void if effected while the borrower is insolvent. Article 901 declares

absolutely void, if performed or executed after the inception of legal insolvency [as defined in Article 888] . . . .

1—Any act or contract of the debtor which is either gratuitous or, if for consideration should be deemed gratuitous with respect to the excess which the debtor has given over what he has received in return;

2—The creation of a ‘prenda’ or ‘hipoteca’ or any other act or undertaking intended to secure obligations previously contracted or to give them any preference over other obligations;

3—The payment of debts not due by reason of the nonexpiration of their term or the nonfulfillment of a condition precedent to payment; [and]

4—The payment of due debts not made in cash or in negotiable commercial instruments.

Article 905 declares

voidable at the demand of the receiver or of any interested creditor, regardless of when effected:

1—Juristic acts or contracts involving simulation, which is deemed to consist in the affirmation or declaration by the parties of things or facts which are not true; [and]

2—Any alienations whether gratuitously or for consideration, when the other party had notice that the debtor performed the act or entered into the contract in order to withhold the thing or its value, in whole or in part, from the reach of his creditors.

In that these articles can, by their terms, be invoked only in the context of a bankruptcy proceeding, they are, in the normal course, useful to the lender solely as negotiating resources. In this sense, they are remedies whose invocation can be threatened in an effort to deter defaulting borrowers and/or beneficiary third parties from perpetrating or continuing, as the case may be, covenant-breaching transactions, but whose effectiveness is distinctly limited outside of an incipient bankruptcy situation.

Article 848<sup>62</sup> provides for the remedy known in civil law as the

62. C. Civ., art. 848 states:

Even if his debt was subject to a condition or had not matured, the creditor may ask the court to declare ineffective, with respect to him, the disposition of assets by means of which his debtor prejudices his rights, under the following conditions:

*accion pauliana*<sup>63</sup> and is of substantially greater utility than either Article 901 or Article 905. Unlike those articles, Article 848 can be invoked outside the context of a bankruptcy proceeding. Unlike Article 901, it is not limited to acts committed after the inception of insolvency, and unlike Article 905(a), the *accion pauliana* provided for by Article 848 is applicable not merely to a few, code-specified transactions, but to all agreements harmful to the plaintiff's interests, provided only that the *mens rea* requirement is met. This latter difference, e.g., between the right to attack only sham, or simulated, contracts and the right to attack any prejudicial arrangement, even one which is otherwise valid, is important to a lender. The difference was well-explicated by the Supreme Court of Costa Rica in a 1970 judgment:

The Accion Pauliana is initiated to attack a true contract in which the debtor disposes of property in fraud of his creditors, where the contract would be valid were it not for the fraud, that is, if the debtor had other property with which to satisfy his obligations, while the action for absolute simulation is intended to invalidate an act or contract which has only apparent existence and by means of which the relief sought is that the Court declare that the property has not been transferred and that it still belongs to the debtor.<sup>64</sup>

For all of the foregoing reasons, then, a lender seeking to invalidate a prejudicial transaction would look primarily to the *accion pauliana* provided for by Article 848. Yet, despite its seemingly broad sweep, it should be noted that for an *accion pauliana* to succeed, the plaintiff must prove not only that it has actually been harmed by the act

a) that the debtor knew of the prejudice that his act caused to the rights of the creditor, or, if the said act occurred prior to the inception of the debt, that it fraudulently intended to frustrate the satisfaction of the debt; [and]

b) that, in addition, with respect to acts or instruments effected or entered into for consideration, the third party knew of the injury, and if the act was effected prior to the inception of the debt, that such party participated in the fraudulent pre-execution of the prejudicial act.

. . . .

Satisfaction of a due debt is not subject to revocation.

The ineffectiveness of the act does not prejudice rights acquired for consideration by third parties acting in good faith, subject to the effect of the registration of a claim for revocation in the Public Registry.

63. For a detailed discussion of the *accion pauliana*, see Amos & Walton, *supra* note 5, at 243-47.

64. Corte Suprema de Costa Rica, Sentencia No. 22, 14:30 horas, 31 Mar. 1970, Semestre I.

complained of, but also that, where the transaction was for consideration, there was a "concerted fraudulent intent" on the part of the debtor and the third party to prejudice the creditor.<sup>65</sup> Particularly since there will almost always be an "ordinary course" commercial justification for the transaction between the debtor and the third party, and because of certain principles of Costa Rican registral law to be discussed below, conclusive proof of such concert and intent may be quite difficult to adduce.

The lender seeking redress against a third party benefiting from a covenant violation may also consider invoking Civil Code Article 1045—a provision that has a counterpart in virtually every civil code in the world. Article 1045 states: "[a]nyone who through fraud, fault, negligence or carelessness causes harm to another is liable for the repair of such harm together with indirect damages." The wording seems straightforward, but proving the requisite intent or negligence may, as in an Article 848 action, present unusual problems in the typical lending context.

For example, in one of the Costa Rica work-out situations referred to in Part IV, the borrower had ostensibly given "Lender A" a first mortgage on "Parcel A" which was represented by the borrower to have been carved out of "Parcel B." Subsequently, and in violation of its loan agreement with Lender A, the borrower proceeded to give a first mortgage on Parcel B to "Lender B." Because the borrower's attorney had failed to comply with certain relevant provisions of the Costa Rica land transfer law in attempting to create Parcel A out of Parcel B, Parcel A in fact had no legal existence, and the mortgage given to Lender B effectively applied to all of the original Parcel B, including the portion thereof that was to have been Parcel A. Despite the fact that Lender B had actual knowledge that Lender A believed that it had a lien on Parcel A, Lender A could not, with any hope of success, proceed under Article 848 or Article 1045. This resulted from: (i) the fact that since the land registry entry setting forth Parcel A's metes and bounds description was legally insufficient, Lender B was entitled to assert that in taking Parcel B as collateral, it was unaware that it was also acquiring—or in Lender A's view, usurping—a senior position with respect to the parcel on which Lender A had expected to have a first mortgage; and (ii) the difficulty of proving that Lender B had intended to harm Lender A, as opposed to intending, in the

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65. Amos & Walton, *supra* note 5, at 246.

exercise of simple commercial prudence, to collateralize its antecedent debt.

