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Briefing note

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ICMA consults on sovereign bonds

The International Capital Market Association (ICMA) is consulting on the appropriate form of collective action clauses and pari passu provisions for sovereign bonds. Both proposals raise important issues, particularly in the context of sovereign debt restructuring. Collective action clauses can facilitate debt restructuring while, as shown by the ongoing litigation against Argentina, pari passu clauses can hinder the process. But how should the desire of a sovereign to ease the path to a debt restructuring be weighed against the entitlement of bondholders to be paid? How should the rights of the holders of different bonds be balanced? How can the risk of triggering an accelerated exit be avoided? How much say should creditors have in determining the depth and/or shape of any restructuring? How can creditor coordination be enhanced? ICMA's consultation offers bondholders the chance to have their say.

The immediacy may have gone out of the Eurozone sovereign debt crisis, but that does not mean that nothing is happening. Numerous official and private sector parties are exploring what lessons can be learnt from recent restructurings - from Greece to the Caribbean and beyond - in order to ease the pain in the future whilst avoiding official sector taxpayer funded bailouts.

In October 2012, the Institute of International Finance (IIF) published an Addendum to its "Principles for Stable Capital Flows and Fair Debt Restructuring". This reflected on the Greek PSI and included some additional recommendations to its 2004 market guidelines aimed at encouraging early crisis containment and a process for voluntary market-based restructurings based on negotiations between sovereign debtors and their creditors. In its Addendum, the IIF concluded that the use of collective action clauses with an aggregation mechanism should be explored further. More recently, the IIF's Special Committee on Financial Crisis Prevention and Resolution has stated that the further development of collective action clauses with aggregation and the arrangements for broader creditor engagement, as well as a clarification of the pari passu language, would be desirable and helpful. At the same time, it acknowledges that a balance needs to be struck between the need to facilitate timely and adequate debt restructuring, when necessary, and the desirability of adequately respecting and protecting creditor property rights. (See "Views on the Way Forward for Strengthening the Framework for Sovereign Debt Restructuring" – January 2014.)

In April 2013, IMF staff also issued a paper on developments in sovereign debt restructuring entitled "Sovereign Debt Restructuring Recent Developments and Implications for the Fund's Legal and Policy Framework" for consideration by the Fund's Executive Board. The paper looked at a number of different issues including the extent to which effective

Key issues

- ICMA consults on collective action clauses with aggregation, pari passu and Noteholders' committees.
- The formulation of each provision can have important implications for a sovereign and its creditors in resolving a sovereign debt crisis.
- In order to ensure a well functioning cross-border capital market, however, it is important to maintain a balance as between debtor and creditor rights.

aggregated voting could be achieved through a contractual framework. The possibility of exploring more "robust aggregation clauses" in sovereign bond issues was one topic the paper highlighted.

ICMA has also been engaging in discussions with governmental authorities and international organisations and has now publicly entered this arena. ICMA's mission is to promote the creation of orderly and well-functioning capital markets, which it carries out by various means, including suggesting standard form provisions for use in capital market transaction contracts and related documents. As part of this, ICMA is consulting with its members and other interested parties on what its standard sovereign collective action clause should look like as well as on the introduction, for the first time, of a standard pari passu clause in its ICMA Primary Market Handbook.

Collective action clauses

Collective action clauses (CACs) allow the holders of bonds to vote to change the terms of their bonds (e.g. to reduce principal amount, change the interest rate or extend the repayment date). If the resolution put to bondholders is passed by the requisite majority (commonly 75%), the change binds all holders. The absence of a need for unanimity to change the terms of a bond reduces the risk that a small number of bondholders might block a restructuring agreed by the majority, whether by not voting or in order to hold the issuer and the majority to ransom. However, if a dissenting minority can gain control of enough of an issue, it can still block a restructuring which can have severe consequences for a country seeking to resolve its debt sustainability.

CACs within a single bond issue have been common for some years and have formed part of the ICMA Primary Market Handbook since 2004. The key innovation now proposed by ICMA to its recommended form of sovereign CAC is an aggregation feature.

Aggregation allows bondholders across a number of bond issues to vote collectively to change the terms of all their bonds. As a result, aggregation acts in some ways like a voluntary contract-based insolvency procedure, binding all bondholders if the requisite number approve a restructuring and removing the difficulties that can be caused by creditors who choose not to participate in a restructuring. Not only does this bring a wider range of bondholders into a single restructuring but it also makes it harder for a dissenting creditor to acquire a holding that might block a restructuring which is approved by most.

In the European context, Article 12 of the Treaty Establishing the European Stability Mechanism requires CACs to be included in all euro area government securities, whether governed by domestic or foreign law, issued after 1 January 2013 with a maturity over one year. The model CAC developed by the euro area (often referred to, informally, as the euro area model CAC) has an aggregation mechanism.

Following a protracted negotiation process with private creditors and in order to smooth the path of its 2012 debt restructuring, it is also worth noting that one of the tools used by Greece as part of the PSI noteholder consent solicitation and exchange exercise, was to pass legislation to enable the aggregation of consents being sought in respect of Greek-law governed bonds issued by the Republic, without distinction by series. By this means, Greece avoided problems with potential holdout creditors of its Greek law governed bonds (but it did have holdout creditors in some foreign law governed bonds, the terms of which could not be changed by Greek legislation).

