A Debt Restructuring Mechanism for Sovereigns

Do we need a legal procedure?

von
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Abdicating a treaty right imposes a very clear expression of the bondholder's will by which he expressly gives up the prerogative of action against the State. In an arbitration case, the tribunal has underlined the requirements to relinquish the BIT's right to arbitration: "A waiver of investment rights such as those provided under a treaty must be expressed and unequivocal and made by the parties involved in the dispute"[23]. Precluding the Bondholder from bringing claims under BIT, requires a waiver directly addressing the right to accept an offer to arbitrate treaty-based disputes.

The BIT right of arbitration is clearly one element which reinforces the position of the Bondholder in restructuring. Entitled with the right to provoke an international decision about the conformity of the restructuring to the BIT, Bondholders gain a high protected legal position. It is very uncertain if the State has the power to modify this legal situation unilaterally even by common agreement. The waiver of right appears to be the more secure way to escape the risk of arbitration but it depends on the consent of the Bondholder. The BIT right of arbitration has finally for a main consequence to underline the consensual nature of restructuring.

[23] Impregilo S.p.A. v Argentine Republic, ICSID case no. ARB/07/17, award 21 June 2011, § 166.

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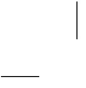
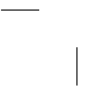

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F. Disenfranchisement in Sovereign Bonds

Keegan S. Drake[*]

Abstract

Long a part of sovereign bonds governed by English law, Collective Action Clauses, or CACs, became widespread in the early 2000s for bonds governed by American law. These clauses allow bondholders to change their bonds' payment terms with something less than a unanimous vote, usually a supermajority. Amid the present European sovereign debt crisis, many view CACs as the most promising legal means of averting financial catastrophe. Too, a Model CAC is slated to be adopted by Eurozone sovereign-issuers beginning on January 1, 2013.

This article introduces a bond provision related to CACs that, to date, has received little scholarly attention: disenfranchisement, which is intended to safeguard the CAC process by barring a sovereign from lessening or even abrogating its obligations. This article advocates disenfranchisement as an essential part of any forward-looking legal solution to sovereign defaults. Yet it argues that present disenfranchisement language uses an inapt corporate paradigm. The current language does not align fully with the historical justifications for CACs or the realities of the modern sovereign debt market. Mindful of CACs' purposes and values, this article uses the discussion to flag the strengths and weaknesses of the proposed Eurozone Model CAC for financial policymakers as well as the broader sovereign debt investment community.

I. Introduction

Rafael Correa fulfilled a peculiar campaign promise in December 2008.[1] Two years into his first term as President of Ecuador, Correa announced that he would ignore scheduled bond payments totaling $ 60 mln.,[2] voluntarily placing the South American republic in default.[3] Correa's move evinced his political populism – he had denounced Ecuador's foreign debt as "immoral and illegitimate,"[4] just short of

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[1] *Simon Romero*, Ecuador: President Orders Debt Default, N.Y. Times, Dec. 13, 2008, at A6.

[2] World News: World Watch, Wall St. J., December 16, 2008, at A16. Unless otherwise stated, this article uses the dollar sign ("$") to denominate currency only in U.S. dollars.

[3] *Matt Moffett, Joanna Slater*, Ecuador Says It Will Default on Its Foreign Debt, Wall St. J., December 13, 2008, at A8. The default was "voluntary" in the sense that Ecuador had enough money to pay its debts without becoming insolvent; it simply chose not to do so. *Arturo C. Porzecanski*, When Bad Things Happen to Good Contracts: The Case of Ecuador, 73 Law & Contemp. Probs., no. 4, 2010, at 256.

[4] *Romero*, supra note 1.

