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Sector Focus

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Recent developments in sovereign debt restructuring: a step in the right direction?

KEY POINTS

- In September 2014, in response to the Argentinian and Greek debt crises, both the International Monetary Fund (IMF) and the United Nations General Assembly (UN) published their proposals for making the restructuring of sovereign debt a more orderly process.
- The IMF's focus is on firming up the contractual framework of sovereign bond documentation, while the UN's focus is on establishing a legal framework for sovereign debt restructuring.
- Although the UN may have a long road to travel in order to establish a sovereign debt restructuring regime and the benefits of the IMF's push to tackle collective action problems will not likely be seen in the short term, on balance, these developments are steps in the right direction.

In 2012, holdout creditors managed to secure payments of approximately $5bn from the Greek government after it agreed to pay (despite previous statements to the contrary), in full, the 3% of bondholders who had refused the government's offer to exchange their debt for new, longer-term securities (and accept a 75% loss).

In Argentina, just less than 8% of its bondholders rejected both Argentina's 2005 and 2010 restructurings and in June 2014, the American Supreme Court ruled that Argentina owed those hold out creditors 100% of the face value of their debt and prevented the trustee (Bank of New York) from transferring funds to creditors who had agreed to exchange their debt, unless it also paid (in full, plus interest) the 8% who did not sign up to the deal. As a result, Argentina could not pay the 92% majority who had agreed to the restructuring, leading Argentina to default on debt exchanged as part of the restructurings.

Partly in response to these issues, both the International Monetary Fund (IMF) and the United Nations General Assembly (UN) have been exploring ways to harmonise the restructuring of sovereigns.

While the IMF has recently supported a more market-based approach, publishing a report in September 2014 which focused on the merits of strengthening the contractual framework of sovereign bond documentation, the UN has focused its efforts on establishing a multilateral legal framework for sovereign debt restructuring, adopting a resolution in favour of doing so in September 2014.

This article will take a look at these developments, in an effort to understand how they might change the landscape of sovereign restructurings in the next few years.

MARKET-DRIVEN SOLUTIONS AND COLLECTIVE ACTION CLAUSES

In the absence of an international insolvency procedure for sovereigns, over the past decade, the market has sought commercial solutions to the problems caused by holdout creditors through changes to sovereign bond documentation, in particular, through the introduction of Collection Action Clauses (CACs) and amendments to *pari passu* provisions.

This article does not propose to discuss the intricacies of the *pari passu* clause in sovereign bond documentation and the issues this clause caused in Argentina's sovereign bond restructuring, except to note that the changes advocated by both the IMF and the International Capital Market Association (ICMA) are aimed at clarifying and standardising this clause, in an effort to remove the ambiguities which gave rise to issues which have plagued Argentina's restructurings.

CACs, however, have recently garnered a fair bit of media attention and are worth looking into in more detail in order to understand what the changes really mean for sovereign restructurings in the next few years.

CACs are clauses which allow a super-majority of bondholders to agree changes to bond terms that are then binding on all holders of the bonds (including those voting against a restructuring). CACs can apply to a single issue or across bond series. Aggregation provisions allow countries to apply voting thresholds across bond series, thereby effectively allowing them to be treated as a single group and removing the threat posed by holdouts.

CACs are not new and, in particular, have been a mandatory fixture in the Eurozone since 1 January 2013, when the Eurozone required all of its sovereign bonds (both domestic and international) issued on or after that date, with a maturity over one year, to include CACs that follow the Eurozone's Common Terms of Reference (CTR).

Outside of the Eurozone, CACs are not mandatory, but in July 2014, the ICMA published updated CAC and *pari passu* clauses and strongly recommended that these should be included in all

FIGURE 1: CAC VOTING THRESHOLDS

			Single Series	Multiple Series – Single Limb Voting	Multiple Series – Two Limb Voting	Single Series	Multiple Series – Single Limb Voting	Multiple Series– Two Limb Voting
			Meeting			**Written Resolution**		
Quorum	**Eurozone**	*Reserved Matters*	66⅔%	Not permitted	66⅔%	N/A	Not permitted	N/A
		Non-reserved Matters	50%	Not permitted	Not permitted	N/A	Not permitted	Not permitted
	ICMA	*Reserved Matters*	The meeting must be duly convened and held in accordance with the procedures prescribed by the issuer and set out in the relevant bond documentation			N/A	N/A	N/A
		Non-reserved Matters				N/A	Not permitted	Not permitted
Voting threshold	**Eurozone**	*Reserved matters*	75%	Not permitted	75% of all affected series (in aggregate), plus 66⅔% of each affected (individual) series		66⅔%	66⅔% of all affected series (in aggregate), plus 50% of each affected (individual) series
		Non-reserved matters	50%	Not permitted	Not permitted		50%	Not permitted
	ICMA	*Reserved matters*	75%	75% of all affected series (in aggregate)	66⅔% of all affected series (in aggregate), plus 50% of each affected (individual) series	75%	75% of all affected series (in aggregate)	66⅔% of all affetced series (in aggregate), plus 50% of each affected (individual) series
		Non-reserved matters	50%	Not permitted	Not permitted	50%	Not permitted	Not permitted

