COLLECTIVE ACTION CLAUSES: Sovereign Bondholders Cornered?

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ABSTRACT

A default in its debt obligations compels a sovereign borrower to adopt drastic measures in order to contain a spiralling financial crisis. One of such steps is to restructure a debt which is in default. Every sovereign debt restructuring results in considerable loss to the claims of the bondholders, therefore, equitable measures must be adopted during debt restructuring to ensure that sovereigns do not misuse the restructuring process to their advantage, otherwise termed 'debtor moral hazard'. However, recent spate of restructurings, especially by Latin American countries, like Argentina, Brazil, Mexico and Uruguay, have seen ingenious use of collective action clauses (CACs), whereby a predefined majority of creditors allow the sovereign debtor to restructure the debt with considerable ease, as opposed to the traditional norm of seeking a unanimous consent. It has been argued that a country in genuine financial hardship would face enormous difficulty to restructure its debt with unanimous consent had it not been for the use of CACs. Whether the use of CACs actually promotes an equitable restructuring or provides a heavy bargaining chip in favour of the sovereign debtor is debatable. However, drafting of restructured bond contracts with CACs do push the sovereign bond investors to a corner; bondholders are mostly left with no choice than to agree to the restructuring and forego a part of their claim in the hope of salvaging whatever they can from the deal, lest they are left out. This paper studies four major bond contracts - Argentina & Uruguay (exchange offers) and Brazil & Mexico (fresh issuances) which has included CACs in them, to study their legal implications on bondholders' rights *vis-à-vis* their claims against the sovereign debtor.

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> "*When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor and least hurtful to the debtor.*" [1]

I. INTRODUCTION

Adam Smith's quote above could not be any better placed. As economic recession in the world following the sub-prime crisis becomes more and more prominent, the realities of bankruptcy are staring corporations in the face and it will not be long before the impact is transmitted to the State as a sovereign borrower. This is not to say that the risk of default by sovereign borrowers has emerged only now; it had always remained ever since sovereigns began to borrow from non-conventional commercial sources.

With the increase in global liquidity and market integration, the international financial markets witnessed new investment opportunities. While investors struggled for maximum returns and diversified risks – which created demand and liquidity for novel financial products – the developing countries, or emerging markets, matched this demand by exploiting different ways to access much needed international capital.[2] During the world debt crisis of the 1980s, sovereign debts were majorly held by commercial bank syndicates.[3] At later stages sovereign borrowers began to meet their debt requirements from international financial markets, which offered an easy and accessible option for countries with scarce capital sources.[4] But the capital markets were volatile and borrowing countries were exposed to unstable financial risks, and they often defaulted on their debt obligations. This necessitated countries to manage their debt either by way of immature debt satisfaction or debt rescheduling. Paying up was not always a viable option and rescheduling or restructuring of the debt was being opted in a more aggressive way.

The effects of issuing public debt, both domestic and external have been the subject of substantial scrutiny and analysis.[5] A series of sovereign defaults and restructurings spanning the two decades of 1980 to 2000 have thrown open interesting challenge to debtors, investors, academicians and lawyers alike. The enormous consequences of mismanaging international public debt have generated significant scrutiny and analysis. A general consensus seems to have emerged that sovereign debt restructuring mechanisms need to be more orderly and

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[1] Smith, Adam, *Wealth of Nations*, Book V, Ch. III, at 416 (1776).

[2] (Andritzky 2006, p.3).

[3] (Buchheit and Gulati, Exit Consents in Sovereign Bond Exchanges 2000, p.2, FN 3).

[4] See Garcia-Hamilton, Olivares-Caminal and Zenarruza 2005, p.1; Also see L. C. Buchheit, '*Sovereign Debtors and Their Bondholders*', 2000 – "As a result of the Brady Plan, most of the emerging market debt held by private investors is now in the form of bonds, not in commercial bank loans."

[5] (Cowan, et al. 2006, pp.1-2).

economical. While workable mechanisms of rescheduling sovereign debt obligations have since emerged, the procedures employed entails the creditors to share the burden of reduction of their claims against their investments. Sovereign issuers have devised ways to legally reduce their debt obligations, and the investors, having not many viable alternatives to realise their investments in full, are being left with no choice other than accept whatever is in offer to them. This raises critical questions regarding the mechanisms employed by sovereigns to handle the debt they have been successful in mismanaging due to which investors have to suffer. Debt instruments are being loaded with legal facilitators (the collective action clauses, exit consents, etc.) which allow the debtor to lessen their debt burden with considerable ease, albeit at the cost of their creditworthiness.[6]

This paper is an analysis of the legal implications of including collective action clauses (CACs) in sovereign bond contracts and their impact on investors. The study examines sovereign debt 'exchange offers' [of Argentina (2005) & Uruguay (2003)], where the debt issuer or debtor announces an option to its creditors or bondholders whereby the bondholders may offer their existing bonds which will then be exchanged for new bonds with altered terms and conditions, usually with relaxed payment schedules. Offer documents of fresh bond issues of emerging countries [Brazil (2003) & Mexico (2003)] have also been examined for the unique nature of the legal clauses used, which have been discussed later in the paper. Other exchange offers Pakistan (1999), Ecuador (2000) Russia (2006), Belize (2007) and Peru (2007) have also been studied in detail to understand the way in which the issuers have utilised CACs and have restructured their debts successfully. Table 1 below gives the details of the bonds documents analyzed for this paper.[7]

Table 1: Bond Documents Analyzed:

Country	Nature of Offer	Details of Bonds	Prospectus Date
Argentina [8]	Exchange Offer	An aggregate of approximately 180 series of bonds were exchanged for (i) Par bonds due December 2038, (ii) Discount bonds due December 2033, (iii) Quasi-par bonds due December 2045, and (iv) GDP-linked securities that expire in December 2035.	Jan. 10, 2005
Uruguay [9]	Exchange Offer	An aggregate of approximately 16 series of bonds were	April 10, 2003

[6] Although a country's creditworthiness plays an important role in its borrowing capacity, but the measure and accuracy of creditworthiness is now being viewed with serious doubt. The UN has recently expressed its anguish over the dismal performance of credit rating agencies (CRAs) and questioned the wisdom of relying on the CRA opinions for making investment decisions. "The failure of big CRAs to predict the 1997–1998 Asian crisis and the recent bankruptcies of Enron, WorldCom and Parmalat has raised questions concerning the rating process and the accountability of CRAs and has prompted legislators to scrutinize rating agencies." (Elkhoury January 2008, at p. 2).

[7] All documents referred to here are in record with the author.

[8] The Republic of Argentina, Prospectus Supplement (to Prospectus dated December 27, 2004), January 10, 2005.

[9] República Oriental del Uruguay, Prospectus Supplement (to Prospectus dated April 10, 2003), April 10, 2003.

		exchanged for either: (a) Maturity Extension Alternative, or (b) Benchmark Bond Alternative, involving the issuance of one or more of 15 Maturity Extension Bonds and 3 Benchmark Bonds.	
Belize [10]	Exchange Offer	An aggregate of approximately 13 series of bonds and two Insured Loans were exchanged for U.S. Dollar Bonds Due 2029.	December 18, 2006
Peru [11]	Exchange Offer	9.125% U.S. Dollar-Denominated Global Bonds due 2012 were exchanged for U.S.$750,000,000 8.375% U.S. Dollar-Denominated Global Bonds due 2016, or 8.75% U.S. Dollar-Denominated Global Bonds due 2033.	January 17, 2007
Brazil [12]	Fresh Issuance	US$1,000,000,000 10% Global Bonds due 2007	April 29, 2003
Mexico [13]	Fresh Issuance	U.S. $30,000,000,000 Global Medium-Term Notes, Series A Due Nine Months or more from date of issue; and US $1,000,000,000 6.625% Global Notes due 2015 (Interest payable March 3 and September 3; Issue price: 97.637%). The notes to mature on March 3, 2015.	February 26, 2003
Pakistan [14]	Exchange Offer	Any of all of (i) U.S.$150,000,000 11½ % Notes due 1999, (ii) U.S.$160,000,000 6% Exchangeable Notes due 2002, and (iii) U.S.$300,000,000 Floating Rate Notes due 2000 were exchanged for U.S. Dollar Denominated 10 per cent. Notes due 2002/2005.	November 15, 1999
Ecuador [15]	Exchange Offer	(i) Collateralized Par Bonds due 2025, (ii) Collateralized Discount Bonds due 2025, (iii) Past due Interest Bonds due 2015, (iv) IE Bonds due 2004; (v) 11¼% Fixed Rate Eurobonds due 2002; (vi) Floating Rate Eurobonds due 2004 were exchanged for: (i) US$ 2,700,000,000 US Dollar Denominated Step-up Global Bonds due 2030; and (ii) US$ 1,250,000,000 12% US Dollar Denominated Step-up Global Bonds due 2012.	August 23, 2000
Russia [16]	Exchange Offer	The U.S.$907,788,786 Bonds due 31 March 2007 to 31	November 23,

[10] Belize - Offer to Exchange, Offering Memorandum, December 18, 2006.

[11] Republic of Peru Prospectus Supplement (to Prospectus, dated January 17, 2007), February 15, 2007.

[12] Federal Republic of Brazil, Prospectus Supplement (to Prospectus dated February 12, 2002), April 29, 2003.

[13] Pricing Supplement (to Prospectus dated December 4, 2002 and Prospectus Supplement dated December 4, 2002), February 26, 2003.

[14] The Islamic republic of Pakistan – Offer to Exchange, Offering Memorandum, November 15, 1999.

[15] The Republic of Ecuador, Listing Particular Document, August 23, 2000.

[16] Russian Federation, Prospectus, November 23, 2006.

		March 2030 and U.S.$140,534,766 Bonds due 31 March 2006 to 31 March 2010 issued in connection with the Russian Federation's August 2000 London Club restructuring were further restructured either for cash payment or for altered payment dates and interest rates.	2006

A. Debt Contracts with a Sovereign State

Debt contracts with a sovereign state are characteristically different from that with a corporation. In a debt contract with a corporation, the parties are relatively easy to identify, there are negotiations between the parties, and governing laws are clearly laid out (normally based on the jurisdiction in which the corporation is registered). However, multi-creditor sovereign debt instruments are different and uncommon legal arrangements.[17] There is no international statute which regulates sovereign debts. Each sovereign has its own particular needs, thereby designing the debt contract to suit the particular circumstances in which the country seeks to borrow. Where sovereign bonds are traded as securities, the bonds keep changing hands frequently and the bondholders may sometimes be widely dispersed across the globe, making it difficult to coordinate or communicate among issuer and bondholders, or among bondholders themselves. Managing sovereign debt, therefore, is a very complex and time-taking task.

As discussed earlier, emerging market economies constitute a sizeable component of sovereign issuers who have restructured their bonds. Gelpern and Gulati have cited the following definition of emerging markets:

> *"The Economist defines emerging markets as developing countries, explained in turn as [a] euphemism for the world's poor countries." The term is also used occasionally to describe all countries with annual per capita income of below $10,725, classified as low- and middle-income by the World Bank. This excludes high-income or "mature market" issuers such as the United States and the other G-7 economies with well-established domestic financial systems, steady access to domestic and international investors, and the capacity to issue debt in their own currencies. We prefer a narrower definition that reflects the fact that only a minority of all low and middle-income countries have market access on any meaningful scale. J.P. Morgan's Emerging Markets Bond Index Global (EMBIG) includes U.S.-dollar-denominated debt instruments of governments and state-owned entities in thirty-three countries, for which dealers quote prices daily."*[18]

[17] (Buchheit and Gulati, Sovereign Bonds and the Collective Will 2002, p.1320)

[18] (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007, pp. 7-8)

With the opening of the new avenues of accessing finance through the international capital markets, the number of emerging market sovereign bond issuers have been on the rise;[19] evidently, therefore, they exhibit a greater amount of restructuring activity. Emerging market debt is actively traded: a leading industry association reported annual trading volume at over $5.5 trillion in 2005, slightly below the historic high of $6 trillion reached in 1997.[20] In addition, Catao and Kapur also mention that many emerging markets are more volatile than both their advanced counterparts and other developing country peers, and they tend to carry a higher default risk and face a lower credit ceiling.[21] It is in the light of these factors that this paper focuses on studying emerging market debt exchanges.