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invoking the specter of odious debt[5] – as well as his economic cunning.[6] The 2008 default, Ecuador's second in less than ten years,[7] frightened its bondholders, whose selling brought the market price for the country's bonds to one-fifth of their face value.[8] A former finance minister and an American-trained economist,[9] Correa then arranged for a sympathetic Ecuadorian bank to repurchase the notes.[10] In so doing, Correa was able to take advantage of a powerful but seemingly innocuous provision within the republic's bond contracts. The effect was that Correa enlarged his own proportion of bonds such that the other, fragmented bondholders were rendered unable to exercise collective rights otherwise permitted by the bond's language.[11]

Three years later and half a world away, eleventh-hour negotiations occurred so that Greece could meet a € 14.5 bln. bond obligation.[12] Some feared that default would produce messy consequences for the regional[13] and world economies;[14] one journalist evocatively called a missed bond payment a "step into the unknown,"[15] reminiscent of the unforeseen, chaotic aftermath of Lehman Brothers's collapse.[16] The solution was to swap the old bonds, at a steep discount, for new ones that Greece presumably would be able to honor.[17] This plan required the involvement of

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[5] *Idem.* For an introduction to odious debt, a subject beyond this article's scope, see generally *Lee C. Bucheit, Mitu Gulati, Robert B. Thompson*, The Dilemma of Odious Debts, 56 Duke L.J. 1201 (2007); *Christoph G. Paulus*, The Evolution of the Concept of 'Odious Debts', ZaöRV 68 (2008), 391.

[6] In fact, Correa's announcement was staggered for maximum effect. He announced that Ecuador would default on $ 30.6 mln. worth of bonds on a Friday, then later confirmed Ecuador would default on another $ 29.4 mln. in time for markets to open the following Monday. Supra note 2.

[7] *Moffett, Slater*, supra note 3.

[8] Specifically, bonds were quoted at 20 cents per US dollar. *Felix Salmon*, Lessons from Ecuador's Bond Default, Felix Salmon (May 29, 2009), http://blogs.reuters.com/felix-salmon/2009/05/29/lessons-from-ecuadors-bond-default/.

[9] *Moffett, Slater*, supra note 3.

[10] *Salmon*, supra note 8.

[11] *Idem.*

[12] *Peter Spiegel, Hugh Carnegy, Quentin Peel*, Extra Funds for Greek Rescue Remains Central Sticking Point, Fin. Times, February 7, 2012, at 4.

[13] See *Liz Alderman, Landon Thomas Jr.,* In Europe, Stagnation as a Way of Life, N.Y. Times, February 10, 2012, at B1 ("[T]he eventual terms of Greece's bailout deal could lead to a new set of regional uncertainties."); *William Boston, Bernd Radowitz, Andrea Thomas*, World News: Greek Bailout in Peril – France, Germany Press Athens, Bondholders to Reduce Debt, Wall St. J., January 10, 2012, at A9 ("Fears that Greece could struggle to avoid a messy debt default are already threatening to revive the financial-market jitters that plagued the Eurozone for much of last year.").

[14] See *Rachel Donadido, Niki Kitsantonis*, As Greek Default Looms Larger, Europeans Turn to Controlling It, N.Y. Times, January 16, 2012, at A1 ("European European officials now say that the task is … to avoid the sort of uncontrolled default that many experts fear could threaten the global financial system."); *Stephen Fidler*, World Economic Forum: Shadow Over Growth – Europe's Turmoil Is 'the Big Question' for Global Economy; Recession Means Banks Pull Back From Emerging Markets, Wall St. J., January 25, 2012, at A8 ("Europe isn't like Las Vegas: What happens here doesn't stay here. Not only does recession reduce the demand for exports from emerging and other economies, but it also affects the behavior of financial institutions with wider consequences for the global economy.").

[15] *Simon Nixon*, A Greek Exit from the Euro Would Offer No Easy Way Out, Wall St. J., February 16, 2012, at C12.

[16] *Idem.*

[17] See *Matthew Dalton, Stephen Fidler, Costas Paris*, Europe Reaches a Greek Deal – New Bailout Set as Debt Deadline Looms; Private Creditors Take Deeper Losses, Wall St. J., February 21, 2012, at A1 ("Private-sector creditors agreed to take a write-down on their bonds of 53.5 % – more than the 50 % write-down that had been conceded before the meeting.").

