Sovereign debt enforcement and sovereign immunity: Historical evidence on the role of financial engineering and legal innovation

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The paper contributes to recent work exploring alternative mechanisms for enforcing sovereign debt beyond the classical dichotomy reputation versus sanctions. It reviews the ultimately successful efforts by lawyers to structure sovereign debt products so as to enable courts to become competent in matters of sovereign debt, thus anticipating on some aspects of the Griesa ruling on Argentina. The findings qualify the absolute immunity story, and opens new perspective on the significance of sovereign debt contracts and contractual clauses.

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I am grateful to Alberto Gamboa for dedicated research assistance.

Judge Griesa's much-discussed 2014 ruling in favor of Argentina's hold out creditors has brought to the fore the twin importance of tribunals and vulture funds for sovereign debt markets. The ruling itself was a response to a lawsuit brought about by vulture fund NML Capital, which had purchased Argentine debt at low prices in the aftermath of the 2001 default and subsequently used aggressive hold out tactics to secure a high rate of return. The vultures scored a victory with the Griesa ruling because the decision recognized that the vultures were entitled to recover the face value of their investment, but more importantly, because Griesa ordered that Argentina must pay the vultures at the same time it made the next semiannual interest payment to the bondholders who had accepted the debt restructuring, known as the debt-swap bondholders, because they had assented to the reduction of interest. This was the essence of Griesa's so-called *pari passu* decision – a decision that ordered that the two groups of creditors be treated "alike." The reason why the order has been seen as a game changer is that, while a US judge is powerless against a foreign sovereign (so that a decision against a foreign sovereign is purely nominal), he has authority over a New York bank. According to the order, banks found helping the Argentine pay the new bondholders before the old ones, would violate the judge's order. Argentine authorities countered that the deposited amounts were fiduciary property of swap bondholders. In other words the question was whether the money in New York belonged to the debt swap bondholders or to the Argentine government. The decision was subjected to much criticism, but the ruling was subsequently upheld by the United States Court of Appeals while the Supreme Court found no reason to revise it.[1]

This paper argues that Judge Griesa's ruling is only one episode in a saga that goes quite far in the past. It argues that the interaction between vultures and tribunals is in fact an essential and very old driver of the dynamics of the international financial system. The history of the foreign debt vultures, which sociologist Saskia Sassen (Sassen, 2014) suggests goes to thirty years ago, is found to be an ancient one. As early as in the 19th century, sophisticate financiers sought to use legal talent and the legal system in order to maximize returns from sovereign debt investments – and in particular from sovereign debt defaulters. Moreover, this paper shows that the attempt

[1] For a good summary of the situation as it stood in the aftermath of the Supreme Court decision, in June 2014, see Floyd Norris, "The Muddled Case of Argentine Bonds", *New York Times*, July 24, 2014. A critical review of the ruling is Stiglitz (2014).

at assigning sovereign debt to legal spaces that would come within the reach of courts, as was tried with Griesa ruling and order, is not recent either. This article concerns itself with deconstructing the process whereby similar efforts were attempted in the past, so as to shed light on the present.

To this end, I demonstrate that, even in a sovereign debt context traditionally characterized as exhibiting such an extreme form of sovereign immunity as the 19th century, ordinary tribunals nonetheless played in some cases a significant role. How this was achieved is the topic of this paper. Namely, I prove the existence and articulate the logic of ultimately successful efforts to create a legal middle ground – contemporaries did use the expression "*in medio*" – consisting in a carve-out to the principle of sovereign immunity. In effect, these attempts amounted to the construction, by international lawyers reading between the lines of former court rulings, of a space where the law of the land would be competent. These innovations occurred as a number of financiers and lawyers interested in developing tools to provide greater security to foreign debt property rights experimented with contracts. Both the historical process (which involved the alliance of finance and legal expertise) and the historical outcome (the successful production of a carve out to sovereign immunity), were not without some resemblances with the Griesa ruling, in that it resulted in creating a territory that courts would be enabled to govern. In the Argentine case, the "in medio" territory consisted in the flows of money from bank accounts in New York, which Griesa sought to govern. What I seek to prove is that "in medio" economic territories have a long history. This is a novel point, which I am the first to make, as far as I know.[2]

The importance of this finding is threefold. First, it is interesting in and for itself, because macroeconomic history and the legal history literature have generally taken for granted conventional characterizations of the period as one where courts abstained from mingling in sovereign debt. To quote just one example, the legal scholar Weidemaier (2010, p. 337) recently described the 19th century as an age of "absolute sovereign immunity." To make that claim, legal historians have typically relied on the works of prominent authorities in international law such as Westlake.[3] Indeed, legal

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[2] For a recent paper emphasizing a similar point, namely the importance of remedies in modern set up, see Schumacher et al. (2014).

[3] For instance Westlake (1890, p. 226) who wrote: "Foreign states, and those persons in them who are called sovereigns, whether their title be emperor, king, grand-duke, or any other, and whether their power in their states be absolute or limited, cannot be sued in England on their obligations."

authorities generally contended, that no action could be maintained in an English court against a foreign potentate for actions, whether right or wrong, accomplished by the foreign sovereign in his or her capacity. This principle was traditionally traced back to Emer de Vattel's law of nations and occasionally to decisions by Lord Mansfield.[4] But over the 19th century, the principle became embedded into the British legal system through important decisions, the most important one being Duke of Brunswick v King of Hanover, which had entrenched the principle with the help of a high profile, unanimous decision resulting from an appeal in the House of Lords in July 1848.[5] As one judge, quoting the Brunswick decision would declare in 1851: "To cite a foreign potentate in a municipal court for any complaint against him in his public capacity is contrary to the law of nations, and an insult which he is entitled to resent."[6] As we shall see, this was technically true, but it does not mean that other approaches could not be attempted. In fact, the reference to Westlake is ironical given his own effort to subvert this principle, as we shall discover.

The second important contribution of this paper is best seen if put in the light of the contemporary literature on the history of sovereign debt. This literature presents itself as a succession of discoveries of competing and sometimes complementary sovereign debt enforcement regimes. A first generation of arguments emphasized the alternative between reputation and sanctions. Among historically inspired contributions, the best illustrations are provided by the works of North and Weingast (1989) who emphasize the credibility enhancing role of domestic institutions and Mitchener and Weidenmier (2005, 2010) who emphasize what they describe as "super sanctions" – the punishment of defaulters through such reprisals as the dispatching of a gunboat. A second generation of works has explored other ways to raise credibility, beyond sanctions and reputation. For instance, looking at the experience of Peru, Vizcarra (2009) suggests that the inclusion of a tangible collateral in sovereign debt

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Intriguingly, a point not dissimilar to the one I make here, namely that the view from the ground differs from the theory, has been recently articulated, but for the modern period, by modern proponents of the view that Gulati and Weidenmaier (2017).

[4] See Wadsworth v The Queen of Spain, 1851 17 Q.B. 195 p. 1255.

[5] Duke of Brunswick v King of Hanover, 9 E.R. 993, 1848. The decision was returned on July 31, 1848.

[6] Opinion of Lord Campbell C.J. in de Haber v Queen of Portugal (1851) 17 Queen's Bench Reports 196, p. 1259. The discussion further elaborated: "No English court has jurisdiction to entertain any complaints against [the foreign potentate] in that capacity. Redress for such complaints affecting a British subject is only to be obtained by the laws and tribunals of the country which the foreign potentate rules, or by the representations, remonstrances or acts of the British Government."

contracts raised repayment outlook.[7] My own work has explored the possibility of other enforcement technologies for instance how intermediaries concerned about their prestige could secure higher repayment rates (Flandreau and Flores 2009). More recently, I have argued that the committee of the London Stock Exchange really acted as a court of justice for sovereign debt, so that the notion of absolute sovereign immunity ought to be qualified. By using the power to exclude defaulters that had not reached a satisfactory agreement with their bondholders, the stock exchange committee provided enforcement services and also served as a coordinating device for creditors (Flandreau 2013). These arguments are not necessarily exclusive of previous ones (the exclusion from the stock exchange can be interpreted as a sanction) but they contribute a richer understanding. Seen from this vantage point, this paper adds to this generation of works by showing yet another way out of the sovereign immunity conundrum – namely, and perhaps surprisingly, the legal system itself.

The third contribution of this paper is the light it sheds on some current development of a literature originated by legal scholars but is currently inspiring also analytical and quantitative work in modern macroeconomic history. A few years ago, an influential book by Gulati and Scott sought to trace through the construction of a historical database of sovereign debt contracts, the rise of the so-called *pari passu* clause, which at the time was playing an important role in the litigations brought about by vulture funds. Part of the goal of this book was to undermine the case for such clauses, but it also rose an interesting question, namely why was it that clauses were written into sovereign debt contracts (including *pari passu* clauses) in an era characterized by absolute sovereign immunity. The answer that has been given to this question in the literature, by both macroeconomic historians and legal historians, is that contracts were written in anticipation of military intervention by imperial powers on behalf of the bondholders. According to Ahmed, Alfaro and Maurer (2010), imperial interventions in the broader Caribbean region (the sphere of influence of the "Dollar Diplomacy") constituted at the turn of the 20th century a substitute for the lawsuits brought about today by vulture funds. More recently Gulati and Chabot (2014) have pushed the beyond the remit of the dollar diplomacy, arguing in the context of *pari passu* clauses in sovereign debt contracts that "the clause had value, we suspect, because its violation provided a justification for the gunboats to be sent

[7] For a similar point, see Chabot and Santarosa (2017).

in. Today, there are no gunboats that will enforce debt contracts, but there are courts that will at least try."[8] This however, is a very unlikely interpretation in view of the solid work by D.C.M. Platt who persuasively argued, on the basis of a thoroughly researched analysis of the British government's attitude towards the claims of the bondholders that the British Navy never became a collection agency (Platt 1967). While I do not claim that the evidence reported does explain all clauses in every single sovereign debt contract, my suggestion to bring back the court system into the sovereign debt story does provide a novel starting point for thinking of the reasons why some clauses in sovereign debt contracts were written in the first place. As I suggest they were included as part of a highly experimental *tâtonnement* process, whereby alternative theories and schemes were attempted then discarded when they did not work. Indeed, if one takes the time to wander around the fine print of the legal decisions such as the ones discussed above, a striking feature emerges, striking at least for the economic historian. A limited number of individuals, now plaintiffs, now defendants, now counsels, now judges, played a critical role in structuring sovereign debt. It was quite frequent to see some litigants involved in several cases. In one striking instance, which gives a glimpse on the overlap between law making and investment, it was revealed that a judge in chancery was himself a large holder of the bonds from the very sovereign state involved in two lawsuits which the judge in question was about to hear.[9] Although this point has been occasionally made by a few scholars interpreting the dynamics of corporate law in some given historical context, it has never been made in the context of sovereign debt law.[10]

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[8] Gulati and Chabot (2014, pp. 31). Another article discussing the same theme is Weidenmaier (2010), which addresses the emergence of arbitration clauses in sovereign debt contracts at the turn of the 20th century. Remarking that there were no courts to enforce such clauses he concludes that it must be that clauses factored in the intervention of the United States government. As he concludes, "although rare, such interventions occasionally produced favorable restructuring terms, sometimes accompanied by supervision or outright control of the borrower's finances by the lender's home state" (Weidemaier 2010, p. 339). The possibility to rely on external force would explain "the apparent puzzle of why some foreign creditors included seemingly unenforceable dispute-resolution terms" (Weidemaier 2010, p. 355).

[9] After this was exposed by the defense, the case was transferred to another judge. The judge in question was Vice Chancellor Malins and the country was Peru; See *Pall Mall Gazette*, 1 August 1876; See also *Times*, Aug 2, 1876 and *Western Mail*, August 2, 1876 for a humorous account of how the judge had to make a "melancholy admission that Peruvian bonds which had cost him £1,000 were now worth £250 only."

[10] For a work providing inroads on the interaction between entrepreneurial practice and the dynamic of the law, see Kostal (1994), Harris (2000). For an illustration of how the point is not taken into account by modern students of sovereign debt, see Panizza, Ugo, Federico Sturzenegger, and Jeromin Zettelmeyer (2009). My point also differs from the point made by Weidemaier (2014).

In the end, while admittedly limited in scope and focused on some aspects only of the sovereign debt default process, this paper hopefully raises questions that can contribute a novel understanding of the subject. In particular, against the lawyer inspired literature that focuses on contracts and their clauses, my approach suggests to embrace a broader institutional perspective. Clauses are meaningless without an idea of the venue for which they have been written. These venues can be legal or extra-legal, but in all cases they interact with one another, because they provided alternatives to litigants. This calls for more careful discussion of the institutional process and a thorough economic perspective that integrate the role of legal innovation. A practical consequence of this is that recent empirical work that has sought to price the value of individual clauses in sovereign debt contracts may be mis-specified because it looks at clauses as "self-standing," rather than recognizing that the same clause may have different value depending on the chosen venue. At a broader level, the argument in this paper suggests that the assumption in the modern macroeconomic literature that the legal system is exogenous to the sovereign debt game may not be sustainable. This is perhaps the main lesson from the Griesa ruling, and it is the key point on which I want to draw the attention of researchers.