Due to lack of rich and comparable cross-country data, economists have faced some difficulty in proposing theoretical models to study the impact of public debt and develop sophisticated techniques to measure debt sustainability.[22] However, there has still been carried out some commendable empirical studies to study sovereign debt and its various features.[23] Some of these studies have been considered in this paper to understand the level of adverse effect, if any, on sovereign debt investors.

B. Managing Sovereign Default

Makipaa has categorised sovereign debt into four categories – debt owed to International Finance Institutions, bilateral loans to governmental creditors, commercial loans to banks and private loans owed to bondholders.[24] Emerging market debts studied in this paper are those which deal with multiple creditor classes including numerous private sector creditors (banks, bondholders, multilaterals, suppliers) in their portfolios. A sovereign generally issues its debt in the form of sovereign bonds. Such bonds, as opposed to municipal bonds or corporate bonds are issued by a national government. Default is sometimes referred to as such event in which the sovereign has insufficient assets to pay either the debt or any of its periodical payments of

[19] (Zazzarelli, et al. 2007, p.4) – Some of the identified sources of cross-country data on public debt mentioned by the authors are: the International Financial Statistics (IFS) published by the International Monetary Fund and the World Development Indicators (WDI) and Global Development Finance (GDF) published by the World Bank. Data on smaller set of countries are also available from the UN Economic Commission for Latin America (ECLAC) and from the Organization for Economic Cooperation and Development (OECD). The authors are quick to add, though, that all these sources present several important drawbacks.

[20] (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007, p.9).

[21] (Catão and Kapur 2004, p.25)

[22] (Cowan, et al. 2006, p.2).

[23] See generally: (Eichengreen and Mody, Would Collective Action Clauses Raise Borrowing Costs? July 5, 2000); (Becker, Richards and Thaicharoen 2003); (Gugiatti and Richards March 2003); (Dixon and Wall June 2000); (Jeanne and Zettelmeyer 2005); (Mauro, Sussman and Yafeh 2002); (Zhang 1999); (Lane and Phillips 2000); (Dell'Ariccia, Schnabel and Zettelmeyer 2000).

[24] (Makipaa 2003, p.7).

interest on the debt, or such an event where the debtors cash-flows or asset-liability ratio falls below a sustainable level, or a situation where any of the events defined as an 'event of default' has occurred.

Moody's defines both sovereign and corporate issuers as defaulting when either of the following happens:[25]

1. Issuer misses or delays disbursement of interest and/or principal.
2. A debt exchange is announced, where:
    a) The issuer offers bondholders a new security or package of securities that amounts to a diminished financial obligation such as new debt instruments with a lower coupon or par value; or
    b) The exchange had the apparent purpose of helping the borrower avoid a "stronger" event of default (such as a missed interest or principal payment).

According to Moody's, a sovereign default occurs whenever a country defaults on any of its bonds. Standard & Poor's (S&P) defines default as the failure of a borrower to meet principal or interest payment of its debt obligations on the due date.[26]

Sovereign defaults are rarely outright, and are usually a political decision, influenced by macroeconomic factors such as currency crisis, natural calamity or disaster, balance of payment, central bank reserves, etc.[27] When a sovereign defaults on its bonds, it is forced to restructure their debt whereby the debtor and the creditors agree to reduce (or postpone) the debt payments. See Table 2 below for a summary of some of the sovereign bond default volumes and probable circumstances surrounding the default.

Table 2: Chronological Summary of Sovereign Bond-Default Volumes and Circumstances Surrounding the Defaults [28]

Year	Country	Total Defaulted Debt ($ mn.)	Comments
Nov-98	Pakistan	$1,627	Pakistan missed an interest payment but cured the default subsequently within the grace period (within 4 days). Shortly, thereafter, it defaulted again and resolved that default via a distressed exchange which was completed in 1999.
Aug-98	Russia	$72,709	Missed payments first on local currency Treasury obligations. Later a debt service moratorium was extended to foreign currency obligations issued in Russia but mostly held by foreign investors.

[25] (Zazzarelli, et al. 2007, p.5).

[26] (Chambers and Alexeeva 2002).

[27] (Di April 2005, p.1).

[28] (Zazzarelli, et al. 2007) – Exhibit 7, p. 10.

			Subsequently, failed to pay principal on MINFIN III foreign currency bonds. Debts were restructured in Aug 1999 and Feb 2000.
Sep-98	Ukraine	$1,271	Moratorium on debt service for bearer bonds owned by anonymous entities. Only those entities willing to identify themselves and convert to local currency accounts were eligible for debt repayments, which amounted to a distressed exchange.
Jul-98	Venezuela	$270	Defaulted on domestic currency bonds in 1998, although the default was cured within a short period of time.
Aug-99	Ecuador	$6,604	Missed payment was followed by a distressed exchange; over 90% of bonds were restructured.
Sep-00	Peru	$4,870	Peru missed payment on its Brady Bonds but subsequently paid approximately $80 million in interest payments to cure the default, within a 30-day period.
Jan-00	Ukraine	$1,064	Defaulted on DM-denominated Eurobonds in Feb 2000 and defaulted on USD denominated bonds in Jan 2000. Offered to exchange bonds with longer term and lower coupon. The conversion was accepted by a majority of bondholders.
Nov-01	Argentina	$82,268	Declared it would miss payment on foreign debt in November 2001. Actual payment missed on Jan 3, 2002. Debt was restructured through a distressed exchange offering where the bondholders received haircuts of approximately 70%.
Jun-01	Moldova	$145	Missed payment on the bond in June 2001 but cured default shortly thereafter. Afterwards, it began gradually buying back its bonds, but in June 2002, after having bought back about 50% of its bonds, it defaulted again on remaining $70 million of its outstanding issue.
Apr-03	Uruguay	$5,744	Contagion from Argentina debt crisis in 2001 led to a currency crisis in Uruguay. To restore debt-sustainability, Uruguay completed a distressed exchange with bondholders that led to extension of maturity by five years.
Apr-05	Dominican Republic	$1,622	After several grace period defaults (missed payments cured within the grace period), the country executed an exchange offer in which old bonds were swapped for new bonds with a five-year maturity extension, but the same coupon and principal.
Dec-06	Belize	$242	Belize announced a distressed exchange of its external bonds for new bonds due in 2029 with a face value of U.S. $ 546.8. The new bonds are denominated in U.S. dollars and provide for step-up coupons that have been set at 4.25% per annum for the first three years after issuance. When the collective action clause in one of Belize's existing bonds is taken into account, the total amount covered by this financial restructuring represents 98.1% of the eligible claims.

As noted above, there is no international statute that is applicable to all sovereign defaults, unlike the various bankruptcy codes of several nations for corporate defaults.[29] There are quite a few instances where sovereign defaults were cured or averted through large-scale assistance from international financial institutions.[30] So far the prevalent method of sovereign debt defaults has been bail-outs by the international financial institutions (like IMF); but lender moral hazard was perceived as the undesired aspects of the system. To contain lender moral hazard, analysts suggested ''bailing-in'' or involving the private sector to bear part of the burden when countries encounter debt-servicing problems and approach the international financial institutions for assistance.[31] In this way reforms in the international financial architecture were brought about to debt managements. Proponents of debt buy-back, exchange offers and voluntary debt reductions methods argue that the benefit of this method is that debtors can improve their financial welfare and handle debt crisis by capturing a part of the discount at which their debt trades in the secondary market.[32] However, debt contracts specify payment schedules that might get difficult to honour *in toto*.

Three major approaches were put forward for sovereign debt restructuring:[33]

1. Establishment of a statutory framework for International Bankruptcy - This contemplates an internationally recognised statute in the form of 'Sovereign Debt Restructuring Mechanism' (SDRM) proposed by the International Monetary Fund (IMF).[34]
2. Voluntary & Contractual Arrangements such as Exchange offers, Collective action Clauses and other devices.[35]
3. A third proposal, from Kunibert Raffer, and others adapts U.S. sovereign bankruptcy laws, known as "Chapter 9", to the needs of developing countries.[36]

[29] A corporate debtor engaged in reorganization under the U.S. Bankruptcy Code can rely upon the feature of the Code that allows a qualified majority of creditors of a class to bind any dissenting members of that class. See U.S. Bankruptcy Code, 11 U.S.C. § 1129(b). Sovereign debtors, of course, do not have the benefit of a national bankruptcy codes.

[30] For example, Mexico was given a $50 billion loan from the United States Treasury, the International Monetary Fund (IMF), the Bank for International Settlements, and the Bank of Canada during the Mexican Peso crisis of 1994. Such a 'bailout' of private creditors by the official sector, though suboptimal in many respects, was seen as necessary in the absence of a viable alternative means of crisis resolution. (Haseler 2007).

[31] (Becker, Richards and Thaicharoen 2003, p. 128).

[32] (Acharya and Diwan 1989, p.1); (Drage and Hovaguimian 2004, p.3). See Table 3-A and 3-B above for data on governing law.

[33] (Dodd 2002, p.3).

[34] (Krueger 2002) .

[35] (Arora and Olivares-Caminal 2003).

[36] *Supra Note* 33.

This paper primarily focuses on the second approach that is the contractual methods of debt management by way of an exchange offer, where the sovereign debtor issues a new security laced with CACs, in exchange for existing bond instruments which have either defaulted, or which the issuer perceives definitely to default in the near future.

C. Exchange Offers & CACs

Most sovereign bonds issued by emerging markets follow either the New York law or the English law documentation.[37] (See Table 3-A and 3-B below). While bonds issued under English law usually had the opportunity to amend bond provisions with a majority voting system,[38] bonds governed under New York law would provide that payment terms of the bond can be amended only with the consent of each bondholder affected thereby.[39] Thus, a 100% unanimous consent was required to restructure key payment terms of a sovereign debt. This meant that when the bond issuer defaulted on its bonds, the actions of any one bondholder could dramatically affect the interests of all the other lenders.[40] Predictably, this was quite difficult to achieve and bond contract drafters sought for newer and easier methods to draft bond contracts to by-pass the unanimous consent requirement.

Table 3-A: Emerging market bond issuance by Currency and Governing Law, 1990 – August 2000 [41]

	Governing law											
Currency	England	New York	Japan	German	Luxembourg	Switzerland	Hong Kong	Austria	Spain	Italy	Other	Total
U.K. pound	17	2	0	0	0	0	0	0	0	0	0	19
U.S. dollar	752	812	0	3	8	0	5	0	0	0	60	1614
Japanese yen	94	11	249	0	2	0	0	0	0	0	0	355
Deutsche mark	27	5	0	142	9	0	0	0	0	0	0	182
Euro	79	23	0	42	6	0	0	0	0	3	1	152
Swiss franc	0	1	0	0	0	16	0	0	0	0	0	17
HK dollar	27	1	0	0	0	0	10	0	0	0	1	38
Austrian schilling	5	0	0	0	0	0	0	13	0	0	0	18
Spanish peseta	0	0	0	0	0	0	0	0	11	0	0	11
Italian lira	30	16	0	0	0	0	0	0	0	0	2	46
Total bonds	1031	871	249	187	25	16	15	13	11	3	64	2452

[37] (Becker, Richards and Thaicharoen 2003, p.130).

[38] (Bond and Eraslan 2005, p.1).

[39] This was the view held by issuers before 2003, when debts started to be issued under New York law with majority action provisions.

[40] (Chamberlin 2001, p.1).