The relevance of register entries and "actual knowledge" derives from certain principles of Costa Rican registral law. One of the fundamental features of civil law systems is the so-called "principle of publicity." The principle states that certain juristic "circumstances," such as the existence of interests in real property and chattels, and the status and capacities of persons and business entities, are effective as against third parties only if and after they have been inscribed in the public register concerned with the particular type of juristic "circumstance" in question, and that agreements and circumstances which are not so inscribed are ineffective against third parties.<sup>66</sup> Mortgages, for example, have no effect against third parties until entered in the Mortgage Section of the Public Register; a company does not exist as such until the fact and details of its formation have been entered in the Commercial Register.

A second principle of registral law relevant to the discussion of enforcement problems is the obverse of the principle of publicity, namely, the "principle of public faith." In essence, this principle states that once such juristic "circumstances" as those referred to have been registered, all third parties are deemed to have constructive notice of them.<sup>67</sup> An important corollary of the principle of public faith is that any third party seeking to take advantage of that principle must have acted in "good faith," i.e., without actual knowledge of

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66. See, e.g., C. Crv., art. 455: "Documents which have not been registered are ineffective against third parties until after the date of their filing with the Registrar"; C. Com., art. 19: "The charter of a company, modifications thereof; and dissolution, merger and all other acts which in any respect modify its structure must be set forth in a public writing, published in extract in the official gazette and registered in the Commercial Register"; and C. Com., art. 22: "Until the publication and registration referred to in Article 19 have been effected, resolutions, agreements and corporate documents are ineffective as against third parties, and the company founders are jointly liable to such third parties for all obligations which in such circumstances are contracted in the name of the company."

67. See, e.g., C. Crv., art. 456:

Registration does not validate registered agreements or contracts which even though specified by law do not appear in the Register or contracts which are performed or agreed to *by persons who according to the Register appear to have the right to do so*, once registered are not invalid with respect to third parties even though subsequently the right of such person is annulled or dissolved by means of an unregistered document for non-statutorily specified causes or for causes which even though specified by law do not appear in the Register (emphasis added).

the nonregistered agreement.<sup>68</sup> The phrase "good faith" or, in Costa Rican law, *buena fe*, is used frequently throughout the Costa Rica Civil Code,<sup>69</sup> but is never explicitly defined therein. Article 285, however, states by implication the principle that a party is acting in "bad faith," and its actions are, therefore, not "bona fide," if it asserts the benefit of a registrarial entry at the same time that it has actual knowledge of a state of facts contrary to those set forth in the entry:

In all cases where the law requires possession to be in good faith, he shall be deemed a possessor in good faith, who in the act of taking possession believed that he had the right to such possession. If he had sufficient reason to doubt that he has such right, he should not be deemed a possessor in good faith. . . . Possession shall cease to be in good faith at the moment the possessor acquires the certainty that he may possess improperly.

The essence of the principle of public faith and the effect of actual knowledge are further elucidated by the following commentary by a leading civil law scholar:

If a right has been registered . . . , it is presumed that the right exists . . . . Similarly, if a registered right . . . has been cancelled, it is presumed that the right does not exist . . . [but t]hese presumptions are rebuttable . . . . [*E*]ntries are deemed correct unless the [party asserting the benefit of the entry] knows of their incorrectness . . . . This is often referred to as the rule of public faith . . . . It should . . . be noted that it does not require any reliance on the part of [that party] upon the contents of the [register]. The [party asserting the benefit] is protected in any case in which he did not positively know that the contents of the [register] were incorrect. It does not matter whether his ignorance was due to lack of care. It does not even matter whether he ever consulted the [register]. Even if he did not know the actual contents of the [register], the latter are treated as if they were cor-

68. While, as discussed *infra*, this rule is nowhere explicitly stated in the Codes, it is a cardinal and well-settled principle of civil law. See notes 69 and 70 *infra* and accompanying text.

69. See, e.g., C. Civ., arts. 306, 321, 327-29, and 1065. The same principle of equivalence of actual knowledge of a contrary state of fact with lack of bona fide, or good faith, status is reflected in the German Civil Code § 892 which states in pertinent part: "[With respect to a person acquiring an interest in real property,] . . . an entry in the land register is [conclusively] deemed correct unless an objection to its correctness is registered [therein] or the incorrectness is known to such person" (emphasis added).



rect . . . *The benefits [of the rule of registral faith] are withheld from [parties] who . . . act in bad faith* (emphasis added).<sup>70</sup>

With respect to business corporations, it is well settled that among the items of information required to be registered and, hence, subject to the principle of publicity, and to the rule of public faith in particular, are:

the legal form under which a business is conducted; all facts pertaining to its ownership; appointment and removal of agents exercising managerial functions, as well as limitations upon, and revocation of, their powers; in the case of a partnership, the names of the general partners, and the names and liability limits of the limited partners; in the case of a corporation, the amount of its capital as well as appointment and removal of officers, and limitations upon, and revocation of, their powers . . . [and the] cessation or revocation of the powers of [all other] individuals authorized to act on behalf of a commercial firm.<sup>71</sup>