The use of aggregation in CACs is not without its issues and controversies. For example:

- Should it be sufficient for the resolution to be passed by the requisite number of bondholders voting in a single aggregated group across all debt securities involved or should it also be necessary for a majority of the bondholders in each individual issue to vote in favour of the resolution, even if by a lower majority? The new model euro area CAC takes the latter approach, as does ICMA's proposal, driven by concerns that the rights of holders of a particular bond should not be entirely overridden by holders of other bonds whose interests may be different. In contrast, other parties currently favour the former approach because it makes it easier for a restructuring to be achieved and prevents dissenting holders utilising any blocking interest in a single issue to derail the success of the overall restructuring process.
- What should the majorities be? The euro area model aggregated CAC requires for reserved matters (e.g. changing the amount of any payment) a 75% majority of all debt securities, taken in aggregate, and a

majority of more than 66⅔% in each individual series, in each case represented at meetings of the bondholders of the relevant series. ICMA's proposal requires the support of at least 66⅔% and 50% of the aggregate principal amount of the outstanding debt securities respectively. Amendments by written resolution are also provided for with a broadly similar approach being taken as to relevant thresholds.

- Should aggregation be possible only for bonds with the same governing law or also across different governing laws? In a world where sovereigns issue debt internationally and domestically and in each case to both foreign and local investors, would the inclusion of aggregated CACs within foreign law debt instruments only provide the enhanced contractual mechanism parties are seeking to facilitate sovereign debt restructuring? Or has the time now come to encourage the inclusion of aggregated CACs in domestic law debt securities also – especially, if, as seen in the case of Greece, countries may resort to the passing of legislation to facilitate restructuring outcomes which prescribe that aggregated collective action procedures may apply to contracts entered into prior to such legislation.
- On the other hand, if all series of bonds that are aggregated are governed by a single law, the effect of the clause should be consistent; however, if the series are governed by different laws, it may not be the same. Moreover, litigation risks may be higher if such provisions are adopted in non-common law jurisdictions without supporting domestic legislation in view of the cramming down element.
- The extent of aggregation. Issues can only be aggregated if they contain CACs with aggregated voting, but should it be left entirely to the issuer to decide which series should be aggregated? And should creditors be aware of this at the outset? Should the issuer be able to exclude a particular issue that voted against the restructuring proposal, leaving only those that voted in favour?

Pari passu clauses

Pari passu clauses hit the headlines recently because of the decision in NML Capital v Argentina (see our briefing entitled "Sovereign pari passu clauses: don't cry for Argentina – yet"). The US court decided that a pari passu clause in a bond issued by Argentina not only prohibited Argentina from subordinating that bond below certain other obligations but that it also stopped Argentina paying sums due on other bonds without at the same time paying all sums due on the bond in question. Further, the court decided that third parties who were involved in payments by Argentina in breach of this provision risked being in contempt of the US court.

The effect of any particular pari passu clause will depend upon its drafting, but the approach of the US courts, if followed (and the US litigation has not yet reached an end) has the potential to impede some future sovereign debt restructurings. If similar circumstances arose, not only might particular bondholders choose not to take part in a restructuring but they could then potentially seek to block payments to those who have taken part unless they are paid off themselves, by invoking a similar legal remedy. This ransom effect is not conducive to a consensual restructuring of a sovereign's indebtedness, nor is the threat of protracted litigation conducive to a sovereign regaining market access on a normal basis.

ICMA's consultation paper therefore raises the question of whether it is worth keeping pari passu clauses in sovereign bonds at all. They function well in corporate bonds, where concepts of subordination and priority operate in the event of the corporate issuer's insolvency. Their function is less significant in relation to a sovereign borrower, for which there is no applicable insolvency process. If they are retained, should they expressly say that they do not have the effect bestowed on them by the US courts in order to prevent them being used to secure a ransom payment? Alternatively, should parties contemplate including a pari passu provision which contains a rateable payment formulation to reflect a specifically negotiated position?

Noteholders' committees

The ICMA Primary Market Handbook already has provisions aimed at facilitating the formation of Noteholders' committees although these are not always included even where a collective action clause forms part of the terms and conditions of the sovereign bonds. Should their further use be encouraged in order to promote the recognition of creditors' committees by sovereigns, enhance creditor coordination and facilitate negotiations as between a sovereign debtor and its creditors with a view to increasing the opportunities that a voluntary debt restructuring can be reached by the parties? Or should creditors be left to organise themselves on an ad hoc basis, as necessary, in each country case, without an upfront contractual framework being included?

Conclusion

Those involved in bond issues can negotiate such terms as they wish to include in their bond documentation but, in a market often driven by precedent, ICMA's standard clauses carry significant weight. Anyone who wants to influence what sovereign bonds look like in the future and, in particular, the mechanics for ensuring that bonds issued by a sovereign facing debt sustainability problems can be restructured in an efficient and timely way, should respond to ICMA.

ICMA's consultation paper can be found at http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Sovereign-Debt-Information/ICMA-Sovereign-Bond-Consultation-Paper-79801-5-863-v1-8-161213.pdf.

Clifford Chance LLP advised ICMA in relation to the legal issues raised by its consultation paper.

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