[41] (Becker, Richards and Thaicharoen 2003, p. 132)

Table 3-B: Foreign Currency Sovereign Bond Issuance by Governing Law 1994-2004 ($ billion) [42]

Governing law	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004, to 30 Sept*
New York (with CACs)	13.1	7.1	21.3	22.0	18.0	22.2	34.7	37.2	36.3	46.7 (21.8)	33.4 (31.1)
English - with CACs	26.7	26.2	25.0	26.8	30.0	17.9	12.5	14.2	14.4	21.4	27.4
Italian	4.6	10.3	3.8	7.0	11.4	5.0	5.8	7.7	1.5	4.9	2.1
German	7.2	5.9	12.4	7.8	6.1	8.6	4.7	0.9	0.0	0.5	1.8
Japanese - with CACs	4.6	3.9	9.2	2.1	0.1	0.7	5.5	4.2	0.2	0.4	0.9
Swiss	0.2	1.2	1.2	0.7	1.4	0.1	0.6	0.4	0.1	0.4	1.6
Luxembourg - with CACs	0.3	0.3	0.1	0.5	1.7	0.3	0.0	0.0	0.0	0.0	0.0
Other *	3.9	4.8	7.2	7.3	10.8	2.5	0.0	0.4	1.0	0.4	7.2**
TOTAL	**60.7**	**59.9**	**80.3**	**74.1**	**79.6**	**57.4**	**63.7**	**64.9**	**53.4**	**74.7**	**74.4**
% of total with CACs	**52.1**	**50.8**	**42.7**	**39.6**	**40.0**	**33.0**	**28.1**	**28.2**	**27.3**	**58.4**	**79.8**
% of total issued under NY law	**21.7**	**11.9**	**26.6**	**29.7**	**22.6**	**38.7**	**54.4**	**57.3**	**67.9**	**62.5**	**44.9**

Source: Dealogic Bondware and IMF
* Other includes Austria, Canada, Colombia, Denmark, Finland, France, Greece, Korea, Netherlands, Portugal, Spain, and other US issues.
** Includes foreign currency issues by Denmark, Finland and Korea, and by some Canadian provinces and Crown corporations in their own legal jurisdictions.

Unanimity voting provisions make successful restructuring almost impossible and often hurtful to both the debtor and the creditor. To deal with the unanimous voting and 'bail-in' issues, debt swap or exchange offers offered a ready solution. In an exchange offer, or debt swap, an offer is made to the creditors of sovereign bonds to offer their old bonds to the issuer in return for restructured bonds usually with relaxed payment terms.[43] A restructured bond may include collective action clauses in order to ward off the problems of unanimous voting and hold-out creditors. Various exchange offers were made by sovereign issuers to restructure debt that had either already defaulted or were most likely to default. Countries like Argentina announced its exchange offer for its bonds in 2005, Mexico in Mexico, Brazil and Uruguay in 2003, Ukraine in 1999 and Ecuador in 2000.

There has been considerable debate over the use of CACs in bond contracts, which allow a qualifying majority of bondholders to agree to restructure the payment terms on their bonds.[44]

[42] (Drage and Hovaguimian 2004, p.3)

[43] Details of some successful exchange offers can be found at the following IMF documents: "Involving the Private Sector in the Resolution of Financial Crises – Restructuring International Sovereign Bonds", 11 January 2001 (Available at: www.imf.org/external/pubs/ft/series/03/ips.pdf. Last accessed Aug. 10, 2008.); "Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework", 1 August 2003 (Available at: www.imf.org/external/np/pdr/sdrm/2003/080103.pdf. Last accessed Aug. 10, 2008.).

[44] (Becker, Richards and Thaicharoen 2003, p.128).

This majority decision of amending bond terms ultimately become binding on dissenting bondholders. Analysts view CACs as a tool that could facilitate investor bail-ins in the future and reduce the need for bail-outs by international financial institutions, as also to make the entire restructuring mechanism more swift and orderly.

It has been argued that including CACs in a restructured bonds can benefit both lenders and borrowers since the value of a restructured bond is most likely to be greater than any amount that can be recovered from a defaulted sovereign, because it helps to increase the countries' output and makes more resources available to the debtor to service the debt. However, the benefits of the CACs have been viewed with quite some scepticism and it has been argued that this could lead to borrower moral hazard, which means the easier it is to restructure, the more will the borrower be prone to restructure or seek debt-reduction.

Further ahead we discuss the evolution and legal characteristics of collective action clauses used in sovereign debt exchange offers, the various provisions of a bond contract that CACs seek to amend and the implications of the same on investor value of their claim against the issuer.

II. COLLECTIVE ACTION CLAUSES

A. Tracing CACs in History

Even though the use of CACs for sovereign debt restructuring have been initiated fairly recently, such clauses empowering a majority members of a group to act on behalf of all the members have been in existence for a long time. Perhaps the prudence and efficiency of operation had necessitated collective decision making. Discussed below are some of the prominent proponents of CACs.

Palmer

The earliest use of CACs may be traced back to Francis B. Palmer in his book *Company Precedents* which is a collection of corporate form documents used in the courts of England & Wales.[45] Palmer recommended the use of such clauses in trust deeds and other documents of debentures and debenture stock, and grouped such clauses under the head 'power of majorities'.[46] He claimed that 'it was then a common practice to give power to a specified majority of the holders to sanction certain modifications of the rights of the (debenture) holders as a body', stating the object of the clause to 'protect the interest of the group against unreasonable conduct of the minorities and to prevent deadlock caused due to lack of unanimity which defeats a beneficial arrangement'.[47] In order to strike the importance of including the clause into corporate documents, Palmer wrote:

> "...indeed the draftsman who omits to insert [majority action] provision runs the risk of being accused of neglecting the best interests of the debenture or debenture stock holders."[48]

Palmer's majority action clauses must have caught up fast as he continues to rave about it in at least until the 8th edition of the book and it was also incorporated in commercial transactions as evidenced by the number of cases cited by Palmer where the clause was in question.[49]

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[45] (Buchheit and Gulati, Sovereign Bonds and the Collective Will 2002, p.1325).

[46] Palmer, Francis B. *Company Precedents.* Ed. 4th. Edited by Palmer, Francis B., assisted by C. Macnaghten. London: Stevens & Sons Ltd., 1922. p. 397. (As also mentioned in the later editions of the book.).

[47] Palmer, *Supra* 46, (12th Ed., p.152.).

[48] Palmer, *Supra* 47, p. 153.

[49] Palmer, *Supra* 47, pp. 150-160.

G-10 Working Group

Following an intense meeting of the Governors and Ministers of the G-10[50] in Halifax in 1995, a Working Group was formed to formulate policies for an orderly sovereign liquidity crisis so that the large scale rescue packages did not become a precursor to moral hazard. In 1996, the Working Group came out with a report, often referred to as the Rey Report'[51] which basically concluded that the best way to address the moral hazard issue was to make modest changes to the institutional framework (as against establishing an international sovereign bankruptcy court), but also recommended the use of majority voting clauses in international bond contracts.[52] The Rey Report recommended collective 'representation' clauses, to facilitate coordination, and qualified majority voting to by-pass the unanimity requirement to amend the bond terms.

Further, the G-10 Working Group on Contractual Clauses was formed in June 2002 in order to promote the development of suitable contractual provisions. This Working Group recommended that majority amendment clauses be included in sovereign bonds to permit a supermajority of bondholders to amend the payment terms of the bond.[53] The Working Group termed this clause as critical because it 'provide(d) flexibility in reaching agreement on the terms of a restructuring that debtors and creditors find to be in their collective interest'.[54]

John B Taylor

One of the earliest proponents of using majority action clauses in bond contracts have known to be John B. Taylor, then U.S. Under-Secretary of Treasury for International Affairs.[55] In his remarks, Taylor proposed a 'decentralized and market-oriented' approach in order to facilitate a more orderly and predictable debt restructuring.[56] He advocated the use of a super-majority strength of bondholders as against a unanimous decision making process prevalent in bond contracts.[57]

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[50] Consists of France, Germany, Belgium, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and Canada, with Switzerland playing a minor role. See http://www.bis.org/publ/g10.htm for more on G-10.

[51] After Jean-Jacques Rey of Belgium, who headed the G-10 Working Group in 1996.

[52] (G-10 1996, pp.15-17).

[53] (G-10:Working-Group 2002, p.3).

[54] *Supra Note* 53.

[55] (Andritzky 2006, p.66).

[56] (Taylor 2002).

[57] "Currently, the clauses in many bonds require the consent of 100 percent of bondholders to change the financial terms. ……. In contrast, majority action clauses allow a super-majority of bondholders holding, for example, 75 percent rather than 100 percent of the principal-to agree to a restructuring. The decision of this super majority is binding on the minority." (Taylor 2002).

Buchheit, Gulati, Eichengreen, Portes & others

The contribution of academics, economists, analysts and lawyers cannot be ignored when tracing the evolution of CACs. G. Mitu Gulati[58], along with Stephen Choi, Ashoka Mody[59], Anna Gelpern[60] and various others have also made significant academic contribution in analysing different aspects of CACs.[61] There has also been considerable debate among the IMF scholars, as can be seen by the number of academic papers published by IMF.[62]

Eichengreen and Portes have carried out several empirical studies to test the viability and effectiveness of CACs and advocate the use of CACs in all sovereign debt loan agreements and bond indentures.[63] The New York law firm - *Cleary Gottlieb Steen & Hamilton*, which handles a lot of sovereign clients and represented Mexico and Uruguay, have been instrumental in drafting these clauses in quite a few sovereign debt exchanges.[64] Lee C. Buchheit, a senior Partner at the firm have been a prolific advocate CACs and was among the first to urge the use of CACs and exit consents in sovereign debt restructuring.[65] Other prominent law firms involved in sovereign debt management have also made some significant contributions.[66] Gelpern also mentions the contribution of institutional investors and trade associations for the role they played in augmenting the CACs cause.[67]

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[58] Professor of Law, Georgetown Law Center.

[59] International Monetary Fund.

[60] International Affairs Fellow, Council on Foreign Relations, Washington D.C.

[61] See generally: (Becker, Richards and Thaicharoen 2003); (Choi and Gulati 2004); (L. C. Buchheit, Choice of Law Clauses and Regulatory Statutes 1996); (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007).

[62] See generally: (Krueger 2002); (Kletzer December 2002); (F. Gianviti 2002). "Collective action clauses can make a useful contribution to the resolution of debt problems, ……. The international community has been urging emerging market countries to adopt collective action clauses for the past five years, with very limited success." Anne Krueger, First Deputy Managing Director, International Monetary Fund, Conference on "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics; Washington DC, April 1, 2002 (Available At: http://www.imf.org/external/np/speeches/2002/040102.htm. Last accessed Aug. 10, 2008).

[63] See generally: (Eichengreen, Toward a New International Financial Architecture - A Practical Post-Asia Agenda 1999); (Eichengreen and Portes, Debt & Default in the 1930s: Causes & Consequences 1986); (Eichengreen and Mody, Would Collective Action Clauses Raise Borrowing Costs? July 5, 2000); Eichengreen, Barry and Richard Portes, "Crisis? What crisis? Orderly Workouts for Sovereign Debtors" *Center for Econ Policy Res*, 109-10 (1995).

[64] (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007, p.20).

[65] See generally: (L. C. Buchheit, The Collective Representation Clause 1998); (L. C. Buchheit, How Ecuador Escaped the Brady Bond Trap Dec. 2000); (Buchheit and Gulati, Sovereign Bonds and the Collective Will 2002); (Buchheit and Gulati, Exit Consents in Sovereign Bond Exchanges 2000); (Breaking The Mold 2005), p.23).

[66] Sullivan & Cromwell LLP, *First Use of Collective Action Clauses* (2003), (Available at: http://www.sullcrom.com/practice/servicedetail.aspx?firmService=21&pdText=PDInfoText3&pdname=LR021969. Last accessed Aug. 10, 2008); Arnold & Porter LLP, *Firm Advises Brazil on Innovative $1 Billion Global Bond Issue* (May 2003), (Available at: http://www.arnoldporter.com/case.cfm?publication_ID=743. Last accessed Aug. 10, 2008) - See (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007, FN 89).

[67] *Supra Note* 64, p. 21.