The foregoing principles are relevant to negative covenant enforcement in that they materially restrict the bases upon which suits may be brought against third parties benefiting from covenant violations. Clearly, if the circumstance or fact upon which the lender seeks to rely in its suit is registered, all third parties will be deemed to have constructive knowledge of it. If, on the other hand, the circumstance or fact is not registered, a third party may participate in a covenant-violative transaction without incurring liability to the lender, unless the lender can successfully invoke the rule of public faith and con-

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70. Schlesinger, *supra* note 4, at 467, 469; See also Pacheco, *Costa Rica: Real Estate Purchases by Foreign Investors*, TAX MANAGEMENT INT'L J. 2 (December 1972):

The property books of the Public Register contain all information about a specific parcel of land which may affect *bona fide* purchasers. . . . Private contracts and guarantees made by the owner of the land but not entered in the Public Registry will not affect *bona fide* purchasers. . . . [O]nly those [liabilities] which appear on the registry entry will affect the *bona fide* purchaser. . . . (emphasis added).

See also Rheinstein, *Some Fundamental Differences in Real Property Ideas of the "Civil Law" and the Common Law Systems*, 3 U. CHI. L. REV. 624, 625, 627 (1936):

[The property register system is] intended not only to simplify the formalities of land transactions but also to guarantee the utmost security for *bona fide* purchasers and mortgagees. Unless . . . notice [of a secondary heir's interest in a parcel of real property] has been entered [in the Land Register], *bona fide* purchasers and mortgagees will acquire good title from the primary heir (emphasis added and footnote omitted).

71. Schlesinger, *supra* note 4, at 475-76.

clusively prove that the third party had actual knowledge of the violation.

It may appear a relatively trivial exercise to ensure that all negative covenants are duly registered. Such registration, however, cannot in all cases be taken as a certainty since it is the practice of some civil law notaries not to register the entire document (land mortgage, chattel mortgage, loan agreement) evidencing the lender's obligation. On the contrary, only such portions of those documents as they consider "vital" will be submitted for registration. Hence, all or a portion of the negative covenant section may be omitted from protocolization by a notary who does not consider that portion vital. It is also not unusual for negative covenant sections to be omitted by inadvertence. In either such circumstance, the covenant, since not registered, cannot be deemed to be within the constructive knowledge of a third party. For example, in one of the Costa Rica loan work-out situations which gave rise to the development of the enforcement mechanisms described below, Lender A had indeed included in its loan agreement a covenant against mortgaging borrower assets. It was not the loan agreement, however, but Lender A's mortgage which was to be registered, and the notary, in drafting the mortgage, had failed to incorporate therein the negative covenant provisions from the loan agreement. Consequently, when the borrower, in violation of the loan agreement, executed a mortgage on certain of its property in favor of Lender B, Lender A had no cause of action against Lender B.

## VI. CIVIL LAW ENFORCEMENT MECHANISMS

Given the disadvantages of litigating negative covenant violations in civil law jurisdictions, it is relatively clear that enforcement cannot be achieved by mechanisms which rely on deterrence, but which leave the capacity for violation in the borrower's hands. Hence, the enforcement mechanisms to be described in this section aim not to deter the borrower from violating covenants, but: (i) to deprive him of the legal capacity to do so; and (ii) by this deprivation, to in turn, render the borrower incapable of validly transferring benefits to third parties in covenant violative transactions and so create a major disincentive to third party participation in such transactions. Secondly, the mechanisms described in this part are designed to ensure that, in the unlikely event that a violative act were effected and litigation were to become necessary: (i) the *juicio ejecutivo* procedure would be available so that problems of lack of injunctive relief and

high bond cost would be minimized; and (ii) problems of proof of damages would be precluded because of the prior stipulation of the parties.

The foregoing results are sought to be achieved through four discrete enforcement mechanisms: (1) the public registration of the limitation of the capacity of borrower representatives to effect covenant violative transactions; (2) the transfer of voting control of borrower shares to a lender-controlled trustee and the consequent prevention of the revocation of the registered capacity limitations; (3) the provision to the lender of assured access to the *juicio ejecutivo*, with concomitant avoidance of the disadvantages of the *juicio ordinario*; and (4) the elimination of the need to prove amount of damages and the transference of financial liability for violations from the potentially judgment-proof borrower to the shareholders, directors, and officers of the borrower—those individuals who would actually have to authorize or effect any violation which did occur.

#### *Elimination of Capacity to Effect Valid Violations*

The first enforcement mechanism to be described is the limitation of the powers of representation of borrower agents so that they lack the legal capacity to effect covenant violative acts. In turn, any such acts which were actually committed would be voidable at the request of, and hence ineffective as to, the lender. The basis of this approach is Civil Code Article 836 which states, *inter alia*, that any juristic act effected by a person who "relatively" lacks the legal capacity to effect such act is voidable.<sup>72</sup> "Relative incapacity," in turn, is deemed to arise with respect to a given juristic act when the actor has the capacity to effect the act subject only to a condition precedent, such as procurement of the approval of a third party, and the condition has not been fulfilled.<sup>73</sup>

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72. C. Civ., art. 836 states:

There is a relative nullity and grounds for cancellation of an act or contract:

1. When any of the conditions essential for its formation or its existence is imperfect or irregular;
2. When any of the requisites or formalities required by law in view of the exclusive and particular interests of the parties is absent; and
3. When performed or executed by persons of relative incapacity.