The rest of the paper is organized as follows. I start with the article by Vizcarra (2009) quoted above. Despite limitations (I will basically show that her argument is flawed), Vizcarra's work is important because it provides the first attempt to bring the court system back in. Discussing the case of Peru, she argues that the use as collateral of government owned deposits of guano – a natural fertilizer found in large quantities in seagulls populated islets off the country's coasts – raised the creditworthiness of the country's sovereign debt. Of course, to activate the lien, creditors were bound to go to court. Vizcarra does not elaborate on this point, which she treats as implicitly resolved, but she clearly implies that default was expected to trigger the transfer of the collateral to the creditor. As I demonstrate, however, this is not what happned, nor was it what was expected, thus casting doubt on her argument. But while invalid in the specific case she contemplated, Vizcarra's intuition is nonetheless useful and important for the entry point it provides to a richer, dynamic story, of legal creativity and trial balloons, whereby astute financiers and lawyers, the forerunners of the modern vultures, sought to create what I describe as an "*in medio*" territory that could be governed by courts. As I shall argue, they eventually succeeded.

The remainder of the paper is organized as follows. I begin with a discussion of the theory that guano clauses were efficacious. I then deconstruct the argument, showing that in fact, neither the judges nor the markets ever took it seriously. The next sections show that the guano clauses must be conceived as a part of broader experimentations with legal constructions intended to find a way around sovereign immunity. Surveying a succession of cases, that take us form the shores of the Pacific, to those of the Mediterranean and the Atlantic, I then revisit the logic of the key guano decision as the result of such an experimentation which resulted in the articulation of a new theory that finally succeeded in denting the principle of sovereign immunity – the recourse of the law of trust.

Section I. No Shit: The Guano Decisions

In her 2009 article, Catalina Vizcarra argues that after 1849, Peru's concession to her creditors of property rights over exported guano would have enabled the country to secure external loans on remarkably attractive terms despite it being, she writes, "a failed state with a record of fiscal irresponsibility." She states that guano guarantees were written in the prospectuses of successive Peruvian government bonds issued between 1849 and 1872. For instance, the prospectus of a 5.5 million of sterling Peruvian loan issued in August 1862 stated that in addition to pledging all the revenues of the country, "there is given as security for the fulfillment of the engagements entered into by the Peruvian government a special hypothecation of the whole of the guano imported into Great Britain and her colonies and also of that imported into the Kingdom of Belgium." Moreover, it was stated that the merchant banker responsible for paying the coupon was the House of Gibbs, consignees of the guano and financial agents for the Peruvian government. An account in the same prospectus showed that, ostensibly, Gibbs paid the coupon out of the guano revenue.[11] According to Vizcarra, this made the Peruvian experience a "hybrid" case and proves that other possibilities existed beyond the developing of credible domestic institutions or the dispatching of the gunboat.[12]

As indicated in the introduction, Vizcarra is not explicit regarding the mechanism whereby the guano security could be activated. Instead she goes implicitly by the

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[11] *Times*, August 1, 1862.

[12] Vizcarra (2009, p. 358, 376, 384). The most thorough historical treatment of the topic is due to Mathew (1981). The classic text on the guano contracts is Montoya (1921). A treatment of the later period is Miller (1976).

theory that guano, as a commodity, would be more easily seized, quoting some contemporary opinions found in the press that the security of the guano was "unquestionable" because it was "beyond the reach of any Government of Peru to control."[13] There is no doubt that remarks in this spirit can be found in contemporary sources. Promoters of the guano guarantees frequently expressed this view. For instance, in January 1849, when the committee that had brokered the arrangement of the Peruvian debt announced the inclusion of the guano guarantees, it stated that "one half of the net proceeds of the guano should be appropriated by Mr. Gibbs & Sons, for the payment of the dividends and carrying out the arrangements with the bondholders, *independent of the Peruvian government*" (italics in the original transcription) and the bondholders were reported to have chanted "hear, hear."[14] Likewise, in 1859, the future secretary of the Corporation for Foreign Bondholders, Hyde Clarke, in an obituary on the influential vulture investor, foreign debt specialist and veteran of bondholder committees Isaac Lyon Goldsmid, claimed that, having come to the conclusion that general claims "on a government [are] virtually irreclaimable" Goldsmid had in the 1840s began favoring the creation of a "fund which can be identified, followed and earmarked." Clarke added that the Peruvian debt was "a memorable example of [...] satisfactory application" of this notion.[15]

But was this theory valid? The answer is no. In fact, unbeknownst to Vizcarra, three consecutive chancery cases – Smith v Weguelin (1869), Croyle v Dreyfus

[13] For instance, she quotes the language of one contemporary bondholder writing in the Times asserting that "the security of the guano is unquestionable, and from its local situation is beyond the reach of any Government of Peru to control." *Times*, 23 April 1857. The discussion of the logic of the guano collateral is found in Vizcarra (2009, p. 375-6). In one place, Vizcarra argues that "guano had the potential to be superior collateral because guano revenues were collected at the point of sale abroad." In another place, she writes that what kept Peru in line was "the threat of a major loss in government income due to the disruption in the guano trade in case of government default" because, she speculates, finding a competent agent for the distribution of guano was difficult and because such an agent, fearing for its reputation would have been eager to cooperate with creditors, although she gives no evidence to support this conjecture. Note that this is an altogether different argument, more akin to the one in Flandreau and Flores (2009). It is highly dubious that Gibbs had enough a reputation however. The evidence in Mathew (1981, p. 186) suggests the exact opposite to the claim by Vizcarra when he narrates the smooth termination Peru's first contractor Gibbs and their replacement by a group of Peruvian merchants employing the firm of Thomson, Bonar (i.e. the Weguelin group) as their London consignees: "The transfer of power [from Gibbs, in 1861] may have been effected in a highly uncertain fashion, but that it did come about could not have surprised very many people at the time. Gibb's position as contractor had been powerfully challenged in the 1850s: the legality of their contract had been questioned, their mercantile conduct had been criticized, and the capacity of indigenous merchants to displace them had notably improved." This goes on for the rest of Chapter 4, suggestively called "The Removal of Gibbs."

[14] *London Daily News*, January 5, 1849.

[15] Hyde Clarke on Goldsmid, p. 454. (Goldsmid had been associated with the Peruvian debt renegotiation of 1848-9).

(1876) and Twycross v Dreyfus (1876) – tested the argument, only to discover that courts did not buy it.[16] In all three cases, plaintiffs sought an injunction from the judge to govern the behavior of the guano consignees (i.e. Weguelin and Dreyfus, the respective defendants in the said cases). But the judge returned a verdict favorable to the defendants and dismissed the bills with costs. The rulings held that, despite the smokescreen created by the system of consignment and agency, the Peruvian government remained the ultimate owner of the guano. Although we shall return to the matter in greater detail later on, the substance of the decisions was that sovereign immunity covered the actions of the guano consignees because these houses acted in the capacity of agents of the Peruvian government. But agents of sovereign sates were understood to escape personal liability, a principle well entrenched in common law and uniformly emphasized in contemporary legal treatises.[17] As agents, they had to follow the government's instructions. In other words, guano in the hands of Weguelin or Dreyfus was still Peruvian government's guano. But then, the court could not interfere with it.

That this had been the court's theory comes very clearly out of the discussion of decisions. In the first case (Smith v Weguelin) the Master of Rolls Lord Romilly explicitly engaged with the theory of the guano clauses in order to destroy it.[18] He reasoned that if the court of chancery had accepted to govern the behavior of the agents of the Peruvian government with respect to guano, there would be no reason for the court to resist in the future a demand to attach any other government asset. As

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[16] As might be expected, the cases arose from Peruvian bondholders dissatisfied with the way the country dealt with the proceeds from guano. The first case resulted from a dispute regarding bondholder priorities and the two others from attempts to seize guano holdings after the eventual default of Peru. In all three cases, bondholders sought from the court an injunction to govern the behavior of the agents of the Peruvian government in London with respect to the guano holdings. To this end they sued the merchant banks that successively replaced the House of Gibbs as "consignees," namely Weguelin, Gladstone, Bell, & Weguelin and later Dreyfus Brothers and Co.

[17] Treatises including a statement of this principle included, Joseph Chitty, *A Practical Treatise on the Law of Contracts*, Third edition by Thompson Chitty, London: Sweet, 1841. Discussing contracts with government agents, Chitty states that the general rule is that the agent can never been held liable personally, unless a) he has expressly pledged his personal credit, or b) if he has exceeded his capacity (see p. 278-9). Another important authority was the American jurist Joseph Story, *Commentaries on the Law of Agency: As a Branch of Commercial and Maritime Jurisprudence, With Occasional Illustrations from the Civil and Foreign Law*, Boston Little, 1839. The influence of the latter textbook is attested by a statement by the judge in Goodwin v Robarts, (1874-75) L.R. 10 Ex. 337, on p. 344 where Cockburn, C.J. quotes Story (1839, p. 306) to the effect that "in ordinary course of things, an agent, contracting on behalf of the government, or of the public, is not personally bound by such a contract, even though he would be by the terms of the contract, if it were an agency of a private nature."

[18] While his ruling stated that for reasons that won't hold us here, the case had no merit, he took great care to add that, even if the case had had merit, he would have nonetheless returned a verdict in favor of the defendant. The reason was that there was no way to set aside a certain government asset.

he put it, "if the Court of Chancery could seize all the guano belonging to the Peruvian government it might as well seize Peruvian vessels under the article [of the contract] which declares that all the other property and sources of revenue of the Republic should be applicable to payment of the loan."[19] In other words, the lien on guano holdings did not permit to circumvent the obstacle of sovereign immunity, because, if it had served to circumvent it, it would have destroyed it. Driving the point home, the *Economist* subsequently published an article on the ruling, "The Position of Foreign Bondholders," where it elaborated on Smith v Weguelin, a decision that had clarified "a point of no little importance to all foreign bondholders."[20] According to the *Economist*, the verdict showed "[…that] creditors of a foreign Government cannot enforce their rights by attaching property hypothecated to them. " In fact, foreign creditors had nothing else but the "credit and good faith [of the borrower] to look to; and […] hypothecation of certain property is really no additional security."[21]

Figure 1 here

The next question to ask is, had legal sophisticates predicted the outcome? To answer, one way to go is to look at the prices of Peruvian guano securities. If insiders expected the guano clauses to provide a serious guarantee (or equivalently, if as Catalina Vizcarra has suggested the guano guarantees supported the credit of Peru), then the Smith decision should have led to a collapse of Peruvian bond prices (since they contained guano clauses). To address this question, Figure 1 shows the price of the benchmark Peruvian bond (the 1865 5%), which had a guano guarantee. This was a very active security, which contemporary commentary shows to be very responsive to news and the position of the money market. For the sake of completeness, the Figure also shows the price of the other quoted Peruvian security, the much less actively traded 1862 4.5%, which approached redemption. As we can see, Peruvian bond prices were unruffled by the verdict in chancery (which came out on May 27, 1869). This suggests that traders had predicted the verdict. Investors in the London

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[19] Smith v Weguelin, p. 214. Smith v Weguelin, (1869), L.R. 8 Eq. 198; See also for additional material on the bill C 16/455/S132, 1867 S132, and C 16/453/S44; 1867 S44;

[20] *Western Daily Press*, 31 May 1869. *The Economist*, May 29, 1869, p. 626. *Cork Examiner*, 1 June 1869.

[21] *The Economist*, May 29, 1869, p. 626. Regarding the motivations of *The Economist* for taking this view, it should be noted that this was fitting well with the campaigns this journal was waging against the insiders of the London Stock Exchange and their machinations. Under the leadership of Bagehot, the magazine took upon itself to warn outsiders of the perils of foreign investment and of the fragility of guarantees splashed into prospectuses.

stock exchange already knew that it would be very hard to enforce the guano rights in court of law.

When large losses were suffered from Peru's default in July 1875, creditors again tried their luck in chancery, leading to two twin cases, Twycross v Dreyfus and Croyle v Dreyfus. The plaintiff's bill in Twycross charged that the guano clause in the contract had been the reason for their subscribing to a bond issued in 1870 now in arrears. They wanted the guano still held by Dreyfus released to them. The defendant demurred, pointing to the Smith ruling.[22] Vice Chancellor Sir C. Hall indeed found in favor of the defendants and his decision was affirmed in appeal by a full roster of judges. One of them, the Master of Rolls Jessel, declared: "You cannot sue the Peruvian Government at all, and, therefore, you cannot sue its agents," while the Lord Justice Henry James echoed: "You cannot sue the Peruvian Government, and it would be a monstrous usurpation of jurisdiction, in my opinion, to endeavor to sue a foreign government indirectly, by making its agents in this country Defendants… It really would be indirectly endeavoring to make the foreign government responsible to the jurisdiction of this Court."[23] In the end, the apparently ingenious idea of securing the debts of an intangible country via a concession of rights over a tangible commodity, authenticated by the hypothecation spelled out in the prospectus and again on the bonds, had failed to pass the test of reality. Stockpiles of guano ready to be shipped might have been located in Britain, but for all practical purposes these remained an intangible asset beyond the reach of the creditors of the Peruvian state, the property of a foreign sovereign enjoying sovereign immunity.