B. Including CACs in Sovereign Bonds

Majority of sovereign bonds issued under New York law contained a unanimous voting provision, where changes to crucial financial terms of the bonds could not be made without unanimous consent. With frequent defaults and credibility of sovereign borrowers taking a hit, obtaining a unanimous consent was almost impossible to obtain. The fact that bondholders were widely dispersed across the globe and communication with each individual bondholder was extremely difficult did not help much. Also, the bondholders of a single issue could be a heterogeneous group, consisting of people with varied aspirations and financial plans and not everyone could comfortably accept a restructuring plan. Compounded with these is the problem of opportunism where some bondholders may elect to withhold their consent to gain a bargaining high-position, which could be likened to the classic prisoner's dilemma.[68]

Sovereign borrowers issuing bonds governed by English and Japanese law have been known to contain majority restructuring provisions which enable a qualified majority of bondholders to modify key financial terms, and to make that decision binding on all holders of a given bond issue.[69] Such majority amendment provisions are not common in bonds governed by German law, and until recently they were generally not found in bonds governed by New York law. Whereas until 1994 the number of sovereign bonds issued with CACs governed by English law far exceeded those under New York law, but by 2004 bonds under New York law were much more than those under English law.[70] Eichengreen, Gelpern and Gulati do acknowledge that CACs had previously been used by other countries, but since they were either not large enough or they were privately placed under Rule 144A and exempted from registration with the SEC,[71] that not much hype was created around them.[72] However, in 2003, Mexico issued its bonds under the New York law which contained CACs and has since attracted a lot of attention for discussion.

'CACs are clauses in individual loan agreements and bond indentures that enable, typically, a supermajority of creditors (that is, some percentage of creditors higher than a simple majority greater than 50%) who are parties to any such contract, to modify essential terms, such as the amount of principal owed, the interest rate thereon, and maturities.'[73] Including a

[68] (Haseler 2007, p.3).

[69] (Eichengreen, Kletzer and Mody, Crisis Resolution: Next Steps 2003, p.1, FN 2).

[70] See Table 3-B: Foreign currency Sovereign Bond Issuance by Governing Law 1994-2004.

[71] (Guira 1999, p.438).

[72] Lebanon and Qatar in 2000 and Egypt in 2001 (Eichengreen, Kletzer and Mody, Crisis Resolution: Next Steps 2003, p.1, FN.3); Bulgaria, Kazakhstan, Egypt, Lebanon and Qatar (Gelpern and Gulati, Public Symbol in Private Contract - A Case Study 2007).

[73] Steven L. Schwarcz, 85 Cornell L Rev 956, 1014 (2000).

majority enforcement provision in the bond contract provides crucial time and opportunity to the debtor to seek more creditor cooperation when a qualified majority of bondholders are able to limit the minority's ability to enforce their claims against the default of the bonds. Various commentators, analysts and policy-makers advocate the use of CACs for sovereign borrowers who issue debt in international financial markets in the form of bond indentures.[74]

Some of the basic objectives of the growth and adoption of CACs in sovereign bond contracts, as also identified by the G-10 working group[75], are: to encourage coordination, negotiation, dialogue and communication among the creditors and the debtor; to effectively handle hold-out minority creditors who may block the entire transaction by choosing not to participate; and to thwart legal enforcement actions by the hold-out creditors so that the restructuring may take place without detrimental litigation.[76] Proponents of CACs have pointed out the various benefits of including such majority action provisions in sovereign bond contracts so that they facilitate bond restructurings. Some of them are listed below:[77]

- The issuer has more flexibility in managing its crisis by modifying payment dates, amounts and interest rates, and thus avoid being forced to announce an exchange offer;
- Provides collective representation to bondholders in case of a crisis. This is crucial since all bondholders may not be able to attend a joint meeting for several reasons, and their absence would not hold up the proceedings;
- The issuer is in a better position to manage hold-out or rogue creditors who may not be willing to participate and may disrupt the whole proceeding;
- Since CACs have the ability to bind all bondholders with the decision of the supermajority, the requirement of seeking individual consent from all bondholders is dispensed with;
- Restructurings can be carried out both before and after default;
- Protects the issuer from legal action of creditors who may wish to enforce their claim against the bond in a court of law;
- Allows a qualified majority to vote for altering or amending the terms of the bonds to suit particular crisis situations.

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[74] (Buchheit and Gulati, Sovereign Bonds and the Collective Will 2002); (Eichengreen, Toward a New International Financial Architecture - A Practical Post-Asia Agenda 1999, pp. 65-70); (Ahdieh 2004); (Taylor 2002); (Krueger 2002); (G-10:Working-Group 2002); Christopher Greenwood and Hugh Mercer in Barry Eichengreen and Richard Portes, "Crisis? What crisis? Orderly Workouts for Sovereign Debtors", *Center for Econ Policy Res* 109-10 (1995) p.103.

[75] (Drage and Hovaguimian 2004, p.1); (L. C. Buchheit, The Collective Representation Clause 1998, p.11).

[76] For a discussion on holdout creditors, see generally - (Schwarcz, "Idiot's Guide" to Sovereign Debt Restructuring February 2004); Kentaro Tamura, "The Problem of Sovereign Debt Restructuring: How Can We Deal with Holdout Problem Legally?" *Harvard Law School, International Finance Seminar*, Professors Hal Scott and Howell Jackson, April30, 2002.

[77] Discussed variously in: (Geithner, Gianviti and Häusler 2002); (L. C. Buchheit, Sovereign Debtors and Their Bondholders 2000).

- If a debt restructuring using CACs can be carried out swiftly, it may be able to limit the contagion effect.[78]

C. Bond Indenture Provisions Covered Under CACs

Majority Restructuring or Majority Action Provisions

A majority action provision entitles a defined supermajority of bondholders to change the payment terms of the bond and make it binding for all bondholders. These provisions also have the capacity to regulate the decision making process of the bondholder community, like conduct of meetings, quorum requirement for meetings, voting threshold to carry out an amendment in the bond terms.[79] They may also provide that the issuer may restructure the entire bond issue by carrying out an exchange offer.

Majority Enforcement or Non-Acceleration Provisions

Such clauses authorise the supermajority bondholders to make changes in the terms of multiple bond issues of the same sovereign floating in the market, which may be crucial for the issuer from restructuring point of view, such as calling of meetings, acceleration clause, rescission of acceleration, sharing clause, negative pledge, disenfranchisement, delisting of the bond from stock exchange, waiver of sovereign immunity, waiver of legal enforcement of bondholder claims, aggregation, collective representation modes, etc. This helps in containing the cross-acceleration problem, since restructuring proposal of one bond may amount to default in another. All these changes brought about have the potential to discourage hold out creditors and other bondholders to impede the restructuring process.

Majority Amendment Clause

Sovereign issuers carrying out bond exchanges have chosen different threshold levels regulating voting parameters. Most of them have chosen a 66⅔% of the principal outstanding amount as the voting threshold to alter non-payment terms, and 75% (G-10 recommendation) for payment terms. Crucial matters related to bond indenture have been categorised under 'reserve matters' requiring the higher supermajority threshold. Sovereign issuers with sub-investment grade ratings have prescribed a higher threshold of 85% in order to build investor confidence.[80] See Table 4 below for a summary of features of the bonds issued by Mexico (2003), Brazil (2003), Argentina (2005) and Uruguay (2003).

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[78] (Sean 2005, p.13).

[79] (Haseler 2007, p.5).

[80] Belize, Brazil, Guatemala and Venezuela: (Drage and Hovaguimian 2004, p.4).

Table 4. Summary of Key Features of Sovereign Bonds: [81]

Features	*MEXICO*	*BRAZIL*	*ARGENTINA*	*URUGUAY*
Timing of Restructuring	February 2003	April 2003	Dec 2004-Jan 2005	April-May 2003
Offer Period	Fresh Issuance	Fresh Issuance	47 days (Jan 10, 2005 to Feb 25, 2005)	35 days (April 10, 2003 to May 15, 2003)
Bonds Restructured	US $1,000,000,000 6.625% Global Notes due 2015 for U.S. $30,000,000,000 Global Medium-Term Notes, Series A Due 2003.*	US$1,000,000,000, 10% Global Bonds due 2007. *	152 series of Bonds (worth approx. US$ 95 million) exchanged for different Bonds of 4 Series.*	15 series of Bonds including 3 benchmark Bonds exchanged for Different Bonds of 18 Series.*
Participation Result	Fresh Issuance	Fresh Issuance	76.15%[82]	93%[83]
Exit Consents	Yes	Yes	Yes	Yes
Aggregation	No	No	Yes	Yes
CACs Included	Yes	Yes	Yes	Yes
Permanent bondholders' representative (trustee or other)	No – fiscal agent	No – fiscal agent	Yes - Trustee	Yes - Trustee
Governing Law / Jurisdiction	New York, USA.	New York, USA.	New York, USA.	New York, USA.
Waiver of Sovereign Immunity	Yes, but exceptions included.[84]	Has not agreed to waive any defense of sovereign immunity to which it may be entitled in any action other than its immunity from jurisdiction in an action to recognize an arbitral award or in an action brought in Brazil.[85]	Yes, but with certain important exception.[86]	Will not waive immunity from attachment prior to judgment and attachment in aid of execution under Uruguayan law. Agrees that this waiver shall be to the fullest extent permitted under the United States Foreign Sovereign Immunities Act of

[81] Compiled variously from: Offer Documents of United Mexican States, Federative Republic of Brazil, The Republic of Argentina and República Oriental del Uruguay (on record with the author); (Drage and Hovaguimian 2004, pp.15-28, App.A); (Gelpern, How Collective Action is Changing Sovereign Debt 2003, p.22).

* For details, please see Prospectus/Offer Documents.

[82] (Gomez-Giglio 2005, p.345).

[83] (Scott 2006, p.4); (Buchheit and Pam, Uruguay's Innovations 2004).

[84] United Mexican States, Prospectus Supplement (To prospectus dated December 4, 2002), p. 12.

[85] Federative Republic of Brazil, Prospectus Supplement (To prospectus dated February 12, 2002), p.74.

[86] The Republic of Argentina, Prospectus Supplement (to Prospectus Dated December 27, 2004s), p.201.

				1976 and is intended to be irrevocable for purposes of that law.[87]
Voting	…with the affirmative vote (or written consent) of the holders of not less than 66⅔% of the outstanding principal amount of the debt securities of a series that are represented at a meeting For reserve matter – 75% (aggregate).	…Brazil may amend certain key terms of the global bonds, including the maturity date, interest rate and other payment terms, with the consent of the holders of not less than 85% of the aggregate principal amount of the outstanding global bonds.[88]	…with the affirmative vote (or written consent) of the holders of not less than 66⅔% of the outstanding principal amount of the debt securities of a series that are represented at a meeting For reserve matter – 85% (aggregate); and 66⅔% (of that series individually)	….modifications affecting the reserve matters may be made to a single series of debt securities issued under the indenture with the consent of the holders of 75% of the aggregate principal amount outstanding of that series Where Uruguay proposes an amendment to the indenture: 85% (aggregate); and 66⅔% (of that series individually).
Quorum for Meetings	Simple majority of holders of aggregate principal amount (for matters other than reserve matters). For reserve matters – 75%.	Simple majority of holders of aggregate principal amount.	Simple majority of holders of aggregate principal amount (for matters other than reserve matters). 75% for reserve matters.	Simple majority of holders of aggregate principal amount (for matters other than reserve matters). 75% for reserve matters.
Events of Default (*inter alia*)	Non-payment of 30 days, breach of other obligations and not acting within 30 days of notification by any bondholder, cross default with external debt, moratorium on external debt.	Non-payment of 30 days, breach of other obligations and not acting within 30 days of notification by any bondholder, cross default with external debt, moratorium on external debt.	Non-payment of 30 days, Cross Default, Moratorium, Breach of other obligations, validity,	Non-payment of 30 days, breach of other obligations of 60 days, cross default, moratorium, end of IMF membership and more.
Reserved matters[89]:	Yes.	Yes	Yes	Yes. Also adds that if a

[87] República Oriental del Uruguay, Prospectus dated April 10, 2003, p.85.