foreign issuances going forward. In October 2014, Kazakhstan became the first country to adopt the ICMA's recommendations and was quickly followed by Mexico in November 2014.

In its September 2014 report – "Strengthening the contractual framework to address collective action problems in sovereign debt restructuring" (the IMF September Report) – the IMF also voiced its support for the inclusion of a standardised *pari passu* clause and the ICMA-style CAC clause with more robust aggregation features to address collective action problems more effectively.

To effect changes to bond terms under CACs, both the CTR and the ICMA require that a specific meeting quorum is met and that a certain percentage of those bondholders in attendance vote in favour of the amendments at the meeting. The relevant approval thresholds required by the CTR and advocated by the ICMA are summarised in Figure 1.

Both the CTR and the ICMA advocate CACs which offer sovereigns a menu of alternatives, to provide flexibility in circumstances where countries need to offer bondholders different restructuring terms. This menu can be summarised as follows:

- **Single series:** clauses which enable the modification of terms of a single series of bonds are not new. Bonds issued under English law have included some type of CACs for more than a century and have been a standard feature in New York law governed bonds since 2003. Both the ICMA and the CTR envisage that if 75% of a series agrees, the terms can be modified and the remaining minority will be bound by that decision. The problems here are obvious. If a single creditor is able to secure control of just over 25% of a series, it will be able to block that series from restructuring and hold out for better terms (including repayment in full). Furthermore, the utility of a single series modification is questionable in and of itself. In a scenario where a government is looking to restructure, it is unlikely that it would choose to simply restructure a single series of bonds.

FIGURE 2: MATURITIES OF OUTSTANDING INTERNATIONAL SOVEREIGN BONDS
Share of outstanding international bonds that will mature in:

(Cumulative; in percent)

	New York Law	English Law	Total
3 years	17.1%	28.5%	24.0%
5 years	27.7%	45.0%	39.3%
7 years	39.7%	61.0%	53.0%
10 years	61.0%	78.8%	71.3%
>10 years	39.0%	21.2%	28.7%

Source: IMF Paper (2 September 2014) "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring"

- **Multiple series – two limb voting:** the CTR made standard the ability to modify the terms of multiple series of Eurozone bonds, provided 75% of all affected series (in aggregate), plus 662/3% of each affected (individual) series vote in favour of the new terms. The ICMA followed suit, but advocates slightly lower thresholds (662/3% of all affected series (in aggregate), plus 50% of each affected individual series). Prior to the ICMA's recommendations, only Argentina, the Dominican Republic, Greece and Uruguay had included aggregation clauses of this nature in their international sovereign bonds. The problem here is that if any series fails to meet the relevant individual series threshold, it will fall out of the restructuring. As above, those creditors will then be able to block that series from restructuring, thereby preventing a full scale restructuring.
- **Multiple series – single limb voting:** single limb voting is an all or nothing approach, introduced to combat the threat of holdout creditors obtaining a minority blocking stake as in the above scenarios. Greece used a similar statute-based mechanism to restructure its local-law bonds and the ICMA has incorporated this concept into its model provisions. The IMF also supports the single limb voting approach. Provided all creditors are offered terms which are "uniformly applicable", or, in other words, provided all creditors are offered the same instrument or an identical menu of instruments, if 75% of all affected bonds vote in favour of the new terms, the changes will be binding on all note holders. No series or creditor can drop out. Either the requisite approval is achieved and the restructuring is successful, or it isn't, in which case the restructuring simply fails.

ISSUES WITH THE CURRENT MARKET DRIVEN APPROACH

While the changes outlined above have been welcomed by the market, it is important to understand that CAC clauses will not immediately put an end to the threat of Argentinian-style litigation and the holdout issues we saw in both Greece and Argentina.