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[22] The press again spoke of the Twycross and Croyle cases as "two actions of considerable interest raising questions as to the rights of Peruvian bondholders over Guano sent by the Peruvian Government to this country", *Pall Mall Gazette*, 3 August 1876. The *Times*, December 8, 1876. Twycross v Dreyfus, 1876 T. 177 for both the judgment of Vice Chancellor Hall, March 7, 1877 and its appeal on April 18, 1877. Croyle is a twin case and does not have an independent court report, though it was mentioned in the contemporary media.

[23] Twycross v Dreyfus, 1876 T. 177, p. 618 "The first and most important point we have to decide is what the meaning of the bond of a foreign government given to secure the payment of a loan is. As I understand the law, the municipal law of this country does not enable the tribunals of this country to exercise any jurisdiction over foreign governments as such. Nor, so far as I am aware, is there any international tribunal, which exercises any such jurisdiction. The result, therefore, is that these so-called bonds amount to nothing more than engagements of honour, binding, so far as engagements of honour can bind, the government which issues them, but are not contracts enforceable before the ordinary tribunals of any foreign government, or even by the ordinary tribunals of the country which issued them, without the consent of the government of that country. That being so, it appears to me that the bond in question confers no right of action on the Plaintiff, and on that ground it seems to me it follows that the demurrer ought to be allowed."

The overall conclusion is that, as far as the ability to actually seize the collateral is concerned, the institution was little more than an advertisement, and not a very credible one at that. This raises a number of intriguing questions whose thorough discussion far exceeds the boundaries of this article, but which I mention before moving on. First, given that the guano clauses were inoperative and understood to be so, what was the reason for Peru's creditworthiness as captured by the fairly high price that its bonds secured despite what Vizcarra describes as "ongoing political instability and poor capital market reputation." A possible answer is that the ownership of the guano deposits simply raised the fiscal prospects of the Peruvian state. If Peru secured a better credit after the guano was "discovered", it was not at all because guano was an asset that could be seized, but because it made its owner (the Peruvian state) richer. The guano was, so to speak, a rainfall that raised the wealth of Peru, making it a less risky proposition, other things being equal. The guano clauses were a kind of advertisement of this newfound wealth and of course, the distinction was lost in the bond-seller's pitch. In other words, it is not that guano contracts played a kind of institutional magic but that the creditworthiness of Peru was propelled by what Peruvian historians have described as the "guano boom."[24] Second, why were guano clauses written in prospectuses, when they amounted to nil? One possibility, suggested by the aggressive stance taken by the *Economist* against the validity of such clauses, is that they were gimmicks used by contractors to lure investors. However, if such had been the intention, it is somewhat surprising that the first guano ruling in 1869 did not trigger a run on the debt of Peru. Yet another possibility is that, as suggested by Gulati and others, the guano clauses really amounted to a form of contracting for the intervention of the British Navy. Such an interpretation is doubtful, in view of the reluctance of the British government to intervene in such circumstances (Platt 1968). Indeed, as far as we know, Britian never declared war to Peru to enforce the guano contracts. The only alternative I can think of is that, if the guano clauses were not pure propaganda, they were really written with a view to secure enforcement from the authorities of the London stock exchange as suggested in Flandreau (2013). This should deserve further exploration.[25]

[24] See Montoya (1921). Indeed, there is evidence that in the late 1860s investors interpreted the exhaustion of the richest guano deposits as a negative wealth shock. See *Times*, April 15, 1869 for an example of a controversy on this topic, showing the importance of guano outlook for investors.
[25] The *Times* of April 27 1869 mentions "propositions for a new loan" affecting the price of Peruvian bonds. Such propositions were not followed up. It would be interesting to know if

Section II. A Trick Fails

Rather than pursuing these interesting leads, this paper carries on the reasoning by keeping the focus on the role of "ordinary" courts. Namely, I argue that the guano clauses should be understood in the broader framework of experimentation within the British legal system. The guano contracts were part of experimental efforts to articulate and test new legal theories and it takes its full significance once put in the context of earlier and later efforts. As I now show, these efforts concentrated on that characteristic feature of the Griesa ruling, namely the attempt by creditors to harness the payment system of the lending center. The mid-19th century offers an anticipation of the attempt, resulting in two twin disputes in the court of the Lord Mayor of London, Wadsworth v Queen of Spain and De Haber v Queen of Portugal.

In the last weeks of 1850, one Thomas Page Wadsworth, the holder of defaulted Spanish bonds originally issued in 1834, figured out what looked like an ingenious method to secure his debt. It consisted in an old mercantile institution of the city of London, known as "foreign attachment." Foreign attachment provided for the competence of the court of the lord mayor of London for the enforcement of foreign debts. On providing evidence that a party in London, known as the "garnishee" was indebted to some foreign debtor A, a creditor of A could lodge a plaint at the mayor's court against A, mentioning that the garnishee was a creditor of A. Then, if the defendant made four several defaults at four several days to appear before the court, then a writ was issued against the garnishee, who was then to pay for the debt. As one source described it, "the custom of foreign attachment is for no other purpose than to compel defendant's appearance."[26]

One aspect of sovereign immunity that had been emphasized during the Brunswick trials was the notion that while British courts could not compel foreign sovereigns to appear before them, it was nonetheless the case that foreign sovereigns could appear if they so chose, in which case the courts were competent. As it turns out, a creative reading of the Brunswick decisions, combined with the procedure of foreign attachment produced what looked like a winning strategy. One had "simply" to prove one's debt against a sovereign, and designate as "garnishee" the London banker or

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anticipation of bondholder opposition at the London stock exchange caused the shelving of the projects.

[26] J. S. F., *The citizen's pocket chronicle, a digested view of the history of London etc.*, London: Charles Tait, 1827; Woodthorpe Brandon, *A treatise upon the customary law of foreign attachment, and the practice of the Mayor's court of the city of London therein*, London: Butterworths, 1861

entity responsible for running the finances of the defaulter. All that was needed was that this entity be domiciled within the boundaries of the city of London. If the defendant – the sovereign – chose to appear, the court would become competent. If it did not, then the creditor could secure his claim from the garnishee. Upon learning that the Spanish treasury had transferred 10’000£ in London to pay one Liverpool merchant for a corn shipment of large, Wadsworth triggered the foreign attachment procedure. Accordingly, on December 30, 1850 he brought a suit in the lord mayor's court against Her Most Christian Majesty Doña Isabel Segunda, Queen of Spain, showing a 20’000£ debt of overdue interest. He then designated as garnishees Joaquin Scheidnagel, president of the Spanish Financial Commission in London (the body in charge of running the external finances of the Spanish government, in effect an agent of the Spanish government) and the London bankers of this commission John Martin, George Stone, James Martin & Robert Martin.[27]

The ploy worked, at least initially. The lord mayor’s court received the case, and summoned the president of the Spanish financial commission and the bankers. Seeking to deflect the attempt, they declared that they had no property within reach of the process. But Wadsworth’s claim was admitted and, with the defendant refusing to appear, all he needed to do now was proving that the garnishees had Spanish government money at hand, which he managed to do, securing the attachment of the 10’000£.[28] On January 29, 1851, an application was made by the counsel of the garnishees for the recorder of the lord mayor’s court to dissolve the attachment on the grounds that a foreign sovereign could not be held to bail. However, the recorder refused to comply. The course of the lord mayor’s court seemed unstoppable and it is possible that it owed some of its momentum to the close relation that is known to have existed between the lord mayor and the London stock exchange. Moreover, a similar action – de Haber v the Queen of Portugal – was brought up simultaneously with the very same technique of foreign attachment. Foreign attachments were snowballing.[29]

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[27] See Wadsworth v the Queen of Spain, 1851 117 E.R. 1246 (1851), p. 1246. And Wadsworth v the Queen of Spain, 1851 117 E.R. 1262 (1851). The two cases plus the Portuguese one are also available as “In the Matter of Wadsworth and The Queen of Spain. In the Matter of De Haber and the Queen of Portugal,” in *Queen’s Bench Reports*, 1851, pp. 1246-1264;

[28] Wadsworth v the Queen of Spain, 1851, 17 Q.B. 175, p. 1248.

[29] De Haber and the Queen of Portugal 1851 117 E.R. 1255 (1851); In practice, the date of application of the De Haber case (April 16, 1850) suggests that it came first.

The matter was finally resolved by application of the garnishees to queen's bench – a senior court of common law – so as to secure a prohibition to the lord mayor's court. On May 28, 1851, Lord Campbell delivered his judgment in both cases. His decision severely censored the lower court arguing that the lord mayor had trespassed his prerogative by applying the foreign attachment to a sovereign. The ruling, elaborating on Duke of Brunswick v King of Hanover, emphasized the sacrosanct character of sovereign immunity. Immunity meant that a British court could not compel a foreign sovereign to appear. The corollary was that the ploy used by Wadsworth and de Haber (either appear before the court and recognize its competence or let the creditor recover from the garnishees) was self-defeating as a legal strategy because, as the judge explained in the Wadsworth case, "the defendant could not be required to appear without a breach of the law of nations." And of course, it was not competent to a lower court to tamper with the law of nations.[30] It was by contrast proper with his higher court, "vested with the power of preventing all inferior courts from exceeding their jurisdiction to the prejudice of the queen or her subjects, [to] interfere when duly informed of such an excess of jurisdiction."[31] This last point is important as it shows a correspondence between the ability to subvert legal principles and the level of the jurisdiction. It was in particular not competent for a lower court to take a decision, which might create a disruption in the relation of amity between Britain and other sovereigns. As stated in the judgment (for the Portuguese case): "What has been done in this case by the lord mayor's court must be considered as peculiarly in contempt of the Crown, it being an insult to an independent Sovereign, giving that Sovereign just cause of complaint to the British Government, and having a tendency to bring about a misunderstanding between our own Gracious Sovereign and her ally the Queen of Portugal. […] We think we are bound to correct the excess of jurisdiction brought to our notice, and to prohibit the lord mayor's court from proceeding further in this suit."[32] Not surprisingly therefore,

[30] Wadsworth v the Queen of Spain, 1851 117 E.R. 1262 (1851), p. 1262. Campbell summarized the strategy of Wadsworth in the following manner: "The plaintiff's counsel argue […] that, if the Queen of Spain has any privilege against being sued in the courts of this country, she only can take advantage of it; that she ought to have appeared and pleaded to the jurisdiction; that by her non appearance she must be considered as having waived her privilege. "

[31] De Haber and the Queen of Portugal 1851 117 E.R. 1255 (1851), p. 1262.

[32] De Haber and the Queen of Portugal 1851 117 E.R. 1255 (1851), p. 1259. Likewise, he stated (this time about the Spanish case) that "judicial procedure in England would have been liable to great reproach had it not afforded a prompt and effectual remedy at once to put an end to actions brought in perversion of the ancient and laudable custom of foreign attachment, and in violation of the universal

as the next section will discover, it would fall upon the more prestigious court of chancery to start nibbling the principle of sovereign immunity. As I now proceed to show, the attempt by sophisticate investors to use lord mayor's court in order to infringe upon sovereign immunity finally found a first expression in a case decided in the court of chancery.

Section III. Schrödinger's Cash

The case in question, Gladstone v Musurus Bey, arose from Gladstone v Ottoman Bank, a famous case for historians of sovereign immunity. Gladstone v Ottoman Bank revolved around the competence of British municipal courts in foreign acts of state. The dispute pitted against one another two groups of financiers who fought over the privilege of issuing banknotes for the Ottoman Empire. The plaintiffs, the financier William Gladstone, cousin of William Ewart Gladstone, the famous British politician and two business associates They sued in chancery the Ottoman Bank, its directors and the Sultan, on the grounds that in 1858 the Ottoman government had granted them, Gladstone and associates, the right for creating a bank of issue called the Bank of Turkey before rescinding the privilege and transferring it to the Imperial Ottoman Bank.[33] In cancelling the privilege, the Sultan invoked extensive implementation delays, a violation of the terms of the contract, but Gladstone countered that they had been prevented from achieving the goal by some actions imputable to the Turkish government itself, and because the Imperial Ottoman Bank had been incorporated in Britain, they felt the court of chancery ought to be competent. On February 27, 1863, Vice Chancellor Sir W. Page Wood found against Gladstone and his business associates, stating that the decision of the Sultan was his own prerogative so that it is "quite clear that an engagement entered into with a foreign Government such as that upon which the Plaintiffs' rights depend is not an engagement which the Court can enforce, or against the breach of which it can give any relief."[34] The Vice-Chancellor

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law by which all civilized nations are bound. It gives us great satisfaction, therefore, to be able, consistently with the decisions of our predecessors, and the principles by which they have been guided, to grant the relief which is prayed." Wadsworth v Queen of Spain 1851 117 E.R. 1262 (1851), p. 1263.