[88] *Supra Note* **Error! Bookmark not defined.**, p.S-5

[89] Includes: i) change the payment date; (ii) reduce the principal amount; (iii) reduce the portion of the principal amount due in the event of an acceleration; (iv) reduce the interest rate; (v) change the currency or place of payment; (vi) change the obligation of the issuer to pay additional amounts, (vii) change the definition of outstanding or reduce the voting requirements; (viii) authorize the permanent representative to exchange the bonds; (ix) instruct the permanent representative to settle or compromise any proceeding; (x) give to any person the exclusive right to enforce any provision; or (xi) appoint a negotiating representative for any proposed restructuring of the bonds; (xii)governing law, (xiii) jurisdiction, status; (xiv) (pari passu); (xv) events of default.

				change to a reserved matter is sought as part of exchange then terms must not be less favourable than those of new notes (i.e. restriction on use of exit consents).
Majority action provisions for amendments to non-reserved matters	Yes	Yes	Yes	Yes – aggregation clause also added.
Acceleration	Yes	Yes	Yes	Yes – allows individual action if trustee fails to act within 60 days of instruction.
Rescission of acceleration (provided default is cured)	Yes - 50+% can agree if default is remedied.	Yes – 66⅔% can agree if default is remedied.	Yes – 50+% can agree if default is remedied.	Yes – 66⅔% can agree, also specifies some requirements for remedy of default.
Agents	Citibank N.A.; Kredietbank S.A. Luxembourgeoise (Luxembourg Paying and Transfer Agent).	J.P.Morgan Chase Bank; J.P. Morgan Bank Luxembourg S.A. (Luxembourg Listing Agent)	The Bank of New York; Georgeson Shareholder Communications Inc. (information agent); Kredietbank S.A. Luxembourgeoise (Luxembourg listing agent)	Citibank, N.A.; The Bank of New York
Stock Exchange Listing	Luxembourg	Luxembourg	Luxembourg	Luxembourg

III. BONDHOLDER CONCERNS WITH CACs

The incentives for individual investors to decide whether to participate in a restructuring, or to hold out in the hope of receiving more favourable terms, clearly depend on an evaluation of the extent to which a proposed deal protects their individual interests, and the likely payoffs of the alternative strategies in each case.[90] While exchange offers including CACs may provide one of the remedies to collective representation issue of sovereign debt crisis management, it does have its disadvantages. Issuers making proposals of exchange offers not only have to keep in mind the probability of success of the proposal; they also have to consider the factor of creditworthiness for future borrowing from public sources. Inclusion of CACs has significant protection against maverick hold-out and litigating creditors, but consenting creditors might view it as a disincentive if the terms of a restructured bond are too favourable to the issuer. A sovereign issuer thus has to maintain a balance between the two in order to achieve highest participation and retain their creditworthiness.

Buchheit & Gulati have discussed some of the important disadvantages of including CACs in a bond contract.[91]

1. CACs may be included only in new issues or by way of an exchange offer, as most existing bonds do not have such provisions.
2. Even though the CACs have sought to eliminate the unanimous voting requirement, it still requires a supermajority and a group of dissenting creditors may still acquire a blocking holding to manipulate the issuer.
3. Each bond issue has a separate group of creditors, and CACs in a particular contract can only cater to the creditors of that contract. Thus, for a comprehensive exchange offer where the entire debt obligation of the state is sought to be restructured, the sovereign effectively needs to appeal to each bondholder separately.[92]
4. Since bonds are issued in different jurisdictions and currencies,[93] creditors of different jurisdictions may not respond to the bond terms offered in the exchange offer.
5. Even though a supermajority assigned for voting procedures of restructured bonds may preclude hold-out creditors from stopping a restructuring, their claims against the sovereign for the old securities that they retain, continue to remain and the sovereign is obliged to honour them sooner or later.
6. Non-participation may not necessarily be due to deliberate holding out, but may also be due to miscommunication, creditor apathy or sheer inertia. By excluding all non-participating creditors, the debtor may be inclined to deliberately to ignore those creditors who could not participate for genuine reasons.

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[90] (F. Gianviti 2002, p.7).

[91] (Buchheit and Gulati, Sovereign Bonds and the Collective Will 2002).

[92] Unless an aggregation method is adopted, as in the case of Uruguay and Argentina.

[93] Prominent in the case of Argentina.

7. There is a general perception that it might take time for the market to fully accept the new provisions, and the first issuer might be charged a higher spread, the so called 'first mover' problem.

A. The Number Game

Even though the issuer may have assigned a supermajority threshold to cram down on dissenting creditors, this does not necessarily imply that the decision has a majority representation. The different percentages employed while using CACs in an exchange offer are:

1. Quorum requirement for general bondholder meetings – (usually a simple majority above 50%; 75% for reserve matters);[94]
2. Second quorum requirement for an adjourned meeting (25% - e.g. Argentina)
3. Voting for ordinary matters (usually 66⅔ %);
4. Voting for reserve matters (75% - 85%);
5. Dual voting thresholds for certain matters (for example - 85% of the holders of aggregate principal amount , as well as 66⅔ % of the holders of that particular series - Uruguay);
6. Voting for accelerating the bond on default (25%);
7. Voting for rescission of acceleration on default (usually 50%);
8. Minimum representation required to initiate legal proceedings against the issuer through a trustee (where there is a trustee as a permanent bondholder representative);

Even if the technical number requirements are met, there is no guarantee that the decision taken will have majority consent. For example, a vote in an adjourned meeting, where only 30% of the bondholders were present will be a valid resolution even though it has marginal representation. Further, it is quite possible that few institutional investors own the supermajority fraction of bonds and a bilateral negotiation with the issuer may wean them into agreement, whereas a large number of scattered individual creditors may not be able to make their voices heard because they are scattered, unorganised and singularly consider themselves incapable of making a visible difference. This raises important question regarding proportional representation while employing CACs. Consider, also, that there is no uniformity in the international financial architecture about the voting thresholds employed by sovereign issuers in debt exchanges.

B. Exit Consent

Exit consent is the novel feature of debt exchanges and were used in various sovereign debt restructuring.[95] While tendering their old bonds in exchange for new bonds, the existing bondholders give their consent to amend key terms of the old bonds that they would be exiting

[94] **Mexico** (2003): simple majority + 75% for reserve matters; **Brazil** (2003): simple majority; **Argentina** (2005): simple majority + 75% for reserve matters; **Uruguay** (2003): simple majority + 75% for reserve matters.

[95] See (Buchheit and Gulati, Exit Consents in Sovereign Bond Exchanges 2000). Mexico, Brazil, Argentina and Uruguay have all used exit consents in their restructured bond contracts. Some people claim that Buchheit is the father of 'Exit Consents'.

(hence the term 'exit consent'). This type of consent becomes crucial for an issuer to amend terms of the old bonds where the existing bond contract requires unanimous consent for amendment. With the help of exit consents, the issuer may amend key terms of the old bonds – like governing law, delisting from stock exchange, jurisdiction to domestic courts of the issuer, etc. – to render the old bonds commercially unattractive to hold-out creditors. Creditors participating in the exchange offer will be more inclined to give their consent to exit amendments since hold-out creditors are as much threat to the consenting creditors as to the issuer, since they may hold the entire restructuring process at ransom.[96]

Exit consents/amendments have been challenged on their legal as well as moral grounds. One of the criticisms is that it amounts to implicit coercion, insofar as any creditor who is unsure of participating will definitely be intimated at the prospect of being left with the old bond stripped of most of commercial value. Secondly, the fact that the consent was being given by creditors who are actually not going to remain party to the contract, and thus affect the rights of those who will continue to hold the old bonds, could amount to tortious liability on the consenting creditors interfering with the rights of their brethren.[97] Furthermore, could one infer any implied duty of one bondholder towards another, where the action of one might affect the rights of the other?

Buchheit answers all these questions to argue that the exit consents successfully withstand these legal challenges.[98] He cites the judicial pronouncements in *Katz v. Oak Industries, Inc.*[99] and *Kass v. Eastern Airlines*[100] and makes the point that there is no fiduciary duty between the debtor and the creditors since the relationship was contractual; and that incentivising the consenting bondholders, or threatening the dissenting ones, with exit amendments does not amount to coercion. He also argues that it would be extremely difficult for dissenting bondholders to prove a claim based on tort, as also to prove that the consenting bondholders had any implied liability towards the dissenting ones.

Although Buchheit makes very strong points establishing the legal validity of exit amendments, but one wonders what then happens to the claims of the non-participating bondholders! The judicial pronouncements he cites in favour of his arguments, besides being more than two decades old, relate to corporate restructurings. It is yet to be seen if these arguments would hold good in a proceeding brought about by a dissenting sovereign

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[96] An exit consent clause employed in the Belize (2007) exchange offer: "***Consent to Amendments:*** *By tendering an Eligible Claim outstanding under Bear Stearns 9.75% Notes due 2015, each holder thereof will irrevocably consent to amendments to the Bear Stearns 9.75% Notes due 2015 that would have the effect of conforming the maturity date and interest rate, and making certain related amendments to the Bear Stearns 9.75% Notes due 2015. If the voting requirements under this series are met, the amendments to the series will take effect at the closing of the Offer on the Closing Date.*" Belize - Offering Memorandum, p. 26.

[97] (Buchheit and Gulati, Exit Consents in Sovereign Bond Exchanges 2000, p.9).

[98] *Supra Note* 97, p.13.

[99] 508 A.2d 873 (Del. Ch. 1986).

[100] 12 DEL. J. CORP. L. 1074 (1986).

bondholder. The factor of coercing dissenting bondholders using exit consents has the effect of impairing their legal rights since they would not have many viable alternatives left if they did not participate. Once the bond is successfully restructured, it is most likely to lose its commercial value, besides the limited scope of outcome from litigation against the sovereign issuer. Also, with such a strong legal instrument in the hands of sovereign borrowers, the problem of debtor moral hazard is bound to escalate.

C. Aggregation

Although carrying out an exchange offer might sound simple, but it gets more complicated when a sovereign has multiple bond instruments floating in the market. Even when the issuer is able to convince the creditors of one of the issue to agree to the restructuring, a group of creditor might still be able to acquire a holding position in some other issue of the same sovereign. With aggregation this problem could be taken care of. The issuer with multiple issues outstanding restructures all the bonds together. In this way even if one of the bond issue does not receive the require participating percentage, there is a good chance that the restructure may go through successfully if the issuer is able to achieve the participating percentage in aggregate in all the bonds being restructured together.[101] Aggregation has a dual benefit for the issuer – not only does it help in managing the threshold requirements, but also makes it difficult for hold-out creditors to acquire a blocking position. Aggregation is a useful innovation used in the Uruguay restructuring.

Due to aggregation, the hold-outs will now have to acquire a blocking percentage of the aggregate of the all the issues being restructured in order to impede the proposal. Even if it were to acquire a blocking position in one series, it would still not be able to stop the participating bondholders from changing their instruments.[102] Ukraine, Argentina and Uruguay successfully employed the aggregation method to restructure their bonds. It is still to be seen if aggregation could be used to restructure bonds issued simultaneously in different jurisdictions. In Uruguay's case, the aggregation voting threshold was 85%, and a blocking position could be created only by acquiring 15% of the all the issues. This is still difficult to achieve as against acquiring 25% of a single series if the threshold was 75%. In effect aggregation could prove to be another potent tool in the hands of the issuer to consolidate all its outstanding debts and restructure them in one fell swoop. This diminishes the scope of individual bondholder's right to stake its claim and make its voice heard during a massive aggregate restructuring. There have also been suggestions that debtors have to offer higher spreads where they have larger amount of multiple issues outstanding.[103]

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[101] See (Gelpern, How Collective Action is Changing Sovereign Debt 2003, p.20) for an example of aggregation.

[102] (F. Gianviti 2002, p.9).

[103] See: Eichengreen, Barry & Ashoka Mody "Is Aggregation a Problem for Sovereign Debt Restructuring?" *AEA Papers and Proceedings*, May 2003, pp. 80-84.