73. "Relative [as opposed to absolute] incapacity" is not specifically defined in the Costa Rican Codes. The definition set forth in the text—i.e., that the phrase refers to the status of a party whose capacity with respect to a certain juristic act is subject to the approval or confirmation of another party, which approval or confirmation has not been given—was, however, stated by

The capacity of an individual to act for a company can derive from only four sources: particular provisions of the Commercial Code;<sup>74</sup> the company's charter;<sup>75</sup> a delegation of authority set forth in the charter;<sup>76</sup> or a delegation voted by the board of directors.<sup>77</sup> Any such power of representation, regardless of the source from which it emanates, can be limited by an amendment to the company charter.<sup>78</sup> Such amendments, whether their effect is to add new provisions to the charter or to delete provisions formerly in force, can be effected only by resolution of an extraordinary meeting of the shareholders of the company.<sup>79</sup> Given the foregoing principles of commercial law, limitation of the capacity of borrower agents can be achieved through the addition of three amendments to the company charter: a "purposes amendment," a "revocation amendment," and a "limitation amendment."

First, the charter clause, which sets forth the purposes for which the company was organized, is amended by the addition of the following limitation to the standard list of authorized company activities, such as manufacturing, trading, and investing:<sup>80</sup>

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Costa Rican counsel consulted by the author to be the standard civil law definition of relative incapacity.

74. C. Com., art. 182:

The power of judicial and extrajudicial representation of a company inheres in the president of the administrative counsel [e.g., board of directors], as well as the directors indicated by the charter, who hold such powers as they are accorded therein.

If the charter so permits, the counsel may authorize those representing the company to delegate, totally or partially, their functions to other members of the counsel.

75. *Id.*

76. *Id.*

77. C. Com., art. 187:

The administrative counsel, or whoever exercises the power of representation may, among its other powers, appoint functionaries, such as managers, holders of powers-of-attorney, agents or representatives, with such titles as are deemed suitable, to carry out the business of the company or particular aspects thereof and who may or may not be shareholders.

The functionaries referred to in the preceding paragraph have such powers as are established by the charter, the by-laws, the regulations or the respective resolution of appointment.

78. *Id.*

79. C. Com., art. 156(a).

80. The amendments quoted are English translations of the amendments actually used in two loan restructuring situations in Costa Rica in 1978 and 1979. Addition of these amendments is typically achieved by making their enactment a precondition to drawdown, rescheduling, etc., as the case may be.

The Company may not, without the prior express approval of the general shareholders meeting (a) affiliate, merge or consolidate with any other company or enterprise in law or in fact; (b) execute guaranties of any kind; (c) invest in assets of any type not required for its normal operations; (d) engage in activities different from those set forth in this clause; (e) mortgage, pledge or in any other manner encumber its assets except in order to guaranty a portion of the price of any such asset at the time of purchase, provided that no such purchase money lien shall be granted with respect to assets acquired from shareholders, affiliates or subsidiaries of the company or from firms controlled directly or indirectly by such shareholders, affiliates or subsidiaries.

This purposes amendment serves two important functions. First, it constitutes public notice that covenant-violative acts are *ultra vires* as to the borrower; hence, in the event that any such act is sought to be registered in contravention of the purposes clause, it may well be refused registration by the Register on *ultra vires* grounds. Second, the purposes amendment puts third parties on notice as to the legally-sanctioned activities which the borrower can and cannot undertake and hence affords the lender the basis—e.g., the third parties' constructive knowledge of the limitations on borrower prerogatives—of a suit to void any violative transaction on "lack of capacity" grounds.

The two remaining charter amendments are of equally critical importance. The revocation amendment cancels all outstanding powers granted by the company up to the time of the amendment, including powers granted by the board or otherwise delegated. It does not, it should be noted, affect powers of representation arising from code provisions or the charter itself.

The limitation amendment, however, imposes limitations on all four categories of powers. This amendment is appended to the declaration—standard in virtually all charters—that the company shall be administered by a board of directors; that it shall have a president and other officers; that the board may grant powers of all types,<sup>81</sup> revoke them, and grant new powers; that the board may appoint officers and managers, granting to them such powers as are deemed convenient; and that the judicial and extrajudicial power of representation of the company shall inure to the president of the board, who, in the execution of his duties, shall have all powers conveyed by

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81. There are a variety of different types of powers: special, general, *generalissimo*, general powers of management, and general judicial powers; see, e.g., C. Civ., arts. 1253-60.

Article 1253 of the Civil Code. The amendment first introduces, after the clauses authorizing the board to grant “powers of all kinds” and to grant to officers and agents “such powers as may be deemed convenient,” the statement that “all such powers shall be subject to the limitations that follow.” The amendment then adds the following paragraph after the reference to Article 1253 of the Civil Code:

The president and vice-president of the board of directors, all holders of powers of representation, all officers, agents and representatives which have been appointed, are now serving or shall in future be appointed, the board of directors and the executive committee shall at all times require the express authorization of the general meeting of shareholders, granted by final vote: (a) to invest in assets other than those required for the normal operations of the company specified in this charter; (b) to engage in any new line of business; (c) to encumber company assets, other than to guaranty a portion of the price of any such asset at the time of the purchase thereof, provided that such asset at the time of the purchase thereof [sic], provided that such asset has not been acquired from any shareholder, affiliate or subsidiary of the company, or from any enterprise controlled directly or indirectly by any such shareholder, affiliate or subsidiary; (d) to grant loans of any type to shareholders, officers or employees of the company, or to third parties when the total amount of such loans granted by the company exceeds the equivalent of \$50,000; (e) to sell or transfer in any manner assets of the company with a book or market value, whichever shall be greater, of more than the equivalent of \$250,000; (f) to solicit, contract or undertake agreements or obligations or leases outside the normal course of business, or incur financial obligations of any type when the total of such obligations exceeds in any fiscal year the equivalent of \$100,000; (g) to make capital investments or invest in assets in excess of the equivalent of \$250,000 in any fiscal year; or (h) to grant guaranties of any type. In each instance in which a power is granted or an officer, agent or representative is appointed, the foregoing limitations shall be included in the resolution of grant or appointment.