[33] On William Gladstone see Stoskopf (2002, pp. 198-99). The associates were and his associates Michel Emmanuel Rodocanachi, a Greek merchant banker, and Russell Ellice, a former chairman of the East India Company Rodocanachi (1821-1901) had founded in London Rodocanachi Sons & Co. See 'Rodocanachi, Michael Emmanuel', by Stuart Thompstone, *Oxford Dictionary of National Biography*; Russell Ellice (circa 1799 – 1873) was a member of a family of wealthy investors and financiers. His brother and partner was the M.P. Edward Ellice (on him, see "Ellice, Edward" by Gordon Millar, *Oxford Dictionary of National Biography*).

[34] Gladstone v Ottoman Bank, 71 E.R. 221; And National Archive, Gladstone v The Ottoman Bank, Cause number: 1863 G21. The bill of complaint in Gladstone v Ottoman appears to have been filed on

further embarked in a diatribe against the bill asserting that it was frivolous, since it amounted in essence to seeking an injunction against a law from the British parliament.[35] The image made the delights of scores of subsequent legal commentators. As stated in John Westlake's *Treatise on Private International Law* for instance, "in Gladstone v Ottoman Bank, the plaintiff […] attempted in vain to restrain the Ottoman Bank from enjoying in Turkey the benefit of an Act of State of the Sultan, which they alleged was in violation of their rights."[36]

This background enables to understand the significance of the case that interests us here, Gladstone v Musurus Bey. As part of the contract between Gladstone and the Sultan, the financiers had been compelled to make a 20'000£ deposit at the Bank of England in the shape of Turkish bonds, as a security to the Turks for the "perfect execution" of the financiers' part of the bargain. When the dispute with the Ottoman Bank erupted, Gladstone and his associates began to fear for their deposit. They thus filed on December 9 1862 an application in chancery for an injunction against Constantine Musurus, the Turkish Ambassador in London (known as "Musurus Bey"), the Sultan, and the Bank of England praying to restrain the Bank of England from making any payment to Musurus Bey or his representatives on the 20,000£ deposit. Only two days later, the Vice Chancellor reached a verdict, indeed granting to the plaintiffs the "interim injunction" they demanded in order to the restrain the Bank of England from parting with the fund.[37] This verdict is surprising from a judge who was just a few months away from declaring his court incompetent in what was essentially the continuation of the very same dispute. Indeed, the chancellor had just attached sovereign money, in a manner reminiscent to what the lord mayor's court had done in the Wadsworth and De Haber cases.

February 20; The demurrer was filed (by the Ottoman Bank and its directors "W. Clay and others") on February 23, 1863; The case was heard 26-7 February 1863 (*Morning Post*, "Law Intelligence", 26 February 1863; Gladstone v Ottoman Bank, 71 E.R. 221).

[35] Gladstone v Ottoman Bank, 71 E.R. 221. "Suppose there was an Act of Parliament granting to the Bank of England the exclusive right of issuing bank-notes which should be a legal tender throughout the country; and suppose another Act of Parliament was passed which granted the same privileges to some other company. In such a case as that this Court could not possibly interfere. It is not as it was put in argument, that individuals are to be protected in breaking the law with the assistance of foreign authority, and by force of the grant of a foreign sovereign; but that those who depend upon the grant of a foreign sovereign cannot obtain the aid of this Court against the act of the foreign sovereign in making a second grant inconsistent with the first. It is the act of a foreign sovereign power which overrides everything."

[36] Westlake (1890, p. 232).

[37] Gladstone v Musurus Bey, 71 E.R. 216.

The reasoning whereby W. Page Wood arrived at this decision is what is of interest here, because it rested on a legal construction that effectively recognized limits to sovereign immunity in a manner that was not, at the end of the day, so different from that used by Wadsworth and De Haber in lord mayor's court. As the Vice Chancellor explained, the decision arose from the "peculiar circumstances" of the case. As indicated in his decision, "If the bonds [forming the deposit] were the absolute unqualified property of the Sultan—that is to say, of the Turkish Government—there might be some difficulty in attempting to enforce any claim against the Sultan by attaching this fund."[38] But the special circumstances of the case ensured that it was impossible, at the time when Gladstone v Musurus Bey was decided, to know whether at the end of the day, when Gladstone v Ottoman Bank would be decided, the court would be competent or not in the companion law suit. This was not because there was an ambiguity on the principle of sovereign immunity, but because there was an uncertainty as to *whether the Sultan should ultimately decide to join in the Ottoman Bank case*. As indicated, the competence of the court could be activated if the Sultan chose to appear. If the Sultan was eventually to become a party to Gladstone v Ottoman Bank, then the court would indeed become competent, but there was no way to know at this point (when Gladstone v Musurus Bey was decided) what would happen.[39] Now, if it were to be made competent by the appearance of Musurus Bey, then it would have to decide whether the Bank of Turkey's contract had been properly executed or not, and therefore whether the funds at the Bank of England belonged to Gladstone or to the Turkish authorities. The conclusion, the judge reasoned, was that at the time when Gladstone v Musurus Bey was being examined, the money was "a fund *in medio*, which is in one contingent event to become the Sultan's property, and in another contingency to become the Plaintiffs', that it is, therefore, a fund in which both the Sultan and they have contingent interests."[40]

To summarize, ownership of the money in dispute depended on information that was not yet available, so that the funds were in a limbo reminiscent of the unfortunate

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[38] Gladstone v Musurus Bey, 71 E.R. 216, p. 219.

[39] Gladstone v Musurus Bey, 71 E.R. 216, 219-220: "If the Sultan should think fit to appear, the Court may ultimately have to determine which of the two has the better right. That is how the case stands. Upon the facts as now presented I cannot say that, at the hearing, if the Turkish Government should think it right to intervene, there may not be a point to be argued upon the effect to be given to the additional article under all the circumstances that may be proved."

[40] Gladstone v Musurus Bey, 71 E.R. 216. The expression "in medio" came from Scotch practice, where it applied to a fund held between parties litigant.

Schrödinger's cat, which is simultaneously alive and dead in his quantum box. The reason why such a situation was a concern was that it put the Bank of England in a tangle, as Henry Cotton, the bank's standing counsel acting as solicitor in the case, emphasized. The owner of the account where the £20,000 was kept was Musurus Bey and if the ambassador sent a check to the Bank of England, the Bank would have to pay it. On the other hand, if the money did not belong to the Bey, then the Bank could be held liable for having obeyed the instruction. In sum the Bank might be held liable one way or the other. In particular, the Bank's counsel suggested, if the Bank was to act conservatively and refused a request by Musurus Bey to draw on said account, then it better be protected by the court. The result was the *interim* injunction issued by Vice Chancellor W. Page Wood: "It appears to me, he concluded, that the bank will be amply protected [by the injunction], because, if the Turkish Ambassador should present his cheque, the bank, under the order of this Court, would decline to honour it." [41]

As the reasoning of the Vice Chancellor progressed, it unfolded a succession of convoluted hypothetical scenarios. It was imagined for instance that the Ambassador might be about to employ the fund for his own purpose, thus committing a breach of trust. Undoubtedly, the court would have to prevent this from happening. This logic would make the Bank of England a kind of trustee for the money it kept, so to speak, for Turkey. If such were the case, the Court had "jurisdiction to prevent that fund being wasted."[42] Now the absence of the ambassador from the proceedings – itself an admitted result of sovereign immunity – prevented the court from knowing its true motives and whether the imagined scenario was plausible. Thus the specific technology of sovereign immunity – as we see it now, accruing not from an unconditional incompetence of the court but from a contingent one – enabled the court to let its imagination go wild and paradoxically motivated the decision to issue the interim injunction. In fact, if we are to follow the consistent indications of the two available court reports, the rationale for the injunction was not merely the protection of the Bank of England but a deliberate attempt by the Vice Chancellor to try and get Turkish authorities to become part of the litigation. If they wanted their money back, the Vice Chancellor would have claimed in court, they would have to come out of hiding, and participate to the Gladstone v Ottoman Bank lawsuit. This was not very

[41] Gladstone v Musurus Bey, 71 E.R. 216, p. 220
[42] Gladstone v Musurus Bey, 71 E.R. 216, p. 220.

different from the logic contemplated in the Wadsworth and De Haber cases where it had the attachment of Spanish and Portuguese money had been attempted as a ploy to force the appearance of the sovereign in court.[43]

The rest of the story is known: a few months later, when Gladstone v the Ottoman Bank was examined, the Sultan did not become part of the lawsuit. The same Vice Chancellor then declared his court incompetent.[44] But the important element perhaps, was not the reaffirmation of the principle of sovereign immunity, which others have emphasized. It consisted in Vice Chancellor's Page Wood previous theoretical wanderings on the territory of trust, in his reference to the need for judges to provide for the imaginary possibility of a breach of trust, even by the agents of a foreign sovereign, and finally in his emphasis of the predicament of the manager of funds having fiduciary obligations – the Bank of England. In fact, as I proceed to show, all these musings in the territory of counterfactual law were to become the source of inspiration for subsequent legal innovation.

Section IV. The Mother of All *Pari Passu* Verdicts?

On December 7, 1868, the Vice Chancellor Sir Richard Malins rendered what may be considered as the first *pari passu* verdict ever returned by a municipal court in a sovereign debt case, Guedalla v Baring. A sum of about 150'000£ having arrived in London with confused instructions from the Mexican government regarding what to make of the money, it came upon the court of chancery to direct the distribution of the funds. Specifically, the ruling held that two competing sets of bondholders were to participate "equally in the distribution of [the] fund," satisfying the majority of creditors which had explicitly called for "pari passu" treatment. As the Vice

[43] Gladstone v Musurus Bey, 71 E.R. 216, p. 220. See also "Vice-Chancellor's Court, Dec. 11." *Times*, 12 Dec. 1862: "Supposing that the fund were vested in him solely, upon certain trusts, this Court would clearly prevent the Bank from handing it over to him upon a distinct intimation on his part that he intended to apply it to his own use. It appeared to [the Vice Chancellor] therefore, that though M. Musurus, as he was a foreign Ambassador, could not be retained before the Court, yet there was ample jurisdiction to prevent the fund (which was here) from being wasted and getting into hands from which it could not be withdrawn. The Bank would be amply protected, for if M. Musurus presented his check, the check would not, under the order of the Court, be honoured, and the only mode in which he could get at the money would be by taking some proceedings of his own. By taking that course, the position of things would be very much altered. He would be submitting himself to the jurisdiction of English Tribunals, and in that case, English tribunals would be able to administer justice between all parties in a litigation, which he had himself commenced. Under these circumstances, therefore, there must be an order against the Bank of England to restrain them from paying, &c., to any person, otherwise than under the direction of this Court."

[44] I have not been able to trace the details of the case past this point. The interim injunction binding the Bank of England must have lapsed. Perhaps Musurus Bey appropriated the £20,000 or perhaps the matter was settled out of court, with Turkish authorities leaving the financiers the opportunity to repossess the money in exchange for their dropping of any claim.

Chancellor declared at the opening of his decision, "I am satisfied that there was sufficient doubt to justify the institution of this suit," for the fund "could not have [been] distributed […] without the direction of this court." Guedalla thus offers a fascinating instance where a British court intervened to dispose of a sovereign's money, in the very midst of the so-called age of "absolute sovereign immunity." How was such a result arrived at?[45]

The circumstances that produced Guedalla v Baring were indeed very peculiar ones. In 1863, following the French intervention in Mexico, Maximilian was made Emperor of this country. The regime change (Mexico had previously been a republic) had provided scope for an arrangement with the country's foreign creditors. The country's main external debt, a sterling obligation known as the 3% Mexican consolidated and issued in 1851, had been in arrears since 1854. In 1864, desirous to secure access to international capital markets, Maximilian's regime offered an arrangement to holders of the 3% 1851, which was accepted. Mexico would resume the service of the debt and would moreover offer in exchange for the unpaid coupons of the 1851 debt, new securities bearing a 3% interest as well, known as the 3% 1864. Only two years later however, in 1866, the Mexican Emperor Maximilian's regime in the grip of a desperate struggle against Benito Juárez' republican rebellion lived its last days. At the beginning of this year, the French had announced their withdrawal from Mexico while the progress of Juárez's troops, who seized one port after the other, progressively cut Maximilian from fiscal resources.