D. Governing Law

The law under which the bond contract is governed is another important factor having commercial implications. The governing law clause implies submission of the debtor to the jurisdiction of the courts of the country whose laws govern the contract. Bonds governed under English and New York law are the most widely used since the interpretation of international financial agreements are remarkably similar and most standard credit agreements will be enforceable under the laws of either place.[104] These two jurisdictions have created a reputation in the international financial system by following a rich system of judicial precedents and a robust judicial system.[105]

Most sovereign bonds are issued under either English Law or New York Law.[106] However, upon restructuring, a sovereign issuer might amend the governing law provision to subject the bond contract to its domestic jurisdiction. If a borrower is not domiciled in the country of the law governing the agreement it has to appoint an agent in the relevant jurisdiction to carry out the legal proceedings on its behalf. This procedure can be a tedious and time consuming affair. Furthermore, it can prove quite daunting to obtain a judgment against a country in its domestic courts.

E. Disenfranchisement

One of the amendments that may be brought about in the restructured bond is disenfranchisement. This disentitles a group of bonds from consideration for voting and quorum purposes where those bonds are owned or controlled directly or indirectly by the issuer or its public sector instrumentalities. Mexico included the disenfranchisement provision in its 2003 restructuring. This feature has been widely adopted, albeit with a variation in language by introducing 'direct or indirect' control.[107] The Argentine restructuring was carried out effectively much below the 75% threshold because a major portion of the Argentine domestic debt was held by state owned-controlled entities. This has the effect of considerably lowering the voting thresholds thereby increasing the debtor's incentive to control maximum number of bonds to contain hold-out problems.[108] The acceptance rate also becomes substantially below the effective rate of the prescribed threshold due to the manipulation of CACs included.

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[104] (L. C. Buchheit, Choice of Law Clauses and Regulatory Statutes 1996).

[105] *Supra Note* 104.

[106] All four sovereigns – Mexico, Brazil, Argentina and Uruguay, as well as those of Belize, Ecuador and Peru – have issued bonds which are governed by New York Laws; whereas the Russian bonds are governed by English laws.

[107] (Drage and Hovaguimian 2004, p.5)

[108] (Scott 2006, p.4)

F. Signalling Costs

Inclusion of CACs is a fairly recent phenomenon and has not received a wide acceptance world over. Introducing such provisions in jurisdictions which have not seen such provisions might send a wrong signal to the market indicating that the issuer already contemplates defaulting on its debt obligations in the future. This may increase the cost of issuing new debt with CACs.

G. Acceleration and Rescission of Acceleration

Acceleration is a contractual remedy that allows a creditor to declare the full outstanding amount of the bond due and payable upon occurrence of an event of default.[109] Restructured bonds may provide this mandate to accelerate a bond upon a default upon a collective vote of a prescribed percentage of the creditors.[110] Allowing a qualified majority to restrain the ability of a small group of bondholders to accelerate is important particularly when an event of default is triggered by the cross-default provision.[111] If the bonds are issued under a trust structure, as in the case of Argentina and Uruguay, the trustee has the considerable discretion to accelerate the entire issue on behalf of the bondholders in addition to being required to accelerate upon a collective vote.

A requisite percentage of creditors also have the option of reversing the acceleration thus induced upon default. Mexico had prescribed a simple percentage of more than 50%, Brazil - 66⅔%, Argentina – more than 50% and Uruguay - 66⅔%, as the number of creditors who could rescind the acceleration if the default was remedied within a stipulated time. In essence, therefore, the ability to of a collection of bondholder to rescind the acceleration could be of tactical importance to a sovereign in a restructuring. For instance, Ecuador was able to reverse the acceleration of its long-term bonds by paying interest arrears on its old bonds, thus curing the default and eliminating the risk of litigation. [112]

If the issuer were able to amend these clauses in the restructured bond, and manipulate the prescribed majorities required for acceleration and rescission of the acceleration, the bondholders negotiating capacity could be considerably diminished. Some of the jurisdictions like English law, German law and Japanese law do not contain a de-acceleration provision in the (corporate) bonds governed under these laws. [113]

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[109] (Liu 2002, p.9)

[110] (G-10:Working-Group 2002, p.6)

[111] *Supra Note* 109.

[112] (Geithner, Gianviti and Häusler 2002, p.3).

[113] *Supra Note* 109, pp. 9-10.

H. Legal Action

In its restructuring, Mexico and Brazil have employed a fiscal agent, whereas Argentina and Uruguay issued their bonds with a trustee as a permanent bondholder representative. This has an important impact on the non-participating bondholders' right to accelerate the bond in the event of the sovereign's defaults. Under a fiscal agency system, each individual bondholder has a right to enforce his claim and seek payment that is due, if the sovereign defaults. However, under a trust structure, the bondholder's right to enforce his claim is effectively delegated to the trustee.[114] Furthermore, in order that the trustee initiates legal action against the debtor, a certain percentage of bondholders, as prescribed in the contract, must apply to the trustee.[115]

Issuers include a provision in the exchange offer whereby participating bondholders waive their rights to bring about any legal action for their claims against the sovereign issuer. Bringing out legal enforcement against the issuer may be a major impediment for a restructuring procedure, as was witnessed by the famous hold out cases against Peru.[116] 'The New York Court of Appeals in *Pravin Banker Assocs*. balanced two principles to determine whether the court should decide in favour of the creditors who had a rightful claim or for the new international financial architecture being drawn by the restructuring process of Peru's outstanding debts.[117] In another similar case, of *Elliott Assocs.*, the court of appeals balanced similar issues and believed that investor protection was a stronger priority.[118] By asking participating bondholders to surrender their legal claims against the issuer, the debtor categorically stymies any opportunity of a bondholder to seek legal protection if later on it is discovered that the interests of the bondholders have been significantly hampered, or the deal was mismanaged in some way.

I. Sharing Clause

One of the recommendations of the G-10 Working group was to include a sharing clause whereby the litigation recovery proceeds of a successful hold-out creditor would be shared *pro-rata* by all the bondholders. [119] Usually bonds are issued under a trust indenture where the trustee is a permanent bondholder representative, and all claims in a court of law have to be initiated through the trustee and claim proceeds are then entrusted to the trustee who distributes it to the other bondholders. This means that even if any one or a small group of

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[114] *Id.*

[115] Typically 20-25 % bondholders, employed by both Argentina and Uruguay.

[116] See generally: *Pravin Banker Assocs. v. Banco Popular del Peru*, 109 F.3d 850 (2d Cir. 1997); *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363 (2d Cir.1999).

[117] (Garcia-Hamilton, Olivares-Caminal and Zenarruza 2005, p.104).

[118] *Id.*

[119] (G-10:Working-Group 2002, p.2).

bondholders were to successful in their claim against their issuer, the proceeds of the judgement would be shared by all the existing bondholders, hence reducing the incentive of that individual or that group of bondholders to invest in the law-suit all alone.

J. Empirical Studies

Sovereign defaults and debt restructuring are costly affairs and have caused enormous losses to investors. The Argentine debt default of December 2001 was heralded as one of the largest sovereign default in history. By the time of the 2005 debt restructuring, the default involved more than $100 billion of privately held debt ($81.8 billion in principal plus $20 billion in past due interest) in the form of 152 different bonds. Bondholders in Italy held $15.6 billion, the U.S. $9.1 billion, and Japan $3.1 billion.[120] A substantial portion of the Argentine debt was retail, by one estimate 44%, held principally by individuals in Italy and Germany.[121] Investor losses amounted to $67 billion for those who accepted the restructuring and about $30 billion for those who did not (since they could remain unpaid indefinitely); in total there was a loss of $97 billion of public money.[122] Estimated haircut in the Ecuadorian restructuring was about 40%.[123] The Uruguay 2003 exchange targeted all its traded debt, which comprised almost its entire sovereign debt portfolio. The securities eligible for exchange comprised 46 domestically issued bonds and treasury bills, accounting for US$ 1.6 billion in principal; 18 international bonds, accounting for US$ 3.5 billion; and one ‘‘Samurai’’ bond issued in Japan, accounting for about US$ 250 million.[124] The average net present value loss in the Uruguay restructuring was 13%.[125] The Russian restructuring of 1999-2000 witnessed about 50-60% average net present value haircut.[126] Considering the amount of investor losses, serious empirical studies is required to estimate the economical impact of including CACs in sovereign bond contracts.

Experts hold the opinion that making provisions for orderly restructuring could render emerging market issues more attractive by minimizing disputes, lengthy negotiations, and extended periods when no debt service is paid and growth is depressed by a suffocating debt overhang.[127] Mechanisms of debt restructuring which includes CACs, collective representation

[120] *Supra Note* 108.

[121] (Scott 2006, p.4)

[122] *Id.*

[123] (Breaking The Mold 2005), p.23; The shortest instruments - Eurobonds and Brady Interest Equalization bonds e were exchanged at par, while the longer dated Brady bonds were exchanged at 1:0.78 (PDI bonds), 1:0.58 (Discount bonds) and 1:0.40 (Pars) - (Sturzenegger and Zettelmeyer 2005, p.800).

[124] (Sturzenegger and Zettelmeyer 2005, p.803)

[125] *Id.* at p.782.

[126] *Id.* at p.793.

[127] (Eichengreen and Mody, Would Collective Action Clauses Raise Borrowing Costs? July 5, 2000, p.2)

and exit consents have thus been lauded for their efficacy and novelty. In order to reinforce this view, quite a few empirical studies have been carried out to analyse the economical implication of including collective-action clauses in loan contracts. Let us consider some of them to see if they lend any credence to the threat that the CACs might pose to investor protection.

Eichengreen & Mody [128]

The authors carried out a study in 1999 to study the implications of including CACs in loan contracts. They studied a sample of around 2,000 international bonds, and compared the spreads on bonds subject to English law, which typically include collective-action clauses, with spreads on bonds subject to US law, which do not.[129] They considered such factors as launch spreads over risk free rates, the amount of the issue, the maturity in years, the governing law under which the bond contract was written, currency of issue, etc. The authors claimed their research as 'the first systematic analysis of the impact on borrowing costs of collective-action clauses designed to facilitate the orderly restructuring of emerging-market debt.'[130]

The research concluded with the following remarks:

> "The results caution that the impact of contract structure is discernible only when borrowers are disaggregated by credit quality. Results for the whole sample disguise differential effects on borrowers with better and worse credit ratings. Collective-action provisions tend to reduce the cost of borrowing for the more credit-worthy issuers, who benefit from being able to avail themselves of an orderly restructuring process. For less credit-worthy issuers, in contrast, there is evidence of higher spreads."

Although the authors did not discover any direct link between the inclusion of CACs in sovereign bonds, either governed by English or New York law, but they were able to establish that emerging markets with lower credit rating had a higher borrowing costs due to the inclusion of CACs. Considering that the study was carried out in 1999, and a lot of water has flown under the bridge since then, it can be inferred that emerging market sovereign debt issuers will definitely face some difficulties in borrowing under CACs.[131]

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[128] *Id.*

[129] *Id.*

[130] *Id.* at p.21.

[131] The authors admit the same – "….there is the possibility that the markets began to focus on the implications of collective action provisions only recently, and that they have therefore begun to price debt securities accordingly only in recent quarters. Since the likelihood of default was low in the first half of the 1990s and the international policy community was not concerned to see that private investors "took a hit," there may have been no particular reason to focus on the presence or absence of these provisions; since the inauguration of discussions of private sector burden sharing, in contrast, legal protections have become a prominent concern." *Id.* at p.20.

Gugiatti & Richards[132]

Another relevant study was carried out by Gugiatti and Richards who carried out their research primarily based on data from Euromarket and US bond markets. The authors' paper sought to provide empirical evidence to the debate over the desirability of reforms to the way that financial markets and the international community dealt with sovereign debt crises, particularly on the way that the use or non-use of CACs influenced the pricing of debt.[133] They concluded that 'even after the intense debate about sovereign debt restructuring through 2002, the inclusion or absence of CACs still had no economically or statistically significant impact on yields as of early 2003', and that the inclusion of CACs was not relevant to the pricing of debt.[134] Their study even included secondary market data and found similar results.