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the European Central Bank ("ECB"), one of the largest single holders of the old bonds.[18] For its part, the ECB conditioned its participation in any exchange upon restructuring talks "find[ing] a successful outcome,"[19] understood to mean a deal that shielded the ECB's bond holdings from the losses to be borne by private investors.[20] To that end, Greece pledged to exempt ECB-held bonds from the insertion of a retroactive contract provision that would give a haircut to bond yields while also "allow[ing] a recalcitrant minority to be brought into line."[21] Upon this assurance, the ECB acquiesced, and the bond exchange began.[22]

The legal maneuvering in Ecuador and Greece, as in sovereign debt restructurings generally, depended upon the same bond provision: a Collective Action Clause, or CAC. In brief, CACs allow bondholders to change their bonds' terms with something less than a unanimous vote, usually a supermajority. So useful and effective is this provision that, on January 1, 2013, a mandate for a Model CAC[23] went into effect for all Eurozone[24] member-states' government securities with maturities greater than one year.[25]

When a collective of bondholders can change their bonds' terms – including material items such as maturity dates, payment amounts, and interest rates[26] – the individual members of that collective take utmost importance. Disenfranchisement provisions specify that notes owned or controlled by the sovereign-issuer do not count among the relevant voting body necessary to change payment terms. The intent is to bar sovereign-issuers from CAC participation, rendering the sovereigns unable to alter their own bonds.

This article expands the literature on CACs by introducing disenfranchisement. It advocates disenfranchisement provisions as an important part of any forward-looking legal solution to the current Eurozone crisis, as well as a sensible addition to sovereign debt instruments in general. Although the episodes in Ecuador and Greece underscore a need for disenfranchisement, they also illustrate fundamental shortcomings of disenfranchisement's current language. As this article will explain,

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[18] *Steven M. Davidoff*, Greece Has Ways to Fix Debt Woes, but All Lead to Misery, DealBook (May 17, 2011), http://dealbook.nytimes.com/2011/05/17/greece-has-ways-to-fix-debt-woes-but-all-lead-to-misery/.

[19] *Stephen Fidler*, ECB to Help Ease Greek Debt Burden, Wall St. J., February 7, 2012, http://online.wsj.com/article/SB10001424052970203315804577209482775285626.html.

[20] *Stephen Castle, Jack Ewing*, Deal Appears Forthcoming for Bailout on Greek Debt, N.Y. Times, February 17, 2012, at B3.

[21] *Ralph Atkins*, ECB Escapes Forced Loss on Bonds, Fin. Times, February 17, 2012, at 6.

[22] *Castle, Ewing*, supra note 20.

[23] To read the text, to be discussed at length in this article, see EFC Subcomm. on EU Sovereign Debt Markets, Model CAC (February 17, 2012), available at http://europa.eu/efc/sub_committee/pdf/cac_-_text_model_cac.pdf.

[24] The Eurozone encompasses the European Union members that use the Euro as their single currency; as of May 4, 2012, this comprised Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. See ECB: Map of Euro Area 1999–2011, Eur. Cent. Bank, http://www.ecb.int/euro/intro/html/map.en.html (last visited May 4, 2012).

[25] On-Going Work on CACs 2012, Eur. Union, http://europa.eu/efc/sub_committee/cac/cac_2012/index_en.htm (last visited May 4, 2012).

[26] Together, these comprise what bonds often refer to as "payment terms." See e. g. Republic of Italy, Prospectus Supplement, $ 2 bln., 2.125 % Notes Due 2013, at S-5 (September 10, 2010) (on file with author) ("Italy may amend certain key terms of the Notes, including the maturity date, interest rate and other payment terms.").

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the strongest disenfranchisement provision, even the language within the Eurozone's Model CAC, would not have changed the course of events in either country. In light of this irony, this article aspires to flag disenfranchisement for financial policymakers in a manner mindful of the values disenfranchisement protects. Ever in the background are notions of standard debtor-creditor relations and the ability of sovereigns to effect through finance what they cannot through diplomacy.

The discussion proceeds in four parts. Part II describes CACs, the contractual framework within which disenfranchisement operates. Once seldom seen in American law bonds and now seldom missing from them, CACs provide lessons relevant to usage of disenfranchisement. Part III systematically introduces disenfranchisement itself, examining the two methods by which bond contracts may employ it. First, this Part presents full disenfranchisement language; second, provisions elsewhere in the bond that have the effect of disenfranchisement. Part IV details the limitations of disenfranchisement as currently used. Part V applies the foregoing discussion to the Eurozone's Model CAC and offers suggestions for the unintended consequences it may have for future sovereign debt restructurings. Part VI closes.