Against this backdrop, and while Maximilian's regime had missed on July 1 1866 the payment of the coupon on the 1851 and 1864 debt which were due, an "eleventh hour effort" at retaining the goodwill of the London creditors was made, in the shape of the transfer of about 150'000£ to London. This was not enough to pay all the 3% bondholders (both 1851 and 1864) and moreover, a string was still attached, because the transfer, to the Bank of England, was made to the joint consignments of the designated agent of the bondholders, Baring Brothers, and of the Mexican chargé d'affaires in London. In other words, the funds would remain blocked in London until clearance be given by Mexican authorities. As news spread that there was money in

[45] The discussion in this section draws on the court reports: "Guedalla v Baring" *The Times* (London, England), December 8, 1868 and Guedalla v Baring, 19 L.T.R. 597 (1869); "Guedalla v Baring; cause number: 1867 G183C, National Archive, 16/418/G183. Guedalla (1867); Anonymous, *Report of the Provisional Committee of Mexican Bondholders*, London: Fisher, 1868. Compare discussion here with that in Wynne (1951, Vol. 2) p. 27.

London, some bondholders began complaining against Barings. One activist bondholder, Haim Guedalla, began a campaign so as to replace Baring's private agency on behalf of the bondholders with a bondholder committee "composed of and responsible to the bondholders."[46]

In March 1867, while Maximilian and his remaining troops were under siege at Santiago de Querétaro where the final battle of the regime was waged and lost, resulting in the execution of the Mexican Emperor on June 19, 1867, the chargé d'affaires in London, Angel Nunez de Ortega, decided to take action despite his lack of instructions. Claiming that the "interests of the […] bondholders are to a certain extent those of my country's credit," and "notwithstanding the temporary difficulties [!] with which my country is surrounded," he now declared himself disposed to release the funds at the Bank of England.[47] This policy was continued with his successor General Juan Almonte who, still without specific instructions from his government, instructed Barings to distribute the funds "*pro ratâ*" (that is, equitably among creditors). On May 24, 1867 (literally one week after the downfall of Santiago de Querétaro) the money was transferred to the sole account of Baring brothers, who had now exclusive authority to dispose of the money at the Bank of England. However, emphasizing that they were "trustees for the bondholders," (both of 1851 and 1864) they declared that they were unable to proceed with the distribution without the consent of the bondholders, towards whom they were liable. If, subsequently to the distribution of the fund, any party were to bring about a lawsuit against Barings, stating that they had mishandled the money, they would be held responsible.[48]

This was not a trivial point. Active trading had resulted in the population of the 1851 and 1864 bondholders being quite different from one another and the two groups entertained different views on how the fund should be disposed of. The 1851 bondholders, led by Guedalla, insisted on being paid first. They claimed that the money received in London arose from special custom receipts pledged explicitly as securities on the bonds of 1851 but not on those of 1864.[49] The 1864 bondholders, led by one Edward Salmon argued that the money held at the Bank of England should be distributed "rateably" between the 1851 and 1864 bondholders. Moreover, Salmon

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[46] *Report of the Provisional Committee*, p. 4.
[47] *Report of the Provisional Committee*, p. 8.
[48] Guedalla v Baring, National Archive, 16/418/G183; Snswer of Defendant Edward Salmon, p. 12.
[49] Specifically, it was alleged that the funds came from the custom-house in Vera Cruz part of whose revenues had been hypothecated for the 1851 bondholders. See Guedalla v Baring, National Archive, 16/418/G183; Bill of complaint, p. 15-20.

emphasized the instructions of General Almonte's instruction of a "*pro ratâ*" distribution. As Salmon had declared to Barings, "I think it would be unjust to deprive the new bondholders of a *pari passu* distribution of those funds with the old bondholders."[50]

On June 20, 1867, Barings signaled to the bondholders that one way out of the conundrum might be for the various bondholders to come to an understanding. Alternatively, a legal decision might be obtained. Unenthusiastic at the prospect of the unavoidable delays that a lawsuit would entail, the various leaders of the bondholders met on July 8 1867 to as to come to a common understanding. They send a note to Barings asking whether a public meeting of all bondholders invited to ratify a proposed *pari passu* distribution would convince the bankers to release the funds. For situations that were not anticipated by covenants, the default rule was a unanimous vote of bondholders. As a result, Barings provided the following answer to the bondholders: "Nothing short of unanimous consent of all the Mexican Bondholders of both classes would make it safe for us to distribute the funds now in our hands. For our security we consider that the opinion of the court of chancery should be taken as to the rights of the parties."[51] Further unsuccessful negotiations occurred to avoid this outcome, and the bill of Guedalla v Baring was filed with the court of chancery on December 10, 1867.[52]

Guedalla v Baring was filed by Haim Guedalla, representing the 1851 bondholders, against the partners of the House of Barings and Edward Salmon, the latter representing the 1864 bondholders. It was heard in the first days of December 1868. The Vice Chancellor based his decision on the fact that the bonds of 1851 having, so to speak, fathered the bonds of 1864, there was perfect unity of title between the two groups of creditors. The money sitting at the Bank of England was

[50] Three months later Salmon reiterated his claim: "As to the division of the 120,000 [?] in hand there can be no objection to its being divided on my part if it be practicable. I should be consenting: new and old bonds receiving *pari passu*." See National Archive, Guedalla v Baring, Bill of Complain, C 16/418/G183; Letters to Irving and Slade, January 2, 1867, and March 6, 1867; Bill of Complaint, p. 22-4. Salmon later suggested that, since the claim of the 1864 bondholders accrued from the compensation of overdue coupons, the 1864 bondholders might even have priority. Guedalla v Baring, National Archive, 16/418/G183; Answer of defendant Edward Salmon, p. 15.

[51] Guedalla (1867, p. 8-9 and Appendix, p. 14-16). At the end of July 1867, Barings took the decision of releasing to the 1851 bondholders a fraction of the £150,000 they held: precisely, the exact fraction that the 1851 bondholders would receive if the pari passu principle were to be adopted. This unblocked the situation as it enabled representatives of the 1851 bondholders to file a friendly lawsuit in chancery, asking the release of the remaining money in their favor.

[52]Guedalla v Baring, National Archive, 16/418/G183 Costeloe, (2003 p. 219). In March 1868, Barings resigned their financial agency of the Mexican government. See *London Evening Standard*, 28 March 1868

"distributable equally among all the bondholders" and the judge ordered Barings to release the money accordingly. And thus it was that a British court had returned what amounted to a *pari passu* verdict, in a world where enforcement of sovereign claims was notoriously impossible.[53]

The important insight that emerges from this case pertains to the reasons for the willingness of a British court to declare itself competent on a matter involving sovereign debt. The trigger was a combination of two factors. On the one hand, the sovereign, owing to peculiar historical circumstances, was somehow suppressed from the dispute. General Almonte had recommended an equitable distribution but as he himself acknowledged he was doing this without explicit orders from his government."[54] In other words, the sovereign was silent and the break up of diplomatic relations between Britain and Juárez' Mexico after the execution of Maximilian ensured that the ambiguity persisted. On the other hand, there had been Barings' concern with liability. As the bill of complaint emphasized "it is impossible for the defendants Messrs. Baring Brothers and Co. to administer and divide the said fund with safety to themselves except under the direction of this Honorable Court." Malins was sensitive to this argument: His verdict asserted that the bankers "could not have acted without the direction of the court."[55] This suggests a parallel with Gladstone v Musurus Bey. In both cases, the intentions of the sovereign were by the force of circumstances, confused. And in both cases, a bank, custodian of the funds, and declaring itself trustee for some stakeholder (the Bank of England in Gladstone v Musurus Bey, the House of Barings in Guedalla v Barings) played a critical role in forcing the involvement of the court system. As we shall see in the next section, both features: the question of the motivations of the sovereign and the problem of trusteeship would play a decisive role in future efforts to work around sovereign immunity.[56]

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[53] *Times*, December 8, 1868: "It was plain that the new bonds were only issued to the holders of the new ones. The title to receive the new was the production of the old […] No new right had been created by this substitution [of an unpaid interest by a new bond]; there was a unity of title when the bonds were issued. It was the same case as an English mortgage, with a like arrear of interest, when there was a provision for turning principal into interest, carrying interest. The new bonds were therefore an accretion or addition to the old, and the money was distributable rateably among all the bondholders according to the amount of their securities."

[54] Letter dated May 23, 1867; C 16/418/G183, Answer of Defendant Edward Salmon, p. 12.

[55] C 16/418/G183, Bill of Complaint, p. 28; Guedalla (1867, 15); *Times*, December 8, 1868.

[56] Perhaps owing to some judgments as this one, the originality of the Vice Chancellor was well known and earned him this strange epitaph in the Oxford Dictionary that "he had a considerable gift of marshaling facts, expressed himself with fluency and point, and was esteemed for his amiability and

Before we conclude this section however, we must ask ourselves how the market understood the Guedalla verdict. As explained by Edward Salmon, the prospect of the defeat of Maximilian had raised the probability of a selective default on the debts issued under his rule (and the conquest of power by Juárez actually confirmed those expectations). The result, Salmon argued, was the greater decline in the price of securities issued under Maximilian that had been indeed observed following the announcement of the withdrawal of French troops.[57] On the other hand, the Guedalla verdict meant that a court in Britain had decided that money in London for the payment of one coupon should be shared *pari passu* with the other. It might have been taken to suggest that in the future, bondholders would be able secure similar injunctions. Not only had the 1851 and 1864 bonds identical financial characteristics in all respects (coupons, maturity, etc.) but they were now deemed to have a unity of title. There were contemporaries who speculated that, in case of a favorable verdict the price of 1864 Mexican bonds should have rallied. Indeed, the press mentioned an upward movement in the price of the 1864 just after the verdict and, some newspapers argued, because of it. For instance on December 9, the *London Evening Standard* claimed that the "sudden advance of about 1 percent in New Mexican Three per Cents was explained by the circumstance that the Vice Chancellor Malins had decided in the case of 'Guedalla v. Baring' that the sum […] Messrs. Baring Brothers now hold on account of the Mexican dividends, must be distributed *pro rata* among the holders of Old and New Bonds, on the ground that the New Bonds represent the arrears of interest on the Old Bonds and therefore are equally entitled to the payment of dividends."[58]

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generosity of sentiment; but he was talkative and impulsive, and his judgments have not added much to the law of England." *Dictionary of National Biography*, Sidney Lee (ed), Vol. 35, p. 423-4. Note that this is the same judge as the one who would have to recuse himself from the two 1876 guano cases, Twycross and Croyle.

[57] Noting the greater decline of the 1864 bonds following the deterioration of Maximilian's odds of political survival, Edward Salmon declared: "Unless investors fancy, that in the event of Maximilian's abdicating, the succeeding democrat Government might deem the new bonds unworthy to stand on a par with the old ones I can divine no reason for this difference of value." C 16/418/G183; Bill of Complaint, p. 22; Letter from Salmon to Irving, Slade, January 2 1867. The announcement that the bonds of the so-called government of the Empire were no longer to be received by the new government was stated in a circular issued by the Mexican government, dated September 27, 1867. A translation was printed in the London Gazette, November 15, 1867, p. 6060. On the use of bond price differentials during civil wars as a tool enabling to read anticipated political outcomes, see Oosterlinck and Weidenmier (2007).

[58] *London Evening Standard*, 9 December 1868; Likewise the *Era*, (December 13, 1868) declared "Mexican of 1864 have improved 1 ½ percent., on a verdict in the case of Guedalla v. Baring, declaring them to stand in the same position with regard to the hypothecation of duties as the old loan."

Figure 2 shows the behavior of the two bonds: the 3 percent 1851 and the 3 percent 1864. I have also added another Maximilian issue, a so-called 1864 "Anglo-French" 6% issue whose main market was Paris. While subtler nuances are discussed in the note below the Figure, the broad behavior of both 1864 bonds was similar and it contrasts with that of the 1851 bond. The evidence is consistent, therefore, with the correct anticipation that Juárez' regime would treat the Maximilian debts as "odious." More importantly, the evidence shows that the Guedalla verdict did not change the relative position of the 3% 1864 issue with respect to the 3% 1851. There might have been an advance of a few percentage points in the price of the 3% 1864 issue in reaction to the verdict, but this was simply the result of pricing the partial dividend. The market was far from pricing a recurrence of the verdict, which had not succeeded in putting the two classes of securities on an equal footing. And one year later, Guedalla could still lament about the large spread that persisted between the two bonds – a spread, he noted regretfully, that Sir R. Malins' verdict had failed to correct.[59] This made sense of course, because in the future, it was unlikely that the exceptional circumstances that had produced the Guedalla verdict would recur. If the Mexican government were to send money for the 1851 bondholders, it would suffice to use a banker that was not a trustee for the Mexican bondholders. This banker, as agent of the Mexican government, would do exactly as decided by its principal – and it would be able to discriminate. And thus, the conclusion of this section is that the unity of title contemplated in Guedalla v Baring was not considered by investors as credible. Yet the verdict and the legal brainstorming that had occurred on this occasion had serious expanded possibilities, by showing yet another circumstance, under which sovereign immunity could be tampered with. The episode would provide the spark for a new idea.