Although Gugiatti & Richards establish that the market was indifferent to the use of CACs in debt contracts, there is a possibility that the position might change in the near future. Considering that the CACs phenomenon is rather new, the implications of these provisions will become more apparent only when they are used to amend bond terms at times of crisis favourably for the debtor, for which it has been specifically designed.

Becker, Richards & Thaicharoen[135]

A similar study as Gugiatti & Richards was carried out by these authors in 2001. Predictably they arrived at the similar results, that there was no direct effect on pricing of the bonds with the use or non-use of CACs in the bond contracts. Their research studied the pricing of bonds with and without CACs using data for both primary and secondary market yields between 1999 and 2000. Becker *et al*'s results even controvert those of Eichengreen and Mody's results insofar as they find 'no evidence in support of Eichengreen and Mody's finding that lower-rated borrowers on average pay a premium of hundreds of basis points for borrowing under English governing law with CACs'.[136]

Sturzenegger & Zettelmeyer [137]

The authors conducted a study to calculate the investor losses (''haircuts'') and recovery values in recent debt restructurings in Russia, Ukraine, Pakistan, Ecuador, Argentina, and Uruguay. According to the authors, 'Haircuts are computed as the percentage difference between the present values of old and new instruments, discounted at the yield prevailing

[132] (Gugiatti and Richards March 2003).

[133] *Id.* at p.1.

[134] *Id.* at p.21.

[135] (Becker, Richards and Thaicharoen 2003).

[136] *Id.* at p. 157.

[137] (Sturzenegger and Zettelmeyer 2005).

immediately after the exchange. Recovery value means value received in terms of outstanding principal'.[138] They find that the average NPV haircuts ranged from 13% (Uruguay external exchange) to 73% (2005 Argentina exchange); and the recovery rates ranged from 30% to about 75%.

According to this study, Argentina's 2005 exchange was the most difficult restructuring with an average net present value haircut of almost 75%, and the mildest was Uruguay's international bond exchange, with a haircut of only 13%. Perhaps this has to do with the innovative restructuring techniques employed by Uruguay as against the enormous amount of debt of Argentina. Some of the important parameters identified by the authors in their study was the countries' ability to pay, their willingness to pay, the bargaining power between the creditor and the debtor, and most interestingly, intercreditor equity and legal equality among bondholders.[139] The latter two appears more significant for the purposes of this study since the scope of CACs will afford room to the debtor countries for manipulating these two.

[138] *Id.* at p.780.

[139] *Id.* at p.794.

IV. CONCLUSION

Whether or not an investor should participate in a sovereign debt restructuring will depend on various factors. One of them could be the incentives of receiving more favourable terms by holding out, as against the definite loss incurred by a majority of participating investors. The pay-off for an investor will clearly depend on an evaluation of the extent to which a proposed deal protects their individual interests, and the likely payoffs of the alternative strategies in each case.[140] In making this decision, the investors should take into account the level of protection accorded to individual investors, the quality of assurance, intercreditor equity and homogeneity among the instruments to be restructured. Crucial role is also played by the probability that the debtor would service the original claim, and the likely market value of such a claim that is continuing to be serviced, as also the likely risk and return of seeking to obtain recoveries on the phased out debt instruments.[141] Litigation is not always a glorious alternative for any holdout creditor. It is an expensive and cumbersome redistribution procedure which is not only uncertain but also there are hardly many assets of the sovereign vulnerable for attachment. In the absence of sovereign insolvency procedures, there is the danger of a 'race to the courthouse', which benefits few investors at the expense of many.

Success of collective action provisions, as also that of the recourse to legal remedies could depend on the interpretation of sovereign default itself. On one hand a default can be viewed as simply the inability of a sovereign to service its debt and fulfil its financial obligations. On the other hand, one could argue that the financial distress of the sovereign was due to squandering of credit, unplanned and mismanaged expenditure, faulty government policies, corruption, etc. The arguments for CACs would dramatically change based on the view adopted, and in the latter scenario, creditor legal enforcement rights must then be considered pivotal for debtor discipline and containing debtor moral hazard. [142] For example, the Argentinean default has been dubbed as the result of bad policies which had contagion effect on other sovereigns.[143]

Debt maturity and investor participation is essentially a market outcome, but sovereigns, especially emerging market borrowers seem to behave in a myopic way. The most probable reaction is to meet the immediate financing needs rather than to improve the debt profile and sustainability.[144] The tardiness with which emerging markets handle their debt profile only makes matters worse. Policy decision to announce a default is taken after considerable delay by which

[140] (F. Gianviti 2003, p.7)

[141] *Id.*

[142] (Haseler 2007, p.12)

[143] (Colliac and Lapteacru 2008, p.100).

[144] *Id.* at p.95.

time investors have already incurred huge losses. Most governments are highly influenced by political motives and are not eager to employ long-term strategies to contain debt sustainability.

Some countries have been outspoken in their stand with regard to CACs. Germany made an official statement in February 2000 stating that although the government noticed no legal impediment to the use of CACs issued under German law, however, all debt restructurings must conform to the requirements of the Bondholders Act and operate under the limitations of the Civil Code.[145] An aggrieved bondholder may bring an action on the grounds of undue disadvantage and principle of good faith. The Japanese Commercial Code also has similar provisions for corporate bond issues by public sector undertakings. Under Japanese law, issuing a sovereign bond with CACs is not permitted but amendment of financial terms must be carried out with the approval of the court that will ensure that creditor interests are duly protected.

In the name of improving the international financial architecture, CACs are being promoted unabashedly in all sovereign debt issues, without analysing their far reaching consequences. Such blatant use of CACs could amount to a regime change and signal that bond restructuring would now become a frequent phenomenon.[146] There is an urgent need for an international legal infrastructure which can not only promote the judicious use of CACs, but also regulate and prevent abuse. If sovereign debt restructurings, with the use of CACs, were to continue and become market standard, bondholders will soon be cornered and subjected to submission.

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[145] (Liu 2002, p.9)

[146] (Gugiatti and Richards March 2003, p.23)

Appendix

Table A. Collective Action Clauses in UK Debt: [147]

G-10 Recommendation	*Provision in UK US$ 3 bn. Note issue maturing in 2008* *(Comparable provisions are included in the Bank of England Euro Notes maturing in 2007)*
Permanent bondholders' representative	The Trust Deed provides for the appointment of a permanent trustee to act in the best interests of the Noteholders (including enforcement – see below).
Bondholders' negotiating representative elected by ⅔ of bondholders	The ability to appoint a negotiating representative (or committee) is provided in the Trust Deed. Schedule 3, paragraph 18 (g) states: "A meeting of the Noteholders shall ….have the following powers exercisable by Extraordinary Resolution namely … to appoint any person or persons (whether Noteholders or not) as a committee or committees to represent the interests of the Noteholders in any discussions with the Issuer or any other creditors of the Issuer in connection with any proposed restructuring of the Notes or other indebtedness of the Issuer and to confer upon such committee or committees any powers or discretions which the Noteholders could themselves exercise by Extraordinary Resolution." Appointing a representative is not a reserved matter, so a 66.67% vote by principal outstanding is required by Schedule 3 paragraph 20 (b) of the Trust Deed (see below).
Bondholders meeting to be convened at any time upon request of Issuer, trustee, or bondholders representing 10% of principal.	This is provided in the Trust Deed, under paragraph 2 of Schedule 3 to the Trust Deed. "The Issuer or the Trustee may at any time and the Issuer shall upon a request in writing of Noteholders holding not less than 10 per cent. in the aggregate of the principal amount of the Notes for the time being outstanding convene a meeting of the Noteholders." In the event of a meeting where a vote is taken, the quorum provisions in Schedule 3 paragraph 5 to the Trust Deed are identical to the voting thresholds for any amendments, so meetings will never result in a lower voting threshold. "At any such meeting any person or persons … representing in the aggregate (a) in the case of a meeting convened to consider an Extraordinary Resolution relating to any Reserved Matter (as defined below), not less than 75 per cent.; and (b) in the case of a meeting convened to consider any other Extraordinary Resolution, not less than 66.67 per cent. of the principal amount of the Notes for the time being outstanding

[147] Summary Table – G10 Recommendations and UK CACs; Bank of England Publication, "*Collective Action Clauses in UK Debt*", (Available at: http://www.bankofengland.co.uk/publications/other/financialstability/cac/index.htm, Last accessed: Aug. 10, 2008).

	shall form a quorum."
Majority action provisions for amendments to reserved matters and non-reserved matters. **Voting is based on principal outstanding, with a 75% threshold for reserved matters and 66⅔% non reserved matters.** **Votes can be conducted at a meeting, or in writing.**	Material amendments to the terms of the notes would be classified as "Extraordinary resolutions", under the provisions of paragraph 18 of Schedule 3 to the Trust Deed. "A meeting of the Noteholders shall … have the following powers exercisable by Extraordinary Resolution namely: (a) power to sanction any proposal by the Issuer for any modification, abrogation, variation or compromise of, or arrangement in respect of, the rights of the Noteholders against the Issuer whether such rights shall arise under the Notes or otherwise; (b) power to sanction any proposal by the Issuer for the exchange or substitution for the Notes of, or the conversion of the Notes into, other obligations or securities of the Issuer or any entity formed or to be formed; (c) power to assent to any modification of the provisions contained in the Notes, the Conditions, this Schedule, the Trust Deed or the Agency Agreement which shall be proposed by the Issuer … (additional provisions d - g)" Extraordinary resolutions are divided into reserved and non-reserved matters, as set out in paragraph 20 of Schedule 3 to the Trust Deed. Extraordinary resolutions can be passed by votes taken at a meeting, or in writing. "The expression Extraordinary Resolution means: (a) in relation to any Reserved Matter (i) a resolution passed at a meeting of the Noteholders duly convened and held in accordance with the provisions contained herein by a majority consisting of not less than 75 per cent. of the outstanding principal amount of the Notes for the time being outstanding; or (ii) a resolution in writing signed by or on behalf of holders of not less than 75 per cent. of the outstanding principal amount of the Notes for the time being outstanding; and (b) in relation to any other matter (i) a resolution passed at a meeting of the Noteholders duly convened and held in accordance with the provisions contained herein by a majority consisting of not less than 66.67 per cent. of the outstanding principal amount of the Notes for the time being outstanding; or (ii) a resolution in writing signed by or on behalf of holders of not less than 66.67 per cent. of the outstanding principal amount of the Notes for the time being outstanding." The decisions taken by these majority voting procedures are binding all on bondholders, as provided in paragraph 19 of Schedule 3 to the Trust Deed. "An Extraordinary Resolution passed at a meeting of the Noteholders duly convened … or passed by resolution in writing shall be binding upon all the Noteholders, whether present or not present at any such meeting and whether they voted in favour or not."
Reserved matters **(For details see p. 10 of the G10 Working Group's**	The reserved matters include those points specified in the G10 Report, but also go slightly wider to include matters such as any changes to governing law, the status of the notes (including pari passu), and the events of default. The full list of reserved matters is provided in paragraph 21 of Schedule 3 to the Trust Deed (and also in the