- **CTR and ICMA CACs only apply to new issuances:** the new clauses apply only to new bond issues. They do not change existing sovereign bond documentation. According to the IMF September Report, there are currently approximately $900bn worth of international sovereign bonds outstanding, of which about 71% is due to mature within the next 10 years (see Figure 2). Therefore, in reality, the new CAC clauses will address only a small proportion of outstanding sovereign bond debt.
- **Existing CACs do not eliminate the holdout problem:** while CACs are not an entirely new concept and have

FIGURE 3: CACs AND HOLDOUTS IN RECENT SOVEREIGN RESTRUCTURINGS

	Ukraine (2000)	Argentina (2001 and 2005)	Grenada (2005)	Belize (2007)	Seychelles (2009)	Greece (2012)
Predominant governing law	Luxembourg German	New York	New York	New York	English	English, New York, Greek
Creditor structure	Dispersed	Dispersed	Concentrated	Concentrated	Dispersed	Dispersed
Duration (months)	4	42	13	6	19	11
Haircut	18%	76.8%	33.9%	23.7%	56.2%	79%
CACs in original bonds	Partly	Partly	No	Partly	Yes	Partly
Holdouts	3%	24%	3%	2%	16%	3%
NY or English litigation (no of cases)	Domestic litigation only	>100	1	0	0	0

Source: Adapted from Udaibir S. Das, Michael G Papioannou, Christophe Trebesh, IMF Working Paper WP/12/203 (August 2012) "Sovereign debt Restructurings 1950–2010: Concepts, Literature Survey and Stylized Facts"

been incorporated into English and New York law governed sovereign bond documentation for some time, most existing CACs (and even the new CACs required by the CTR) operate on a series by series basis, which leaves open the possibility that holdout creditors could obtain a blocking position.

Figure 4 provides an overview of recent sovereign restructurings where CACs have been present in existing bond documentation and shows that the inclusion of CACs do not always entirely eliminate the holdout problem. Given the nature of existing CACs and the changing nature of bondholders, it is highly likely that sovereign restructurings in the next decade will still struggle with issues caused by holdout creditors.

Russia currently has approximately $38bn of outstanding international sovereign debt. According to the IMF, while its domestic government bonds are governed by local law, Russia's international sovereign bonds, issued between 2003 and 2010, are English law governed and contain some form of CACs (for further detail see: Udaibir S. Das, Michael G Papioannou, Christophe Trebesh, IMF Working Paper WP/12/203 (August 2012) "Sovereign Debt Restructurings 1950-2010: Concepts, Literature Survey and Stylized Facts").

Should Russia's current economic crisis end in another sovereign restructuring, it will be interesting to see whether the CACs contained in its English-law governed international sovereign bonds will help it steer clear of Greek or Argentinian-style holdout issues.

- **Voluntary inclusion:** with the exception of Eurozone sovereign bonds, the inclusion of CAC clauses along the lines of those advocated by the ICMA and the IMF is voluntary. Neither the ICMA nor the IMF has the power to mandate the inclusion of such clauses in international sovereign bonds. While the ICMA and the IMF can play an active role in facilitating agreement among sovereign issuers and market participants regarding the design of the proposed clauses and are actively trying to encourage incorporation of those clauses into new issuances, it will ultimately be up to the countries themselves to decide.

That said, sovereign issuers appear to be embracing the recommendations. Both Kazakhstan and Mexico have fully adopted the ICMA's model clauses and more countries are expected to follow. As for investors, with no premium or concession having been paid for either of those issuances, investors also seem to have accepted the new clauses. While there is a concern that those investing in the Kazakhstan and Mexico's recent issuances may have simply accepted the inclusion of the clauses because they are not expecting either nation to default, it is clear that those who will likely object to the new clauses will be those buying in a distressed situation (ie, secondary purchasers).

UN RESOLUTION

To date, the market driven reforms have focused solely on bond documentation, but have not addressed the variety of other debt instruments (including commercial bank debt and bilateral

FIGURE 4: OVERVIEW OF THE SDRM

	Overview of the IMF's Sovereign Debt Restructuring Mechanism (SDRM)
Overview	Statutory mechanism with two main elements: (i) approval of 75% of creditors of a restructuring offer will bind potential holdouts; (ii) creation of an arbitration body, Debt Resolution Forum (DRF), which must approve a government's restructuring plan and facilitates resolution of disputes
Legal nature	It would have been inserted into the IMF's Articles of Agreement if it had been approved by 3/5 of the IMF's members
Oversight	The DRF would have had the power to ultimately approve a government's restructuring plan and act as an arbitrator in disputes, but it had no other decision-making power. It was envisaged that creditors would have formed a representative creditors committee to negotiate with the government.
Type of debt included	In the end, the SDRM was mainly designed for bondholder debt, although commercial bank debt and bilateral sovereign debt could be restructured as a different class
Who can apply to place a country into the procedure?	SDRM could only be activated by a debtor country who would have had to show why the debt to be restructured was unsustainable
Costs	Creditors' Committee costs would have been born by debtor country
Payment moratorium	No. Under the SDRM the government was expected to meets its contractual obligations as long as possible although the DRF could enact a full suspension if approved by a requisite number of creditors
Interim financing	The SDRM enabled the provision of new super priority funding through IMF facilities.