Section V. Trying One's Chance in Chancery

In this section I return the guano trial and argue that behind the apparent failure of the plaintiff to enforce the guano clauses was nonetheless a powerful and valuable lesson. In fact, it is not the verdict that formed the important piece of news in Smith v Weguelin but the substance of the plea, which the lawyers from Ashurst, Morris & Co put together. The case provided the opportunity to test a radically new theory, a bold argument that reinterpreted the Peruvian arrangement as a trust deed. In order to

[59] *Morning Post*, September 3, 1869.

deliver the argument with its full impact, Ashurst, Morris, counsel for the plaintiff, had put together an impressive line up.[60] One of the two lawyers present at the trial was George Jessel, a leading specialist of corporate law who would succeed the judge in chancery Lord Romilly as Master of the Rolls in Chancery. The other was John Westlake, whose *Treatise on Private International Law* (first published in 1858) had already earned him tremendous respect as a leading light of international private law.[61] Ironically, as I have mentioned above, Westlake is often quoted as an apostle of absolute sovereign immunity in the 19th century.

According to the argument articulated by the plaintiff's counsels the guano company and its agents in London were trustees of an imaginary deed, established by the Peruvian government to the benefit of the bondholders, who were to be the beneficiaries of the trust, or to use the technical term "*cestui que*." As the lawyers concluded, "the bonds therefore created a charge on the proceeds in the hands of the company or its agents, who are trustees for the Peruvian Government and its assignees, the bondholders. The company or its agents were thus "bound to apply the proceeds in accordance with the terms of the bonds," that is, in favor of the bondholders.[62] It was thus proper for the court to order the company to dispose of the proceeds from the sale of guano in accordance with stipulations in existing contracts. Of course, given what we know, the trust idea cannot have been random, since it was reminiscent to the trusteeship duties invoked by the Bank of England and the House of Barings in Musurus Bey and Guedalla.

The theory failed to persuade the judge, and led him to describe the suggested argument as a "singular." The contract, as far as he could see, was "clearly and unmistakeably a foreign contract." It was a contract, he continued, "between the Peruvian Government on the one hand and the Consignment Company on the other, entered into in Peru between Peruvians, and according to the law of Peru" a country where "the doctrine of trusts is wholly unknown." There was nothing in the contract that enabled the plaintiff to embark on such a theory: The original contract simply "gave leave to the company to consign to their agents in London guano to be applied

[60] The solicitors for the defendants was the law firm W. & H.P. Sharp, represented by Sir Roundell Palmer, a former Solicitor General and Attorney General who became Lord Chancellor under Gladstone in 1872. He was assisted by the young Arthur Kekewich, who would later become a judge in the chancery division.
[61] He most probably inspired the digressions in the bill that alluded to the relevance of international law and the "comity of nations."
[62] Smith v Weguelin, (1869) L.R. 8 Eq. 198

in payment of the loans contracted by the Peruvian government as the government shall direct, and the surplus is to be applied, in certain proportions, in payment of disbursements with which the plaintiff has no concern."[63] In other words, the judge rejected the whole construction, which was bound to drag the court on a territory where it should never go.[64]

There is absolutely no doubt that the plaintiff's solicitors in Smith v Weguelin fully recognized what they were standing against and what was to be the likely outcome. Indeed, the court report shows their argument to have ended with an explicit acknowledgement and discussion of the possibility that the case might be drawn back to the problem of sovereign immunity – it spoke of the concern for the Court not to "interfere with the acts of a foreign Government in its sovereign capacity."[65] The most plausible interpretation is that Westlake and Jessel were sending of a trial balloon, part of a dialectic exploration of new legal possibilities.

In fact, the benefit from testing a case, beyond the hope that the plaintiffs may have entertained, can be interpreted within an economic framework by emphasizing the "legal externalities" which litigation generated. Consistent with this interpretation, is the fact that the legal-commercial world of the time was constructed in a way that, precisely, enabled litigants to internalize the externalities. Indeed, a lot of the litigation surveyed here occurred within a limited number of lawyers and financiers. For instance, there was a direct link between the two Turkish disputes and the first guano case. Gladstone was a partner of Weguelin in a merchant bank trading under the name Thomson, Bonar and Co. Having been on the plaintiff side in the two Turkish sovereign immunity cases (Gladstone v Ottoman Bank and Gladstone v Musurus Bey), the same partners perhaps felt confident in their ability to optimize

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63 Smith v Weguelin, (1869) L.R. 8 Eq. 198, p. 212.

64 Smith v Weguelin, (1869) L.R. 8 Eq. 198, p. 213. "And if the Court did make such an attempt, it would fall into this dilemma: either it would simply make itself ridiculous in attempting what is impossible, or if it could assume that the foreign Government was answerable to this Court, and bound to pay according to its decrees, and then found property belonging to the foreign Government in this country, it might alter the relation between the two countries, and enable a bondholder by the aid of the Court of Chancery practically to declare war against a foreign country, for it is clear that if the Court of Chancery could seize all the guano belonging to the Peruvian Government it might as well seize Peruvian vessels under the Article which declares that all the other property and sources of revenue of the Republic should be applicable to payment of the loan."

65 Smith v Weguelin, (1869) L.R. 8 Eq. 198, p. 209.

contracts with foreign sovereigns, explaining why they were found on the defendant side in Smith v Weguelin because Gladstone was in fact a partner of Weguelin.[66]

Experimentation was thus just a way of being, with the group of lawyers and financiers involved in the litigation properly organized to reap the fruits of their collective or separate efforts. Seen as an attempt to enforce a guano clause as a way around sovereign immunity, there is no doubt that Smith v Weguelin was a failure and I have already shown that it was an expected one. But put in the perspective of the extensive litigations surveyed in this paper (and I am only scratching the surface!) Smith had achieved tangible results. By trying this theory on a visibly scandalized judge, they seem to have hoped to have the judge telling them what was missing for the case to be receivable. And the trick worked: It is possible to read between the lines of the Master of the Rolls' admonishing of the plaintiffs what would have been necessary for him not to dismiss them. It involved, he implicitly stated, the full construction of a proper trust contract, of which both the borrowing government and the bondholders would be parties. Chancery did not recognize a legal metaphor but it would enforce the prescriptions of a trust deed, if it were to see the real thing. The point was not lost to observers – lawyers, investors and foreign governments. It would be driven home with the design of the "Church" loan to Bolivia, the subject of the next section.

Section VI. A Court Governs a Foreign Debt Contract (or How the Sovereign Became a Vulture)

In this section, I show how finally, after much *tâtonnement*, lawyers and financiers eventually figured a way whereby the court of chancery became competent to govern the use of money from a foreign debt contract, to the extent, that judicial decisions became a matter of speculation and a powerful driver of bond prices. This is how one can describe the Church loan as a "success," that is, not because the project it contemplated was completed (it was not) but because unlike what has been observed in the experiences so far, the structuring of the loan did effectively provide the court with authority on the money. In this sense, the Church loan was another incremental progress in legal-financial engineering, in that it provided evidence regarding

[66] Weguelin, Gladstone, Bell, & Weguelin traded under the name Thomson, Bonar, and Co. See Bertrand (1967, p. 195) for further connections of this firm.

The loan, which the American scientist and adventurer George Earl Church, a future Vice President of the British Geographical Society, arranged for Bolivia in 1871, deserves the attention of students of the history of sovereign debt for many reasons. Gulati and Scott (2012), on the basis of second hand sources, argue that it provides the first instance ever of the inclusion of a *pari passu* clause in a sovereign debt loan.[67] In my own previous research, I show how promotion of scientific knowledge played a critical part in the success of the loan (Flandreau 2106). From the vantage point of the argument in this paper, however, another interesting aspect of the contract consists in the way the contracts involved elaborated upon the litigation surveyed above with the intention to thwart sovereign immunity. Indeed, the project made extensive recourse to the system of trusteeship, which we have seen had been sketched out by the plaintiff's bill in the Smith case as a theory. But unlike what had happened in the Smith case an effective trusteeship system had been created.

The project that gave rise to the Church loan was to throw Bolivia open to trade via the Amazon River through combined transportation of commodities by river and railway across the border between Bolivia (for the river part) and Brazil (for the railway part). To this end, Church, acting as agent for the government of Bolivia, had received navigation and construction concessions from the two countries. He then launched a navigation company (the National Bolivian Navigation Company or NBNC), which he incorporated in 1870 in New York by an Act of Congress, and a railway company (the Madeira and Mamoré Railway Company or MMRC) which he incorporated in London in 1871 under the British Companies Act of 1862 and 1867. Church and his associates controlled both companies. The whole structure however, had essentially zero capital. Capital was to be injected through the Bolivian government loan.[68] Specifically, a 1.7 million pounds in nominal capital bond issue was arranged by Church in 1872, for which Erlanger acted as underwriter. The placement of the Republic of Bolivia 6% bond began on January 20, 1872. Issued at the price of 68£ for each nominal bond of 100£, its subscription was swift and produced an effective capital of 1.15 million pounds.

As many other contemporary sovereign bonds, the Bolivian loan of 1872 pledged the general revenues of the borrowing government as well as some specific revenues

[67] Gulati and Scott (2012 p. 135 and *passim*); for a qualification of this view, see Gulati and Chabot (2014); Some legal authors are critical the approach consisting in tracing the "first clause ever" (See Weidenmaier 2014).
[68] See Flandreau (2016, p. 209-210)

– in the instance one-fourth of the import duties on merchandises arriving through the Amazon route. Like in the guano contracts, a private entity in relation with the Bolivian government was used as intermediary in an attempt to secure the rights of the bondholders. Church's National Bolivian Navigation Company had received from the Bolivian government the three remaining fourths of the import duties on merchandises arriving through the Amazon route. The innovation compared to the guano contracts was the institution of the trust, called "Deed of Security," and dated May 18, 1871, whereby the company assigned to the trustees of the bondholders through the intermediary of trustees, the revenues in question as well as its own net profits. As the deed recited, the trustees were to apply these resources toward "the payment of the interest and sinking, fund, of the said loan at the proper, dates of maturity". In case the company did not comply, for instance if it retained resources that had been explicitly pledged, the trustees had a right to "enter at once as receivers into possession of all the property and assets of the company."[69] This was repeated in the prospectus of the loan.[70]

The creation of the deed was clearly an attempt at addressing the legal objections that had been raised against the trusteeship interpretation of the guano clauses in Smith. Unlike what had been the case in Smith, a formal deed could be shown to the judge. Through this deed, the private company (not incidentally incorporated in the United States of America, where the law of trusts was known) explicitly consented to make the bondholders the beneficiaries of revenues, which it was to receive from the Bolivian government. Clearly, the lawyers and the financiers involved in the deal (since we know that Erlanger cooperated closely at this point with Philip Rose a leading corporate lawyer) expected that the concern that courts had shown towards the fiduciary responsibilities of the Bank of England and of Barings, and the implicit admission by Romilly that a fully fledged deed of trust would be taken seriously in chancery, would play in favor of their piece of financial engineering.[71] While it was

[69] "Deed of Security," p. 124-5, in Anonymous, *Papers and Documents Relation to the Bolivian Loan*, London: Dunlop, 1873

[70] The prospectus stated that the trustees for the Bondholders would have "full powers for entering at once as receivers into possession of all property and assets" of the company. See prospectus, p. 145-148 in Anonymous, *Papers and Documents Relation to the Bolivian Loan*, London: Dunlop, 1873.

[71] There is evidence that this was no coincidence and that we are dealing here with another case of legal externality. The best legal talent had been involved in the design of the complex contractual architecture that sustained the Church loan. Contractual documentation shows the involvement of the prominent corporate law firm Baxter, Rose and Norton and, according that firm's biographer, a senior partner of this firm, Sir Philip Rose, who was also Benjamin Disraeli's personal lawyer, would have

still possible for the Bolivian government to tamper with custom revenues, at least it could be expected that in the case of any government money reaching the company, the bondholders, via their trustees, would be enabled to get their hand on it.[72]

The logic of trusteeship was industrialized throughout the entire scheme. The trustees for the bondholders had control over the revenues of the navigation company, and also over the net profits of the railway company, hypothecated in a similar fashion. They controlled sums set aside from the proceeds of the loan providing two years of interest service and amortization. Last, they controlled the main prize of the loan, the management of a pot of money of 600'000£ that was to pay for the construction of the road, the most expansive and important part of the project.[73] Specifically, they would be in charge of supervising the progress of the railroad and making payments for the works as they proceeded according to an agreed upon calendar. A prominent lawyer and financial innovator, J. Horatio Lloyd and a merchant banker, J. Bradshaw Wanklyn, were made trustees and instructed to act for the protection of the bondholders.[74] This system, operationalized across many different deeds and contracts listed Table 1 was summarized in detail in the loan prospectus, which claimed: "Mr. J. Horatio Lloyd and Mr. J. Bradshaw Wanklyn (Lumb, Wanklyn and Co.) will act as trustees for the bondholders to exercise, if ever required, these powers, for the protection of the Bondholders."[75] According to contemporary authorities, the arrangement was instrumental to ensure the full placement of the bond. According to the later opinion of the Lord Chancellor of

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worked in close cooperation with the underwriter Erlanger. See St George (1995, p. 139); On Erlanger as a legal-financial entrepreneur, see Lobban (2006). See Table 1 for a list of the contracts involved in the Church loan.