Report)	Offering Circular under Condition 8). "For the purposes of this Trust Deed, a Reserved Matter is any proposal to: (i) postpone the date of maturity of any of the Notes or any date for payment of interest thereof; (ii) reduce or cancel the principal amount of the Notes; (iii) reduce the rate of interest payable in respect of the Notes; (iv) vary the currency or place of payment in which any payment in respect of the Notes is to be made; (v) amend the status of Notes under Condition 2 (Status); (vi) amend the obligation of the Issuer to pay additional amounts under Condition 6 (Taxation) and the Trust Deed; (vii) amend the Events of Default set out in Condition 7 (Events of Default); (viii) amend the law governing the Notes and the Trust Deed referred to in Condition 17 (Governing Law); (ix) modify the provisions contained in this Schedule concerning the quorum required at any meeting of the Noteholders or any adjournment thereof or concerning the majority required to pass an Extraordinary Resolution or the percentage of votes required for the taking of any action; (x) change the definition of "outstanding" in the Trust Deed; (xi) authorise the Trustee, on behalf of all Noteholders, to exchange or substitute the Notes for, or convert the Notes into, other obligations or securities of the Issuer or any other person; (xii) instruct the Trustee, on behalf of all Noteholders, to withdraw, settle or compromise any proceeding or claim asserted by the Trustee pursuant to Condition 7 (Events of Default); (xiii) give to any person or group of persons, other than the Trustee or the Appointee, the exclusive right to enforce any provision of the Trust Deed or the Notes on behalf of all Noteholders after the Noteholders have become entitled to proceed directly against the Issuer in accordance with Clause 8.2 of the Trust Deed and Condition 9; (xiv) confer upon any committee or committees appointed pursuant to paragraph 18(g) any powers or discretions which the Noteholders could themselves exercise by Extraordinary Resolution; (xv) amend this definition in any manner."
Majority enforcement: **- acceleration on instruction by bondholders**	The Trust Deed provides the same enforcement provisions for both acceleration and litigation, through Clause 8 on Proceedings, Action and Indemnification. "The Trustee shall not be bound to take any action or proceedings mentioned in

representing 25% of principal; **- litigation to be instituted by the trustee or on instruction by bondholders representing 25% of principal**	Condition 7 [Event of Default specified in the Offering Circular] … unless respectively directed or requested to do so (i) by an Extraordinary Resolution or (ii) in writing by the holders of at least 25 per cent. in principal amount of the Notes then outstanding …Only the Trustee may enforce the provisions of this Trust Deed. No Note-holder shall be entitled to proceed directly against the Issuer to enforce the performance of any of the provisions of this Trust Deed unless the Trustee having become bound as aforesaid to take proceedings fails to do so within 90 days and such failure is continuing." The Events of Default that give rise to acceleration are specified in Condition 7 of the Offering Circular, which also forms part of the terms and conditions under the Trust Deed. "If any of the following events (each an "Event of Default") occurs and is continuing, the Trustee may at its discretion, and if so requested in writing by holders of at least 25 per cent. in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution … give notice to H.M. Treasury that the principal amount of each Note shall mature and become immediately due and payable, together with accrued interest: (a) H.M. Treasury shall default for a period of seven days or more in the payment on the due date of any principal due on the Notes or any of them or for a period of 15 days or more in the payment on the due date of any interest due in respect of the Notes or any of them; or (b) H.M. Treasury shall default in the performance of any other covenant contained in the Notes or the Trust Deed which default is incapable of remedy or, if in the opinion of the Trustee capable of remedy, is not in the opinion of the Trustee remedied 30 days after written notice thereof shall have been given to H.M. Treasury by the Trustee, provided that in the case of an event falling within paragraph (b), the Trustee shall have certified that in its opinion such event is materially prejudicial to the interests of Noteholders."
Majority enforcement: rescission of acceleration upon decision of bondholders representing 66 ⅔% of principal outstanding	The bonds include terms for the rescission of acceleration, and go slightly wider by providing for the rescission of litigation as well. The threshold for both requires the agreement of Noteholders representing 75% of principal outstanding - slightly higher than the 66 ⅔% noted in the G10 proposal. This is because decisions on enforcement are included as a reserved matter given their significance, see sub-paragraph (xii) in paragraph 21 of Schedule 3 to the Trust Deed. "For the purposes of this Trust Deed, a Reserved Matter is any proposal to … (xii) instruct the Trustee, on behalf of all Noteholders, to withdraw, settle or compromise any proceeding or claim asserted by the Trustee pursuant to Condition 7 (Events of Default)."
Majority enforcement: prorate distribution of proceeds	This is provided in the Trust Deed, under Clause 9 - Application of Monies. "All moneys received by the Trustee under this Trust Deed from the Issuer … shall … be apportioned without priority and rateably between each series of the Notes, and all moneys received by the Trustee under this Trust Deed from the Issuer to the extent attributable in the opinion of the Trustee to a particular series of the Notes …

	(a) First in payment or satisfaction of all amounts then due and unpaid under Clauses 14 and/or 15(j) to the Trustee and/or any Appointee; (b) Secondly in or towards payment without priority and rateably of all principal and interest then due and unpaid in respect of the Notes of that series; (c) Thirdly in or towards payment without priority and rateably of all principal and interest then due and unpaid in respect of the Notes of each other series; and (d) Fourthly in payment of the balance (if any) to the Issuer (without prejudice to, or liability in respect of, any question as to how such payment to the Issuer shall be dealt with as between the Issuer and any other person)."
Disenfranchisement provision – that excludes the Issuer from participating in any votes.	This is provided in the Trust Deed, Clause 1 – under the definition of "outstanding". "outstanding means, in relation to the Notes, all the Notes delivered pursuant to this Trust Deed …provided that for each of the following purposes, namely: (i) the right to attend at any meeting of the holders of the Notes of any series, to vote on any resolution put to Noteholders or, as a Noteholder, to give any instruction or direction to the Trustee; (ii) the determination of whether the Noteholders of the requisite principal amount of outstanding Notes are present at a meeting of Noteholders for quorum purposes or have consented to or voted in favour of any request, demand, authorisation, direction, notice, consent, waiver, amendment, modification or supplement hereunder; (iii) any discretion, power or authority (whether contained in this Trust Deed or vested by operation of law) which the Trustee is required, expressly or impliedly, to exercise in or by reference to the interests of the holders of the Notes; and (iv) the determination by the Trustee whether any event, circumstance, matter or thing is, in its opinion, materially prejudicial to the interests of the holders of the Notes, the Notes owned or controlled, directly or indirectly, by the Issuer or by any public body owned or controlled, directly or indirectly, by the Issuer shall be disregarded and deemed not to be outstanding."
Information provision – to be included on a case by case basis	Not included.

Table B. Collective Action Clauses: G-10 Recommendations and Bonds Issued Under New York Law Since March 2005 [148]

Provisions	*G-10 Recommendations*	*Argentina, Brazil, Colombia, Dominican Republic, El Salvador, Indonesia, Italy, Lebanon, Mexico, Peru, Philippines, Turkey, Uruguay, & Venezuela*
Amendment of Key Terms	75 percent threshold based on either outstanding principal or principal held by those present at a duly convened meeting.	75 percent based on outstanding principal (except the Lebanon bond, where the threshold is based on duly convened meeting).
Aggregate Voting	None.	Argentina, Dominican Republic, and Uruguay: 85 percent of the aggregate outstanding principal of all affected series (taken in aggregate) and 66⅔ percent of outstanding principal of each affected series (taken individually).
Disenfranchisement	Bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities.	Generally bonds owned directly or indirectly by the issuer or its public sector instrumentalities.
Acceleration	25 percent of outstanding principal.	25 percent of outstanding principal (except the Lebanon bond, where each bondholder has the right to accelerate upon default).
De-acceleration	Between 50 and 66⅔ percent of outstanding principal.	• Argentina, Colombia, Dominican Republic, Indonesia, Mexico, Peru, Philippines and Venezuela: 50 percent of outstanding principal. • Uruguay: 66 percent of the outstanding principal. • Brazil, El Salvador, Italy and Turkey: 66⅔ percent of outstanding principal • Lebanon: none.
Initiation of Proceedings	• Mandate the use of a trust or an equivalent legal structure where the trustee can be instructed by 25 percent to initiate lawsuits. • Pro rata distribution of recovered proceeds under trust structure.	Individual bondholder, except the Argentina, Dominican Republic, Indonesia and Uruguay bonds where the trustee has a limited monopoly over initiation of proceedings whose recovery would be distributed pro rata.

[148] International Monetary Fund, *'Progress Report on Crisis Resolution'*, September 21, 2005. (Available at: http://www.imf.org/external/np/pp/eng/2005/092105.htm Last accessed Aug. 10, 2008)

Engagement Provision	• Appoint a bondholder representative for the life of the bond. • 66⅔ percent to appoint at any time any person to represent all holders in negotiation with the issuer or other creditors.	None.
Information Provision	A covenant requiring the issuer to provide certain types of information over the life of the bond and following a default.	None.
Documentation	Trust or an equivalent legal structure.	Fiscal agency agreement, except Argentina, Dominican Republic, Indonesia, and Uruguay which utilized a trust structure.

Table C. Comparison of the G10 Recommendations with the Proposals made by a Group of Seven Trade Associations [149]

G10 Recommendations for New York law bonds	Trade Associations' proposals for New York law bonds	Market practice – in bonds issued by Mexico (and others)
Permanent bondholders' representative (trustee or other).	No – fiscal agent, who represents the issuer.	Trade Associations. Fiscal agent in all recent NY law issues except Uruguay.
Bondholders' negotiating representative elected by ⅔ of Bondholders.	The 'Engagement clause' provides, in the event of default or restructuring, for bondholders to elect a representative *committee* (or individual) with votes from 50% of bondholders, unless more than 25% object. The representative(s) could engage legal counsel and financial advisors and the issuer would pay for the costs.	Neither. No provision for representation (as far as aware).
Bondholders meeting to be convened at any time upon request of issuer, permanent representative, or 10% of bondholders.	Adds lower 5% threshold for bondholders to request Fiscal agent to call a meeting in the event of default, or if a restructuring is announced.	Consistent with both. Slightly closer to G10.
Majority action provisions for amendments to reserved matters with 75% vote.	Higher threshold of 85% and adds that changes to reserved matters are prohibited if more than 10% object.	Closer to G10 (only Brazil and Belize chose 85%).

[149] (Drage and Hovaguimian 2004, pp. 26-27) - Compiled variously from data obtained from: IPMA, IIF, EMCA, EMTA, SIA, ISMA, and TBMA; The Report of the G-10 Working Group on Contractual Clauses was published in March 2003 and can be found at: http://www.bis.org/publ/gten08.htm#pgtop. The trade associations' proposals were circulated in January 2003 and are available at: http://www.emta.org/ndevelop/Final_merged.pdf .

	Also includes some matters which require 100% consent to change.	
List of reserved matters: (i) change the payment date; (ii) reduce the principal amount; (iii) reduce the portion of the principal amount due in the event of an acceleration; (iv) reduce the interest rate; (v) change the currency or place of payment; (vi) change the obligation of the issuer to pay additional amounts; (vii) change the definition of outstanding or reduce the voting requirements; (viii) to (xi) regarding permanent representative and enforcement.	Covers (i) to (vii). Also adds changes to the *pari passu* (or other specified substantive covenants) as appropriate; and any detrimental changes to the events of default or negative pledge provisions. Also adds that changes to the following require 100% consent: governing law, jurisdiction, and waiver of sovereign immunity.	Elements of both. Most cover G10 reserved matters (i) to (vii) but also add *pari passu*, events of default, governing law and jurisdiction (with 75% threshold).
Majority action provisions for amendments to non-reserved matters with 66⅔ % vote.	Higher threshold of 75%.	G-10
Amendments can be agreed in writing or at a meeting.	Yes	Consistent with both.
Acceleration instruction by bondholders representing 25% of Principal.	Yes	Consistent with both.
Rescission of acceleration decision by 66⅔ % of bondholders.	High threshold of 75% vote.	Closer to G10 – mix of thresholds of 66⅔% and 50% (neither as high as Trade Associations 75%).
Litigation to be instituted solely by the permanent representative.	No	Trade Associations.
Continuation and outcome of litigation – directed by majority of bondholders.	No	Trade Associations.
Pro-rata distribution of proceeds.	No	Trade Associations.
Disenfranchisement provision.	Yes	Consistent with both.
Information provision – to be included on a case by case basis.	Requires: SDDS subscription and compliance; publication of 12-month forecasts of central government budget and inflation; Paris Club minutes and terms of agreement; terms of any other restructuring agreements; terms of IMF arrangements; and other information that the fiscal agent, on instruction of 5% of bondholders, may from time to time reasonably request. Notices and other information provided to bondholders must also be given to IPMA, EMTA, EMCA, and the IIF for publication on their websites.	Neither. Only Uruguay has included information requirements and they would apply only in the event that it seeks amendments.

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