Source: Adapted from IMF Paper (2 September 2014) "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring"

Sector Focus

Biog box
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sovereign debt) with which countries raise finance and the range of legal jurisdictions in which the debt is issued.

Right now, countries must negotiate with each creditor group separately. Although the London and Paris Clubs exist to assist in coordinating the restructuring of a country's commercial bank debt and bilateral sovereign debt, sovereigns cannot file for bankruptcy protection which would enable them to ensure that all creditors are treated equally and to procure write downs where the debt cannot be repaid.

Sovereign default can be hugely detrimental to a country's economy. Negotiations with the various stakeholders (not just bondholders) can be a lengthy process and the longer the negotiations, the higher the risk that the country could lose its access to the private funding sector for many years to come. Loss of funding can carry dire consequences for any recovery, regardless of how successful the restructuring was.

It is in this context that the UN's resolution to establish a multilateral legal framework for sovereign debt restructuring has been welcomed by an overwhelming number of UN member countries. However, it is unclear what this framework would look like and it is unlikely we will find out until, at least, September 2015 when the newly established committee is due to release its proposals.

> "In the wake of the Argentinian and Greek crises, there is a collective desire to make the restructuring of sovereign debt a more orderly process"

That said, the concept of a multilateral legal framework for sovereign debt restructuring is not new and the UN committee will not be starting from scratch. While the IMF's attempt at a similar initiative following Argentina's initial default in 2001 failed after the IMF was unsuccessful in generating enough international support to turn the initiative into a new regime, it is worth taking a look at what the IMF proposed as part of its Sovereign Debt Restructuring Mechanism (SDRM).

Figure 4 provides a brief overview of the SDRM's key features. In summary, although in the end, the SDRM was ultimately focused on the restructuring of sovereign bond debt, its initial aim was to address the following concerns:

- **holdout creditors:** the IMF recognised that creditors had the ability to frustrate a country's restructuring plan by simply refusing to consent in an effort to secure full payment;
- **cram down of minority creditors:** the IMF also recognised that there was no way to bind a minority of creditors in circumstances where a majority of creditors had approved the restructuring;
- **responsible debtors:** the IMF also recognised that there was no mechanism to encourage countries who found themselves in financial trouble to act responsibly and seek help/protection at an early stage;
- **new money:** there was (and still is) no way to provide new super-priority private funding to governments.

At the time, the IMF seemed to face insurmountable opposition from legislators and governments who feared the intrusive consequences on sovereign autonomy. Although the same fears appear to exist this time around as well (at least in relation to the 11 member countries which opposed the resolution), the UN resolution passed, with 124 countries voting in favour. Given the overwhelming support with which the resolution passed, it seems unlikely that the UN's initiative will fail. As many of the countries who voted against the original resolution even pointed out, the phraseology of the resolution itself presupposes the outcome: the establishment of a general legal framework.

A comprehensive form of a sovereign debt restructuring procedure would hopefully include all outstanding sovereign debt and would resemble national insolvency procedures. It may incorporate the concept of a moratorium on the relevant sovereign debt, the ability to enforce a haircut, which could be applied to all of the country's creditors and the ability to provide new private funding (akin to debtor-in-possession financing). However, we will have to wait until September to find out how far the UN is willing to go.

CONCLUSION

It is clear that, in the wake of the Argentinian and Greek crises, there is a collective desire to make the restructuring of sovereign debt a more orderly process. However, it remains to be seen whether the UN's proposed legal framework can provide an effective method of achieving that and whether the ICMA and the IMF will succeed in convincing sovereigns of the merits of incorporating their suggested model clauses.

In any event, given that an initial draft of the UN's framework is only expected at the end of this year and the new and improved CAC clauses only apply to new issuances, these developments may not prove to be tools which are particularly helpful in dealing with sovereign default in the short term. Nevertheless, we welcome these developments as steps in the right direction. ■

Further reading

- What to do about *Pari Passu* [2014] 8 *JIBFL* 491.
- The problem of holdout creditors in Eurozone Sovereign Debt restructurings [2013] 4 *JIBFL* 191.
- LexisNexis Loan Ranger blog: Argentina's default on its sovereign debt.