All charter amendments are required by law to be inscribed in the Commercial Register.<sup>82</sup> Once the revocation and limitation amendments have been so inscribed, they constitute constructive notice to all third parties that the capacity of all individuals holding powers of representation of the borrower—whether code-granted, charter-granted, or delegated—to enter into the acts listed in the limitation

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82. C. COM., art. 19; *see also* note 71 *supra*.

amendment is merely conditional; that such individuals are, therefore, under a relative incapacity with respect to such acts; and that, indeed, no general or *generalissimo* powers which do not contain the enumerated limitations may be granted without shareholder vote—the fact of which vote, it should be noted, must be registered in order to be valid.<sup>83</sup>

In so placing the foregoing legal circumstances in the public register, the revocation and limitation amendments ensure that any violative acts effected without the requisite shareholder approval are voidable under Article 836(3). This, in turn, significantly reduces the likelihood that a violation would occur since any third party considering lending to the borrower, taking a mortgage or pledge from it, accepting the borrower's cross-guaranty, making a payment to the borrower in exchange for title to borrower assets, or otherwise participating in a juristic act prohibited by the lender's negative covenants would, in the exercise of ordinary prudence, be likely to dispatch its counsel to check the borrower's entry in the Commercial Register. It is at this entry that the charter amendments would be inscribed; it would be this registral inscription which, by the principle of publicity, would put all third parties on constructive notice of the limited capacity of borrower agents. Consequently, it would be this entry which would alert third parties to the fact that the transaction in contemplation was one which was voidable and consequently, from its point of view, commercially inadvisable. It is unlikely, therefore, that third parties would be willing to participate in transactions listed in the limitations amendment, i.e., the transactions barred by the lender's negative covenants.

### *The Voting Trust*

Charter limitations on agent capacity are, however, by themselves not sufficient to ensure that negative covenants will not be violated. This is so because just as borrower shareholders have the power to vote the revocation and limitation amendments into the charter, so under normal circumstances, would they be free to reconvene at any subsequent time to vote the amendments back out of the charter. If this occurred, the lender, of course, would find itself precisely where it was when the deterrent exercise began. Hence, a second enforcement mechanism—the borrower shares voting trust—must be put in place.

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83. C. Com., art. 235(c).

Under the voting trust arrangement, the borrower's stock is assigned and delivered to a trustee who becomes the record—but not beneficial—owner thereof, either by virtue of the inscription of his name on the shares and in the company stock book (for nominative shares), or by virtue of his physical possession of the shares (for bearer shares).<sup>84</sup> The former shareholders are entitled—by the terms of the trust agreement among the shareholders, the lender, and the trustee—to submit directions to the trustee as to how the shares are to be voted on any particular matter. The text of any resolution in favor of which the former shareholders request the trustee to vote the assigned shares must, however, be forwarded by the trustee to the lender, and the trustee is not entitled to accept the former shareholders' voting direction until and unless the resolution is approved by the lender.<sup>85</sup> With

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84. The following discussion is applicable both to bearer share and to nominative share corporations. It is strongly recommended, however, that the lender require that the borrower issue, or, if bearer shares are already outstanding, convert to nominative shares only. See Keesee, *New Challenges to Investor's Counsel: Legal Risk Analysis and the Work-Out Perspective in LDC Investment*, 5 PEPPERDINE L. REV. 305, 339 (1978). Nominative shares and their transfer are described at C. COM., art. 608, 686-92, and bearer shares and their transfer are described at C. COM., art. 668, 712-26.

85. The specific wording of the assignment and vote-limitation clauses utilized in the 1978-79 Costa Rica restructuring situations referred to in Part IV is as follows:

### 2. Assignment of Shares

(b) The Assignors [e.g., the former shareholders] hereby irrevocably transfer all of their right, title and interest in and to the Shares and to any shares of stock of the Company which they may hereafter acquire (which such future shares, if any, shall also be deemed to be subsumed by the term "Share") to the Trustee.

(c) The Shares shall be accepted and shall at all times be held by the Trustee in safe-keeping for the benefit of the Assignors; and the Trustee shall not sell, transfer, encumber or make any other disposition of the Shares without the prior written consent of the Assignors and of the Lender at the expiration of the Term of this Agreement, or (ii) in the event that the Company is adjudicated a bankrupt and its assets distributed to its creditors, or (iii) after the Company has been voluntarily liquidated, or (iv) in the event of any collection, foreclosure or other action by the Lender against the Company, which, as certified to the Trustee by the Lender has resulted in a final settlement of all Loans and Other Indebtedness as between the Lender and the Company, then the Trustee shall reassign and deliver the Shares to the Assignors.

### 3. Voting Rights

(b) If at any time during the Term of this Agreement an Assignor wishes to direct the Trustee with respect to any matter to vote the



the limitations on the powers of officers and the powers that may be granted by the Board to subsequent attorneys-in-fact, or "mandatories," already amended into the charter, the establishment of the voting trust subject to lender direction ensures that the erstwhile shareholders cannot simply reconvene in an extraordinary general meeting to vote to delete the limitations back out of the charter.<sup>86</sup>

The voting trust, moreover, has a number of other significant advantages. Several of the juristic acts, for example, which are typically barred by negative covenants cannot in any event be effected by individual officers, but rather must be approved by shareholder resolution. Among these acts are merger, dissolution, filing for receivership, and filing for voluntary bankruptcy.<sup>87</sup> Establishment of the voting trust with lender control of shareholder votes provides the lender with the means, which would not be available from the charter amendment mechanism alone, to prevent those acts from being effected without lender approval.