II. Disenfranchisement's Contractual Context

Disenfranchisement is a reform of another, earlier reform; namely, CACs, which allow the modification of a bond's terms with something less than a unanimous vote of bondholders. Because one cannot "understand sovereign debt contracts, markets, or policies without knowing their history,"[27] this Part surveys the history of CACs.

A complicating aspect concerns the bonds' governing law. Much as the United States and the United Kingdom are lightheartedly referred to as two countries separated by a common language, application of American or English law often produces bonds divided by similar boilerplate. Accordingly, this Part uses that dichotomy as a method of analysis, identifying why exactly CACs went from being simply a feature of English law bonds to the market standard across the two legal regimes. It then describes the language and mechanics of a prototypical CAC, setting a foundation for understanding the role of disenfranchisement in the modification process.

1. CAC's History

Bonds under American or English law evolved along separate but parallel paths. Interestingly, the same world events shaded the same contract language differently, depending upon whether one was in New York or London. This Section discusses the evolution of CACs, or "majority action clauses"[28] as they were once called, in American law and then in English law.

a) American Law

The Wall Street Crash of 1929 famously led to immense reforms; however, less discussed is that the crisis also entrenched certain other practices. Among these

[27] *Anna Gelpern, Mitu Gulati*, Foreward: Of Lawyers, Leaders, and Returning Riddles in Sovereign Debt, 73 Law & Contemp. Probs., no. 4, 2010, at i.

[28] VII Sec. and Exch. Comm'n, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees 10–60 (1937–1940).

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were unanimity provisions. In Black Tuesday's wake, the then-newly created Securities and Exchange Commission studied majority action clause proposals but ultimately rejected them as contrary to the interest of securities' holders.[29] Allowing a majority to subordinate the interests of fellow investors fed the SEC's more general concerns about corporate insiders using their knowledge to the disadvantage of others.[30] This sentiment later became law, when Congress passed the Trust Indenture Act of 1939.[31] The act signified congressional disapproval of majority action clauses.[32] Although TIA applied to corporate, not sovereign, bonds, practitioners often used the former as a template for the latter, which meant inclusion in the first usually led to inclusion in the second.[33] In the decades that followed, unanimity remained the market standard for bonds under American law.[34]

Rumbles for change followed the Tequila Crisis of the mid-1990s.[35] There, a bailout package led by the United States averted a messy default in Mexico that, so the metaphor went, would flow through the Americas.[36] To wit, Mexico's external lending did not cause the nation's near-default; instead, the culprit was the republic's decision to delink its peso from the U.S. dollar.[37] The Tequila Crisis did focus attention, however, on the language within Mexico's bonds, and sovereign debt instruments generally.[38] In turn, this led to a reconsideration of CACs' absence.[39]

While unanimity provisions were calcifying into boilerplate, two important aspects of the American sovereign bond market were changing. First, the investing class expanded. By the mid-1970s, the market movers had thinned into "syndicates involving groups of typically ten or twenty banks."[40] Thereafter, the ranks began to expand.[41] New additions included a robust secondary market including opportunistic funds – alternatively called "holdout" or "vulture" funds – that bought risky sovereign bonds with a view to collect premiums above their heavily-discounted purchase prices.[42]

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[29] *Idem.*

[30] *Idem.* Of course, this concern continues to occupy SEC attention. See *James D. Cox, Robert W. Hillman, Donald C. Langevoort*, Securities Regulation: Cases and Materials 879 (6th ed. 2009).

[31] Trust Indenture Act of 1939 ("TIA"), 15 U.S.C. §§ 77aaa-bbbb (2006).

[32] *Federico Sturzenegger, Jeromin Zettelmeyer*, Debt Defaults and Lessons from a Decade of Crises 61 (2006) (citing *Lee C. Buchheit, Mitu Gulati*, Sovereign Bonds and the Collective Will, 51 Emory L.J. 1317 (2002)).

[33] *Idem.*

[34] See *William W. Bratton, Mitu Gulati*, Sovereign Debt Reform and the Best Interest of Creditors, 57 Vand. L. Rev. 1, 3 (2004) (finding that unanimity provisions dominated sovereign bond issuances and those including CACs were a minority).