[72] We cannot help remarking that the company would operate partly in Brazil (and thus might be able to collect the custom revenues there) and was an American one. So a certain contractual distance was created in this way.

[73] The mechanism chosen left no doubt that the Bolivian government had authorized the deed. The principal contract having stated that the repartition of the funds would be directed by the Bolivian government ("Contract for the issue of Bolivian loan," in Anonymous, *Papers and Documents Relation to the Bolivian Loan*, London: Dunlop, 1873, See art. 8, p. 118), the proceeds contract made use of this power to give instructions that the money earmarked for the construction of the road be transferred to the National Bolivian Navigation Company, after which the trustees had been involved to direct the money (See "Contract for disposal of proceeds" in Anonymous, *Papers and Documents Relation to the Bolivian Loan*, London: Dunlop, 1873, See art. 7, p. 122). See Flandreau (2016, p. 114-115 for details on the disposal of funds).

[74] He had designed so-called "Lloyd bonds," an incentive structure to encourage railway contractors to deliver. See Pollins (1957 a and b); For a critical review of Lloyd's bonds, see Robb (1992, p. 51).

[75] See text of prospectus, p. 145-148 in Anonymous, *Papers and Documents Relation to the Bolivian Loan*, London : Dunlop, 1873, p.

Britain, Hugh Cairns: "I think it is obvious that if the money had not been placed in the hands of the trustees the loan would not have been obtained."[76]

The rest of the story is a fascinating one that will deserve to be told in full details some day. For our present purpose, the only thing that needs to be done is to report evidence that the interaction between contractual clauses (the trusteeship arrangements) and the attitude of courts towards such clauses drove bond prices. This means that the clauses were taken seriously. If so, then we may safely concluded that a way around sovereign immunity had been found. Fortunately, the rest of the tale as it unfolded after the issue of the Bolivian loan provided circumstances that enable to examine this conjecture. Indeed, as it turns out, after the above-mentioned impressive web of contracts had been finalized and the loan had been launched successfully, bad news began to pile up providing scope for litigation. While unfortunate for many stakeholders, the disaster provides an opportunity to test the proposition we have articulated, namely that an ordinary court of law could influence market valuations of foreign government debt. Indeed, under the widely held hypothesis of absolute sovereign immunity, we should never see a court of law capable of influencing the price of a sovereign bond.

Figure 3 Here

Figure 3 shows the evolution of the price of Bolivian government debt between the month of issue (January 1872) and the Summer of 1880, when the bonds were paid back and withdrawn from the circulation (July 1880). As can be seen, the price of Bolivian bonds first experienced a long phase of decline, characterized by two consecutive and rather dramatic drops. The first occurred in the spring of 1873, and the second in the first months of 1875. The low tide was reached in June 1876, when Bolivian bonds traded at 16.5 only. After this, the situation improved steadily and despite a violent swing in 1879 (on which I will return later) the bonds reached 46 at the end of the period.

The general reasons for the observed dynamics are easy to interpret: The first drop in the Spring of 1873 coincides with bad news arriving in London regarding the feasibility of the project. The Public Works Construction Company, having discovered that the road was 180 miles long rather than 150 miles as written in the contract and that natives, whom it had apparently expected to be good neighbors or

[76] Flandreau (2016, p. 114).

even perhaps to provide free labor, were attacking the company's parties, it decided to pull out from the project. The dispute resulted in a lawsuit from the National Bolivian Navigation Company and forced Church to turn to another construction company. The deteriorating prospects of the road being constructed had a naturally bad effect on the price of Bolivian debt: With no road, there would be no trade through the Amazon, thus no custom revenue, and no profit for the navigation and railway companies: The securities were collapsing. Likewise, the second fall in early 1875 can be interpreted in relation to the announcement that the money in trust to pay for the interest and amortization had run out, and that Bolivia was technically in default. However, what is more spectacular is the progressive recuperation of the price after 1876: Indeed, during this period, Bolivia remained stubbornly in default, and various attempts to re-launch the project failed one after the other.[77]

To explain the recuperation observed at that point, the simplest way is to factor in the behavior of the court of chancery (which had become known by that time as the chancery division of the high court of justice). Indeed as it turns out the money set aside for the construction of the railway remained a valuable collateral on which a number of "vultures" began to cast their sights. Investors who had purchased the bonds when they traded below 20£ began suing the company for it to release the funds. Bolivian authorities had not been the last to play that game. This aligned them with the bondholders – in sum Bolivia wanted the money released, not as sovereign but as vulture. The stock market began to focus on the court and in the midst of 1876 onwards, the London stock exchange became a place were bets were made as to the eventual decision of the succession of trials that the dispute over the proceeds of the loan held in trust by the navigation company, had triggered. The financial question was to know whether the courts would release the collateral or leave it with the navigation company for it to try and complete the road.

Given this, the gradual improvement of the price until the Summer of 1880 reflects the increasing likelihood of the eventual ruling in March 1880 by the House of Lords which eventually ordered the distribution of the fund among bondholders as was done a few months later.[78] The importance of the court decisions in driving the price of "sovereign" bonds gets further empirical support if we consider the events that took place in the Spring of 1879 when the price of Bolivian debt exhibited a violent swing,

[77] See Gamboa (2015) for a discussion of the episode.
[78] National Bolivian Navigation Company v Wilson, (1880) 5 App. Cass. 176.

first collapsing below 20 and then again violently recuperating to close to forty in a matter of weeks. The cause for these movements was again court decisions.[79] In indeed, on April 24, 1879, Judge Edward Fry, apparently surprising markets had found in favor of the navigation company, which was to keep the money and try harder with the railway. The *Times* of April 26 commented: "The judgment of Mr. Justice Fry in the case of 'The Bolivian Government and bondholders v. The Bolivian Navigation Company,' has excited much surprise and comment in the city. On the bonds its effect has been nothing short of disastrous." However a few weeks later, hope returned when the decision was reversed in appeal, sparking a rally in Bolivian bonds. The rally had indeed begun in the midst of the trial. Between May 27 and May 28, prices rallied from 21 to 27 on the back, the *Times* claimed, of "the extraordinary character of admissions made [yesterday and today] by the principal witness for the defense [i.e. Church and the navigation company] in cross-examination before the court of appeal."[80]

As indicated, it would be fascinating to delve into the infinite detail of this extraordinary piece of litigation. The important element however, was that repeatedly, as the litigation proceeded, attempts were made by various parties to invoke the principle of sovereign immunity, but they were consistently rebuked. The message from the data is unambiguous: The trust arrangement had created a set up where the competence of the court was considerable. The sovereign had nothing left but to appear in court as a scavenger of its own debt. The result was not necessarily pretty, for although the problems of sovereign immunity had been solved other contractual problems had been created. The litigation provided plenty of opportunities to observe the difficulty of the law of trust and the difficulty of long distance projects interacting with one another. But the point is that for all practical purposes, elements enabling the resolution of some problems conventionally associated with sovereign immunity had been eventually figured out. They were to have an important legacy: Systems of international control as would eventually be implemented in Greece or the Ottoman

[79] These successive decisions are reported as Wilson v Church (also known as National Bolivian Navigation Company v. Wilson, or Wilson v Church (1879) 13 Ch. D. 1), comprising a) the Chancery Division of the High Court of Justice's decision ruled of April 24 1879 in favor of the navigation company; and b) the Court of Appeal's decision (Supreme court of Judicature) of May 30, 1879, reversing the lower court's ruling. The trial was largely covered in the media (for instance the *Times*) providing much additional insight.

[80] *Times*, May 29, 1879; The quote is from the money market section which was dated from the day before. The transcripts of the court hearings for the two days mentioned in the money market article are found in the *Times* May 28 and 29 (corresponding to hearings on May 27 and 28).

Empire involved elements of trusteeship. Whether the world that resulted from this was a perfect one – that is another matter.

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Starting with the simple discussion od a seemingly persuasive argument to the effect that the creation of liens on material assets in foreign debt contracts could have significant effects on a country's credibility, with 19th century experience providing an example, this paper has proposed a different way to narrate the problem of sovereign immunity. Instead, it has suggested that the experience of Peru actually stands in a list of failed attempts to enforce such rights before a court. All the evidence we have garnered, both in this case and in related ones, is that the bulk of investors never took such pledges as those of guano output very seriously, as the indifference of Peruvian bond prices to adverse verdicts demonstrates.[81]

On the other hand, confirming the broader intuition of Vizcarra, the Peruvian experience was a remarkable one, and the institutions it summoned, though they were not those imagined by institutional economists and modern lawyers, mattered a lot. Indeed, against the grain of the narrative of a succession decisions that did nothing but repeatedly affirm the principle of sovereign immunity, this chapter has shown that the "failed" guano contracts should be replaced in the perspective of the eventually successful quest by lawyers and financiers to find a theory that would enable them to involve British courts in the management of sovereign debts. For this they needed to transform the no-man's land between foreign and British jurisdictions into a British territory, and they eventually managed to do this. Indeed, the ultimate effect or Gladstone v Musurus Bey, of Guedalla v Baring and of Smith v Weguelin was to lead to a clarification of how cases ought to be presented to the court of chancery if one wanted it to declare itself competent. Better still, Smith v Weguelin provided an opportunity for two influential contemporary lawyers specializing respectively on corporate and international private law to articulate a bold theory of foreign debt agency as trusteeship.

The success of this theory was visible in the way the market priced the sovereign debt of Bolivia. It was also visible when, following Peru's missing of the January 1876 coupon of its guano debts, bondholders Twycross and Croyle tried their luck in

[81] Document similar result in later cases.

chancery. The language used by the solicitor of the defendant in Twycross helps gauge the progresses achieved beyond sovereign immunity. Indeed, as Dreyfus' solicitor declared, "there is no allegation in the claim that the Defendants have constituted themselves trustees for the Plaintiff, not anything to show such a relation. This case is not distinguishable from Smith v. Weguelin. If there had been anything amounting to an equitable assignment of the guano, the Court could have exercised jurisdiction over the fund, because it has ceased to be the property of the Peruvian Government; but there has been nothing of the kind." This proves that by this date, litigators understood that the armor of sovereign immunity had a chink, in the shape of trust law.[82]

I conjecture therefore that trust law became an important instrument of globalization and financial conquest and if this conclusion is admitted, then we must also reckon the importance of institutional processes that go beyond the traditional focus on "good institutions." By looking at institutional processes of a legal financial nature, as I have done here, by admitting the possibility of technical forces operating beyond the remit of credibility or sanctions understood narrowly, such an approach may offer novel ways to combine economic analysis and the history of law, taking the latter out of intellectual history and into the territory of economic and business history. By proceeding in this manner, we may hope to shed a novel light on such things as the adoption of the *pari passu* terminology, which too, like the attempts at reconstructing sovereign debt through the tools of the laws of trust, drew on local practice and experimentation. On this account, it is interesting to note that when the Vice Chancelor Richard Malins adopted his pari passu ruling in Guedalla, he was pleased to say that it was possible for him to decide on what he described as a "higher ground", which boiled down to reducing the problem of foreign government debt to one of "British mortgages"! But this, after all was the court of chancery.[83]

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[82] Twycross v Dreyfus, (1876 T. 177), pp. 608-9.
[83] Guedalla v Baring, 19 L.T.R. 597 (1869); p. 599.