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Shares transferred by such Assignor hereunder, then no less than 21 days prior to the date of such vote, such Assignor shall deliver to the Trustee the complete text (the "Text") of the matter with respect to which the voting direction is proposed to be given; and the Trust shall within 5 days of his receipt thereof transmit the Text by telex to the Lender at the notice address set forth in Exhibit E hereto, with a copy to any Assignor who has not joined in such voting direction. The Lender shall inform the Trustee by telex no later than 10 days prior to the date of the vote whether it approves or disapproves of the Assignor's voting direction with respect to each matter for which direction is proposed to be given. The Trustee shall not accept the Assignor's voting direction unless it has been approved by the Lender. If, as of 5 days prior to the date of vote, the Trustee has not received a response from the Lender, the Trustee shall by telex request to convey such response by telex within 48 hours. The Lender covenants herewith that upon receipt of the aforementioned Trustee telex, it will inform the Trustee by telex at the Trustee telex address set forth in Exhibit E, of its approval or disapproval no later than 48 hours prior to the date of the vote; notwithstanding the foregoing, however, if the Lender does not so indicate approval or disapproval, it shall be deemed to have approved.

86. The charter of a *sociedad anonima*, *soci t  anonyme*, or other analogous entity can, by the terms of the typical civilian jurisdiction commercial code, be changed only by resolution of a general and extraordinary shareholders' meeting. See, e.g., C. COM., art. 156. An "extraordinary" general meeting is a general meeting other than the regularly scheduled "ordinary" general meeting which convenes annually to approve year-end balance sheets, approve dividends, etc.

87. See, e.g., C. COM., art. 221 (merger), and C. COM., art. 855 (voluntary bankruptcy).

As do the publicly-registered revocation and limitation amendments, the voting trust constitutes a significant deterrent to third party participation in violative acts. This results from the fact that even if the board or an officer of the borrower did issue a power not limited in conformity with the charter amendments, the lender would be able to void any act effected by the holder of the power since the beneficiary of the act would be responsible by the principle of publicity for constructive knowledge of the registered fact that the power was invalid. Additionally, since the terms of the trust agreement modify previously registered information bearing on ownership of the company shares and are, therefore, inscribed in the Commercial Register, all third parties are on further notice that all acts requiring "shareholder" approval must in fact be approved by the trustee.

Three additional positive features of the trust arrangement are: (1) that since the trust agreement can be protocolized it can form the basis of a *juicio ejecutivo*; (2) that since, even with the power of attorney and charter limitations in place, corporate representatives retain full power to carry out all functions required in the normal cause of business, shareholder votes should be required no more frequently than the usual general meeting, and the requirement of telex preclearance should not be unduly burdensome; and (3) that not only is the trustee held to a high standard of care in fulfilling his voting duties,<sup>88</sup> but in the normal course, the trustee is likely to be lender's local counsel and, therefore, particularly non-susceptible to locally-generated "misunderstandings" or improper influence which could undermine the lender's control of share voting.

Finally, it should be noted that the trust agreement approach is difficult to circumvent. First, it is difficult to envision a situation wherein a borrower would be able to substitute a "lender approval" of a voting directive for a "lender disapproval," since the disapproval would be transmitted in writing—by telex or letter—directly from lender to trustee. Second, as noted above, the trustee's duty of care is well elaborated in the codes, the penalties for breach of that duty severe, and the disincentives to breach multitudinous. Third, it is highly unlikely that a notary would enter in his protocol book, for subsequent transcription into the Commercial Register, a statement that the trustee had appeared before him and voted borrower stock in a particular way (e.g., in favor of a charter amendment deleting

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88. See, e.g., C. Com., arts. 633-62 (note arts. 644 and 645).

the prior "limitation" amendment, or in favor of a merger or voluntary bankruptcy) if the trustee had not in fact done so. The registration of a charter amendment or corporate decision on the basis of such a protocolized statement of shareholder (e.g., trustee) vote could only occur if the notary were either defrauded into making the attestation or himself participated in a fraud. While such eventualities are not inconceivable, they are relatively improbable. The first scenario is implausible not only because substantial prison terms are prescribed as the penalty for defrauding a notary,<sup>89</sup> but also because it is highly unlikely that given the extent of a notary's code-prescribed duty of care, he could be deceived into accepting and registering a vote attestation not actually made by the trustee.<sup>90</sup> The second scenario is unlikely both because of the severity of the penalties levied against a notary who makes a false attestation,<sup>91</sup> and because a notary's fraudulent attestation that a trustee had appeared before him at a specified time and place and made a particular unambiguous statement would be relatively easy for the trustee to disprove, through, e.g., the testimony of witnesses to his actual whereabouts at such time.

It may be noted for the sake of completeness that at least in theory, an alternative to the trust arrangement does exist as a safeguard against the deletion of the purposes, revocation, and limitation amendments by subsequent shareholder vote. This theoretical alternative consists in the enactment of an additional charter amendment which provides that no modification of the purposes, revocation, or limitation amendments would be registrable without the consent of

89. See CODIGO PENAL [C. PEN.] art. 358 (providing a penalty of one to six years imprisonment for causing the insertion of a false statement in a public document) and art. 359 (providing a penalty of six to twenty-four months for falsification of a private document, such as the minute books of a shareholders' meeting).