[35] *Barry Eichengreen, Richard Portes,* Crisis? What Crisis? Orderly Workouts for Sovereign Debtors 3 (1995).

[36] *Robert E. Rubin, Jacob Weisberg*, In an Uncertain World: Tough Choices from Wall Street to Washington 4 (2003).

[37] *Idem.*

[38] *Anna Gelpern, Mitu Gulati*, Public Symbol in Private Contract: A Case Study, 84 Wash. U. L. Rev. 1627, 1638 (2007).

[39] *Idem.*

[40] *Sturzenegger, Zettelmeyer*, supra note 32, at 12.

[41] *Idem.*

[42] *Jonathan I. Blackman, Rahul Mukhi*, The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna, 73 Law & Contemp. Probs., no. 4, 2010, at 49–50.

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The opportunistic funds' strategy was effective owing to the second market change: a different American legal environment for sovereign debt. In 1976, the Foreign Sovereign Immunities Act[43] became law. The exclusive basis to hale a sovereign before U.S. federal courts,[44] FSIA generally precludes federal jurisdiction over a sovereign-defendant unless one of a number of exceptions is met.[45] Among these is an exception for "commercial activity."[46] In Republic of Argentina v. Weltover,[47] the Supreme Court held that the actions of sovereign-defendants fall within the commercial activity exception when those sovereigns act not as a "regulator of a market, but in the manner of a private player within it,"[48] and when that activity has a direct effect in the U.S.[49] This unanimous holding was an invitation for lawsuits by holdouts, as the underlying case concerned a breach of contract claim resulting from Argentinean bonds issued in New York.[50] Where Weltover provided a path forward for holdout litigation, a later case provided vindication of sorts for the holdouts' strategy. This was the famous (or infamous, depending upon one's perspective) Elliott case.[51] The Elliott court found that the holdout strategy of suing for satisfaction of valid debt did not violate New York law.[52] Combined with Argentina's historic default in 2001, these market and legal changes built momentum for changes to the bond contracts.

The rumbles for reform ended with a thunderclap in 2003, when Mexico issued a bond for $ 1 bln. that included a CAC.[53] It is at least serendipitous that Mexico, the country whose Tequila Crisis spurred calls for broader CAC inclusion, issued the watershed bond with that very reform. A more accurate explanation, however, probably owes more to realpolitik than to poetic justice. A market leader in sovereign debt, Mexico wanted to forestall a global bankruptcy scheme for sovereigns, an idea then gaining momentum on account of an IMF draft proposal.[54] As two scholars noted soon after the CAC shift, "Mexico realized it would be better off if it decided the type of restructuring provisions that it wanted in its bonds and made these provisions the market standard rather than taking the risk of others setting the market standard."[55] In other words, Mexico's move was one familiar to

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[43] Foreign Sovereign Immunities Act of 1976 ("FSIA"), 28 U.S.C. §§ 1602–11 (2006).
[44] Argentine Republic v. Amerada Hess, 488 U.S. 428, 434 (1989).
[45] FSIA, 28 U.S.C. § 1604 (2006).
[46] FSIA, 28 U.S.C. § 1605(a)(2) (2006).
[47] Republic of Argentina v. Weltover, 504 U.S. 607 (1992).
[48] *Idem* at 614.
[49] *Idem* at 616.
[50] *Idem* at 609–10.
[51] Elliott Assocs. v. Banco de la Nación, 194 F.3d 363 (2d Cir. 1999).
[52] *Idem* at 381. While this verdict was helpful for Elliott, perhaps more heartening was its nearly simultaneous victory in a Belgian court, which left Peru to settle with Elliott or risk default. The republic chose the former, reportedly yielding Elliott $ 56.3 mln. on an $ 11.4 mln. investment. *Sturzenegger, Zettelmeyer*, supra note 32, at 69. For an excellent treatment of Elliott and its aftermath, see *Michael Bradley, James D. Cox, Mitu Gulati*, The Market Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market, 39 J. Legal Stud. 289 (2010).
[53] United Mexican States, Pricing Supplement and Prospectus, $ 1 bln., (Feb. 2003) (on file with author).
[54] *Nouriel Roubini, Brad Setser,* Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies 313 (2004).
[55] *Idem.*