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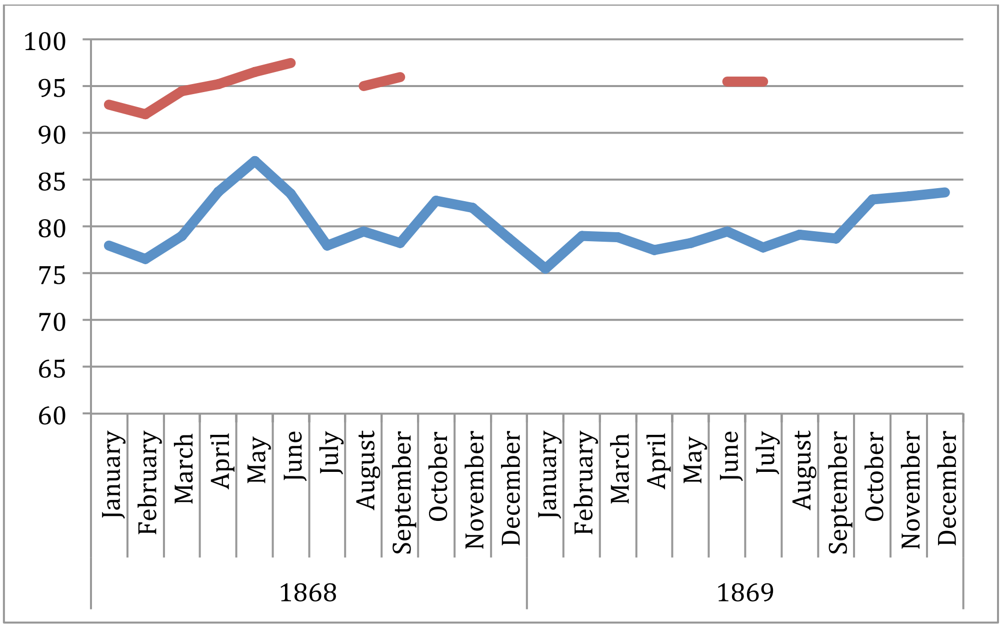
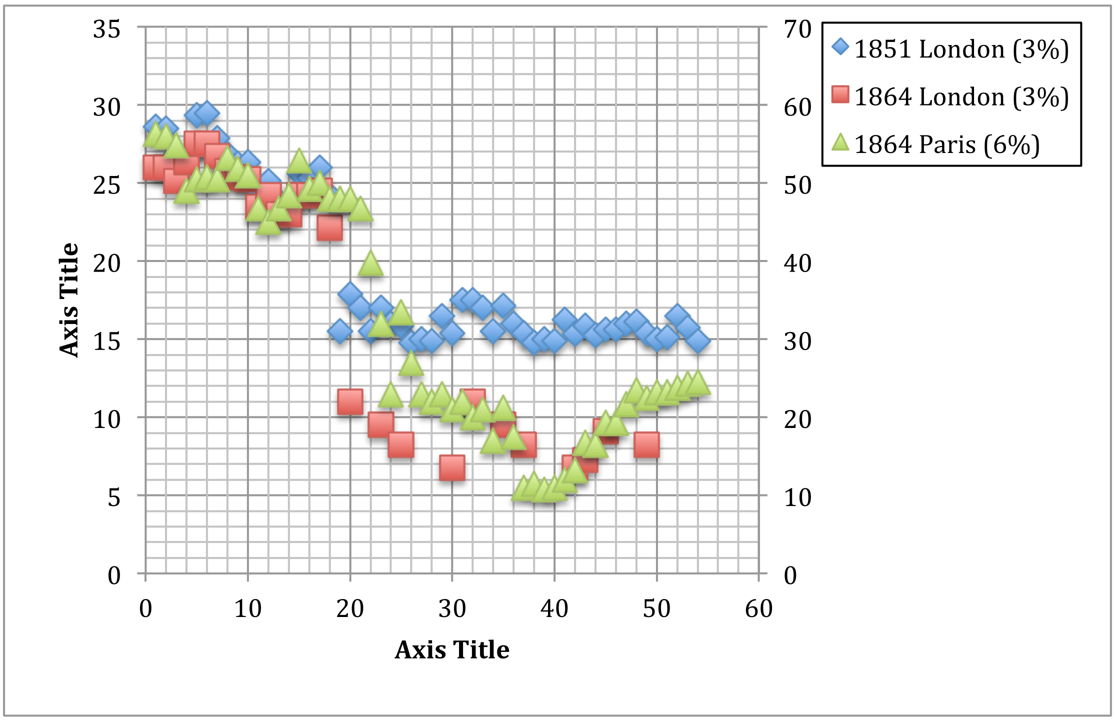
Figure 1. The Price of Peruvian Bonds Circa Smith v. Weguelin



Source: *Course of Exchange*, London Price of 4.5 1862 (Red) and 5 percent 1862 (Blue).

Message: The price of both securities are unaffected by the Smith v Weguelin verdict; Note that the higher price of the 4.5% 1862, albeit bearing a lower coupon than the 5% 1865 There were two Peruvian bonds in the London stock exchange, one of them only showing sufficient liquidity to be of any use. is explained by its shorter reimbursement time horizon. Indeed, if investors had seriously expected the court of chancery to enforce the rights of the holders of Peruvians 4.5% 1862 bonds to see the proceeds of guano be disposed of so as to speed up their reimbursement, then the verdict, if unexpected, should have depreciated the price of such securities. By the same token, the surprise announcement that in fact the court of chancery was unwilling to enforce the guano rights should have had had trickle down effect on the Peruvian 5% 1865 as they, too bore the guano guarantees. Consider Smith v Weguelin, the first of the three guano cases, which was examined in chancery in April and May 1869. It resulted from a bill filed in 1867 by William Smith, an investor in the 4.5% Peruvian loan of 1862. Smith claimed that, upon instructions of the Peruvian government, the agents of a subsequent loan had tampered with the amortization – the reimbursement – of this loan. Alleging this was a breach of Smith sued both the agents of the Peruvian Government in charge of managing the loan of 1862, the so-called Consignment Company known in Spanish as *La Compania de Consignation de Huano en la Gran Bretaña* and the agents of the said Company for the disposal of guano in Europe, Messrs. Weguelin Gladstone, Bell, & Weguelin and others “trading under the name of Thomson, Bonar, & Co.” The bulk of the bill rested on evidence the plaintiffs had that the Peruvian government had given instructions to Weguelin and the Consignment Company that had resulted in slowing down the reimbursement of the 4.5% 1862, thus giving it a lower price on the market than ought to have obtained. The guano holdings, they insisted, ought to be used now to speed up the process and they wanted the court to assist them.

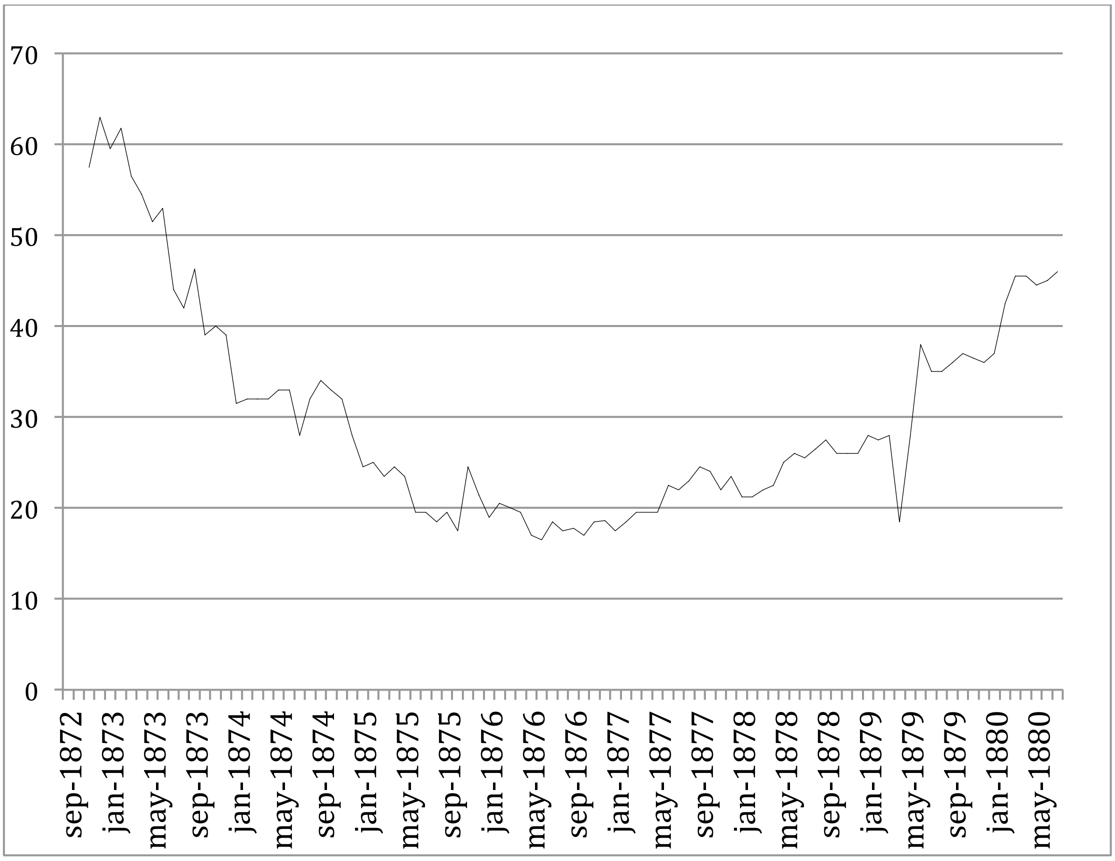
Figure 2. Effect of Guedalla: A Market's Test



Source: *The Course of Exchange* (1851 and 1864 3%); *Cours authentique de la Bourse de Paris* (1864 6%).

Message: The disruption in January 1866 coincides with discussions of Maximilian's abdication, France's withdrawal, and the French military commander in Mexico, Général Bazaine, expressing doubts as to Maximilian's troops ability to continue fighting after the French withdrawal. The two 1864 bonds have a generally similar trajectory. There ought to be some important differences, owing to political circumstances, the French version of the Anglo-French one enjoyed a kind of moral guarantee from the French state, which ended up partly indemnifying investors (See Pierre Dupont-Ferrier, *Le marché financier de Paris sous le Second Empire*, Paris: Alcan, 1925). As seen, although the price of the 6% debt in Paris takes a while to decline, it eventually catches up with the level of the 3% 1864. The general conclusion is that, as far as market expectations are concerned, a unity of title existed between the two 1864 debts, but not between the two London debts. Thus in this case political expectations mattered more than judicial decisions.

Figure 3. Price of Bolivian Loan in the London Stock Exchange (1872-1880)



Source: Author, from London Stock Exchange.

Table 1. The Web of Contracts in Church's Loan to Bolivia

	Date	Heading	Shorthand	Parties	Object
1	8/8/1868 and 12/7/1869	Concession by Bolivia of right to open Bolivia to Amazon	Bolivian Concession	Bolivian Government	- Concession to Church
2	12/22/1869	Commission of Church as Special Agent for Bolivia to raise a loan	Bolivian Decree	Bolivian Government	- Powers to Church for raising the loan
3	4/20/1870	Concession by Brazil of right to construct in Brazilian territory	Brazilian Decree	Brazilian Government	- Concession to Church
4	6/29/1870	Act of the Congress of the United States of America	Incorporation NBNC	US Congress	- Chartering of the NBNC
5	2/27/1871	Articles of Associations MMRC	Incorporation MMRC	MMRC/BoT	- Incorporation of MMRC under Companies Act
6	3/15/1871	Articles of Associations PWCC	Incorporation PWCC	PWCC/BoT	- Incorporation of PWCC under Companies Act
7	5/18/1871	Contract for the Issue of Loan	"Security Contract" also "Principal Contract"	- Church as agent for Bolivia - Erlanger & Company	- Outline of loan - Securities: Custom revenues given to NBNC
8	5/18/1871	Contract as to disposal of proceeds	"Proceeds Contract"	- Church as agent for Bolivia - Erlanger & Company	- Distribution of loan proceeds: - Interest and amortization held in trust by Erlanger - Erlanger's commission etc. - 17% of net proceeds to Bolivia - 83% of net proceeds go to the NBNC
9	5/18/1871	Deed of Security for Bolivian loan	First trusteeship agreement	NBNC to Erlanger	- Securities held by NBNC to be applied to service and amortization of loan. - Erlanger become trustees for NBNC revenues
10	5/18/1871	Contract with respect to construction of works	"Works Contract"	- Church (as holder of the Brazilian concession, President of the NBNC and Chairman of the MMRC) - Erlanger & Company - PWCC	- Terms of construction by PWCC - Amount for payment by NBNC (from proceeds of loan) - Penalties, conditions, arbitration
11	Unknown?	MMRC's Deed hypothecating net profits to Trustees	Mentioned in Prospectus, p. 147 of *Papers and documents*	- MMRC to Erlanger/Trustees?	- Net profits from MMRC go to bondholders
12	1/19/1872	Deed of Transfer	Second trusteeship agreement	- Erlanger & Company - Church (as president of NBNC and agent of Bolivia) - NBNC - MMRC - J.H. Lloyd and J.B. Wanklyn	Transfer of trusteeship from Erlanger to J.H. Lloyd and J.B. Wanklyn, who are "trustees on behalf of the bondholders."
13	1/19/1872	Contract for works	"Final works contract"	- MMRC - NBNC - PWCC	Provides all details about schedule and deliveries from PWCC
14	1/20/1872	Republic of Bolivia Six Percent Government Loan	Prospectus	Lumb and Wanklyn	Details of loan

Source: Author from a variety of primary and secondary souces. Abbreviations: NBNC: National Bolivian Navigation Company; PWCC: Public Works Construction Company; MMCR: Madeira and Mamoré Railway Company.