90. The civil law notary is under a duty to use the utmost care in examining the legality, and generally the validity, of the transaction; this includes, of course, diligent inquiry into the identity and legal capacity of the parties. If the transaction requires approval by a third party or by a public authority, he must so inform the parties. . . . Intentional or negligent violation of any of these duties may subject the notary to disciplinary proceedings and to civil liability for damages. . . . [T]he requirement of notarial form . . . [makes it] more difficult for agents without proper authority . . . to create the semblance of a valid legal transaction. . . .

Schlesinger, *supra* note 4, at 16-17 (emphasis added). See, e.g., C. CIV., art. 629 in text *infra*.

91. See C. PEN., art. 357, providing a penalty of one to six years for fraud in the preparation of a public document by a notary in his capacity as notary.

the lender thereto, in protocolized form and noted in the Commercial Register.

There is, however, a significant problem with the implementation of this "lender approval" amendment mechanism. Article 152 of the Costa Rica Commercial Code states:

The legally convened shareholder's assembly is the supreme authority of the firm, and expresses the collective will on matters within its competence. Those powers which the law or the charter do not allocate to any other organ of the firm are within the competence of the assembly.

When registration of the lender approval amendment was sought in connection with the 1978 Costa Rica work-out, the Office of the Commercial Register interpreted Article 152 as meaning that as the "highest corporate authority," shareholders could not agree to auto-limitation, even in connection with a collateralization arrangement. The argument was made to the registrar that the meaning of Article 152 was not that the shareholders could not contract to forebear from certain acts for the benefit of third parties, but that as among intra-firm entities, i.e., the board, the executive committee, individual directors, the president of the board, officers, and shareholders, the authority of the shareholders was paramount. This indeed appears to be the logical interpretation of Article 152 since, in the ordinary course, shareholders *qua* shareholders limit the exercise of their rights by entering into, *inter alia*, stock retention agreements, voting trust agreements, and agreements to allow lenders to name board members in the event of payment default. Typically, such undertakings as these are accepted by civilian registrars and not attacked as void and unenforceable, as indeed they would be if they contravened an imperative provision of a Costa Rica code, i.e., a provision from which derogation was not permissible.<sup>92</sup> Consequently, it is difficult to accept the argument that shareholders may not enter into agreements limiting their use of their shares.

Ultimately, the Costa Rica Registrar's Office revised its interpretation of Article 152 to allow registration of a lender approval amendment. The issue, however, may be raised in other civil law jurisdic-

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92. See, e.g., C. Civ., art. 10: "Neither a general renunciation of the laws nor a particular renunciation of laws concerned with the public interest is effective. All juristic acts and agreements against prohibitory [e.g., imperative] laws are null and void unless such laws provide otherwise."

tions, and the availability of the lender approval amendment mechanism should not be presumed.

### *Assurance of the Availability of the Juicio Ejecutivo*

The purposes, revocation, and limitation amendments and the voting trust agreement are intended, by: (i) depriving the borrower of the capacity of effect violations; and (ii) creating major disincentives to third party participation in attempted violations, to ensure that the lender need never resort to litigation to correct covenant violations. The possibility must not be ruled out, however, that through bureaucratic error, miscarriage of justice, or other infortuitous event (as, for example, the inadvertent omission of a portion of the loan agreement negative covenant provisions from the limitation amendment), a violation may somehow be effected despite the safeguards discussed above and that litigation may become necessary.

Two additional mechanisms can be implemented by the lender to ensure that if the litigation contingency does so materialize, the lender will be in the best possible legal position. The first mechanism is the inclusion in the protocolized loan agreement or mortgage of a waiver by the borrower of all right to claim that any action based on the document must be brought as a *juicio ordinario* because of alleged ambiguities in the document terms. This waiver, together with the fact that the loan documentation, the charter amendments, and the trust agreement are all protocolized and hence, public documents, should ensure the availability of the *juicio ejecutivo*.

### *The Penalty Clause*

The second "litigation contingency" mechanism is the conclusion of a "penalty clause" agreement with, as appropriate, shareholders, officers, and/or directors of the borrower to obviate the problem of proving the amount of damages resulting from a covenant violation. Under Article 426 of the Commercial Code, any contract may include a clause providing for liquidated damages in the event of breach.<sup>93</sup>

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93. C. COM., art. 426 states:

When a penalty is provided for the non-performance or defective performance of a contract, except in the case of fraud by the obligor or an agreement to the contrary, the obligee may demand only the stipulated performance or the agreed upon penalty; but if the penalty is payable solely in respect of failure to perform within the agreed time or at the agreed place, the obligor may demand both the penalty and performance of the contract.

The obligee can claim either performance or the penalty, and if the parties specifically so agree, can even claim both.<sup>94</sup> If the parties do so agree, the penalty that can be claimed in addition to the principal obligation can be up to twenty-five percent of that principal amount.<sup>95</sup> In either case, the obligee is free to sue for consequential damages arising from a fraudulent breach in addition to any liquidated damages he collects.<sup>96</sup>

The lender utilizes these principles to deter negative covenant violation by providing in the agreement that if despite the trust agreement (e.g., by fraud or mistake, or in the event that for any reason the trust is deemed invalid or unenforceable, as, for example, on the grounds that it is contrary to public policy): (a) the charter is amended to revoke or alter the previously enacted purposes, revocation or limitation amendments; or (b) any act constituting a violation of the lender's negative covenants is effected by a borrower representative, then in either such event, the lender will be entitled for each such breach to a stipulated penalty payment from the obligor under the penalty agreement.

The obvious advantage of the penalty clause mechanism is that it eliminates not only the need to establish the amount of damages, but also the fact that any damages have even been suffered. As Planiol, perhaps the leading French commentator on the civil law, has observed:

Penalty clauses . . . [have a double object; first they] serve to overcome all difficulty as to evaluating the damage suffered by the creditor and as to the amount of the indemnity which is due him; they avoid the necessity for a law suit, or at any rate of having an expert estimate the damage . . . . [Second,] it is not necessary to inquire whether the creditor has or has not suffered damages as a result of the inexecution of the obligation . . . . The agreement as to a fixed amount was made expressly to avoid all inquiries of such nature. The penalty is due (and that is one of its great advantages) from the moment that the debtor is responsible for nonperformance.<sup>97</sup>

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94. *Id.*; C. Civ., art. 711.

95. C. Civ., art. 712.

96. "The penalty clause is effective even if the creditor does not suffer damages. If the damages exceed the amount of the penalty, the obligee may claim a greater indemnification only if he proves fraudulent intent on the part of the obligor." C. Civ., art. 427.

97. M. PLANIOL, *TREATISE ON THE CIVIL LAW* 153-55 (11th ed. 1959).

Beyond the elimination of the need to prove damages, the penalty clause mechanism provides a second feature of significant value to the lender: it allows the lender to shift financial liability for breach of a negative covenant from the borrowing entity to the individual shareholders, directors, and officers of the borrower—the parties within whose discretion it is to determine whether a covenant violation will or will not occur. As summarized by Planiol:

[T]he penalty clause serves to give an action to a person who, without it, would not have one; that is seen in the case of promises and stipulations [e.g., by shareholders, officers, etc.] for the benefit of third parties [e.g., the borrower]. He who promises the act of another does not promise to do anything personally and consequently, no obligation can arise against him; but it is different if a penalty clause is added to the contract; he will be obligated to pay if the third party designated in the act does not do what is expected of him.<sup>98</sup>

It should be noted that there would appear to be no question under Costa Rican law but that an officer, director, or shareholder may validly contract to be individually liable for the acts of a firm with which he was associated.<sup>99</sup>

This personal nature of the obligation allows the lender the option of collecting the penalty amounts through attachment and sale of the individual obligor's personal property, and thereby, augments in two respects the credibility of the lender's threat to litigate in the event of a covenant violation. First, it eliminates the need for the lender to move for satisfaction against borrower property whose sale could materially interfere with borrower operations and loan repayment prospects. Hence, the penalty clause mechanism adds an element of "ready invocability" to the lender's litigation option. Second, the lender is no longer limited to recourse against a borrower which may be little more than a judgment-proof shell. Again, since litigation by the lender in these circumstances appears to offer an enhanced prospect of recovery, lender litigation gains added credibility as a deterrent.

A problem sometimes encountered with the penalty clause approach is that shareholders, officers, and directors will resist the assumption of personal liability. This, however, is not a particularly

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98. *Id.* at 153-54.

99. *See, e.g.*, C. Civ., art. 1045-46.

persuasive ground of opposition, at least with respect to shareholders and directors, in that lenders frequently require personal guaranties of company obligations. The execution of the penalty clause agreement simply broadens the scope of the obligors' responsibility to include not merely breach of the repayment obligation, but breach of the negative covenants as well.

A theoretical disadvantage of the penalty clause approach is that the codes of certain civil law systems empower the court in its discretion to reduce the amount of liquidated damages if it appears "proper to do so." This residual judicial power to interpose the court's judgment in place of the agreement of the parties has, however, been roundly criticized by commentators, is not permitted in many jurisdictions, and, where permitted, is not widely used.<sup>100</sup>

## VII. CONCLUSION

It is not the intention of this paper to arbitrarily adopt a cynical or misanthropic view of the typical borrower-lender relationship and then insist upon lender imposition of involuted and draconian methods as the only means of dealing with the problem. What this paper does attempt is a demonstration: (1) that negative covenants are of critical, not secondary, importance in the post-disbursement lending phase; (2) that because of material variations between common law and civil law legal principles, the covenant enforcement procedures reflected and incorporated in a common law jurisdiction lender's loan documentation are likely to be ineffective deterrents to covenant violations in civil law jurisdictions; (3) that because of the very substantial number of nations that can be considered civil law jurisdictions, the development of enforcement mechanisms that are effective in such jurisdictions is a notably important task; (4) that because of the substantial common origin of civil law legal systems, a solution to the covenant enforcement problem developed for one "model" civil law jurisdiction would have substantial applicability to many others; (5) that Costa

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100. See Planiol, *supra* note 97, at 155-56.

The German. . . and Swiss Code[s] allow the creditor to obtain greater damages if he can prove a greater prejudice, and the debtor can obtain a reduction if the indemnity is excessive in comparison to the harm done. This provision, based on equity, takes away from the penal clause almost all its usefulness. The project [sic; should be translated as "draft"] of the Franco-Italian Code of Obligations (Article 101) retains the principle that the penalty clause cannot be modified by the judge. The Brazilian Code of 1916 (Article 927) does the same.



Rica well qualifies as such a "model" jurisdiction; and (6) that, predicated on the analysis of specific provisions of the laws of Costa Rica, there are four primary enforcement mechanisms—charter amendments, the voting trust, waiver of *juicio ordinario*, and the penalty clause—which effectively ensure the enforceability of negative covenants in civil law jurisdictions.

To the extent that the foregoing points appear to have been adequately demonstrated, it is further urged that U.S. counsel to lenders investing in civil law jurisdictions owe a duty to their clients to make an independent review of the validity of the mechanisms discussed above and, if satisfied of their effectiveness, take steps to see that they are implemented for their clients' benefit. Finally, to take a larger view, it may be observed that few issues point up as well as the matter of negative covenant enforcement the critical need for U.S. lenders' counsel, if their clients are to be properly served, to have the most extensive familiarity possible with the foreign legal systems in which their clients operate.