The problem of sovereign debt restructuring: How can we deal with Holdout problem legally?

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1. Introduction

As ongoing Argentina case suggests, defaults of sovereign debt frequently occurs. These defaults of sovereign debt have been causing significant impact on international financial markets. In order to minimize these impacts, it is necessary to restructure sovereign debt in a timely and efficient manner. However, the restructuring of sovereign debts have been getting difficult, due to the transition of component of sovereign debts from bank loans to bonded debts. Since bondholders are so widely dispersed and diversified that the coordination of bondholders is difficult. The main restructuring technique for sovereign bonds is "exchange offer" under which sovereigns issue new bonds that reflect restructuring plans. However, this technique raises "holdout problem" that some bondholders who reject the exchange offer seeking the full payment of original bonds, disrupt orderly restructuring process. In order to prevent holdout creditors from disrupting restructuring process, several suggestions have been made. Among these suggestions, I will mainly examine the effectiveness and validity of "exit consents".

First, I will describe current international financial market and the difficulties of crisis prevention. Second, I will describe the vulnerability of sovereign against holdout problem, by referring Elliott case. Third I will examine the validity of "exit consents". In examining the "exit consents", I will address the requirements of exit consents in corporate bond restructuring. Then, I will point out the difference between default of sovereign debt and corporate debt, suggesting that court will use strict standard when determining the validity of exit consents. I will point out the limited effectiveness of exit consents in sovereign debt restructuring. Finally I will conclude the utilizing the exit consents itself is insufficient to deal with holdout problem, and propose the implementation of Collective Action Clauses into existing bonds by utilizing exchange offer.

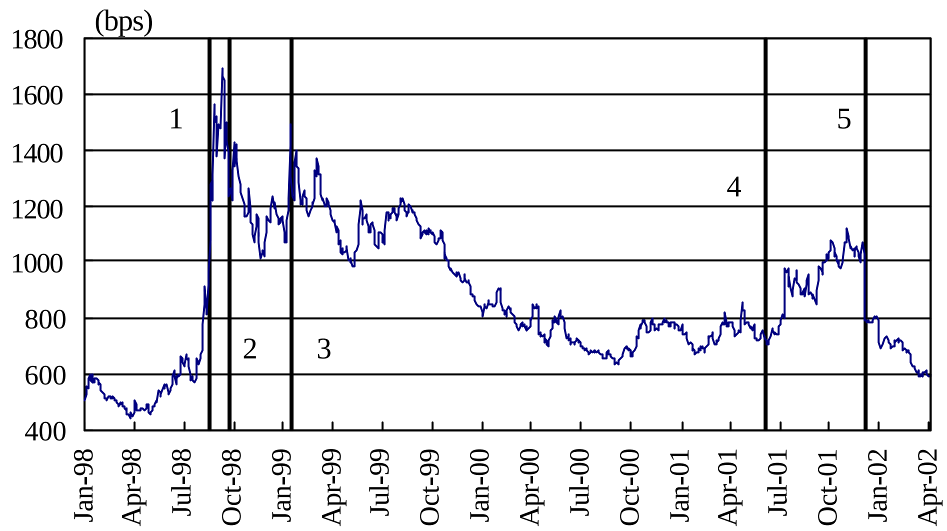
2. Vulnerability of international financial market and impact of holdout problem on restructuring process of sovereign debts

(1) Frequent occurrence of international financial crises

During the last decade, we have seen several international financial crises, such as Mexico (1995), southeastern Asian countries (1997), the Russia (1998), Brazil (1999), and ongoing Argentina cases. These experiences suggest that the difficulty of predicting the occurrence of financial crisis, despite the strong efforts made by international financial communities, such as monetary authorities, and private financial institutions. The difficulties may be well reflected in below graphs[1].

[1] Graphs' data source is Bloomberg. The numbers, which appear in the graphs, are as follows.

(Emerging Markets Bond Index Plus (EMBI+)[2]



The EMBI+ is widely used in monitoring conditions of financial market of emerging countries. This graph suggests at least two things. One is that emerging markets are volatile suggesting frequent occurrence of financial crises. Second is the fact that steep

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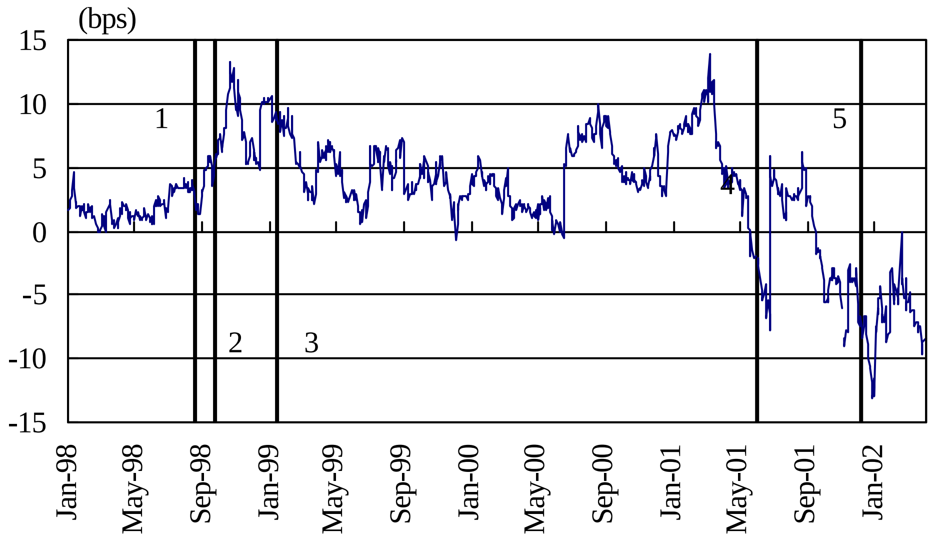
"1" is August 17, 1998, the day when Russia abandoned support for the ruble and halted trading in ruble-denominated GKOs. "2" is September 23, 1998, when the U.S. Federal Reserve Board organized a bail-out of Long Term Capital Management, a large hedge fund which suffered huge loss in Russian market. "3" is January 13, 1999 when Brazil allowed its currency, real, to trade within larger band, virtually devaluation. "4" is July 3, 2001, when Argentina's stock market falls to 28 month low following the rumors that then President would resign. "5" is December 5, 2001 when the IMF announces it will not release $1.3 billion to Argentina.

[2] EMBI+, which is made by JPMorgan Chase, tracks total returns for traded external debt instruments, such as Brady bonds, loans and Eurobonds, in the emerging markets. The component of this indicator reflects the size and liquidity of these external debt markets. The major components are Brazil, Mexico, Russia, Venezuela, and Argentina. See, JPMorgan Chase, "Introducing the Emerging Markets Bond Index Plus (EMBI+), http://www2.jpmorgan.com/MarketDataInd/EMBI/embi.html.

spike of indicators after certain events, such as Russian ruble crisis as 1, suggests huge impact of these events on international financial market. In order to prevent financial crisis from happening, or minimize the impact of crisis, it is important to construct early warning system by monitoring the conditions of financial market. Below graphs are examples of indicators which reflect liquidity risk and credit risk. However, none of them is forward looking in nature and merely reflects a single dimension of market conditions[3].

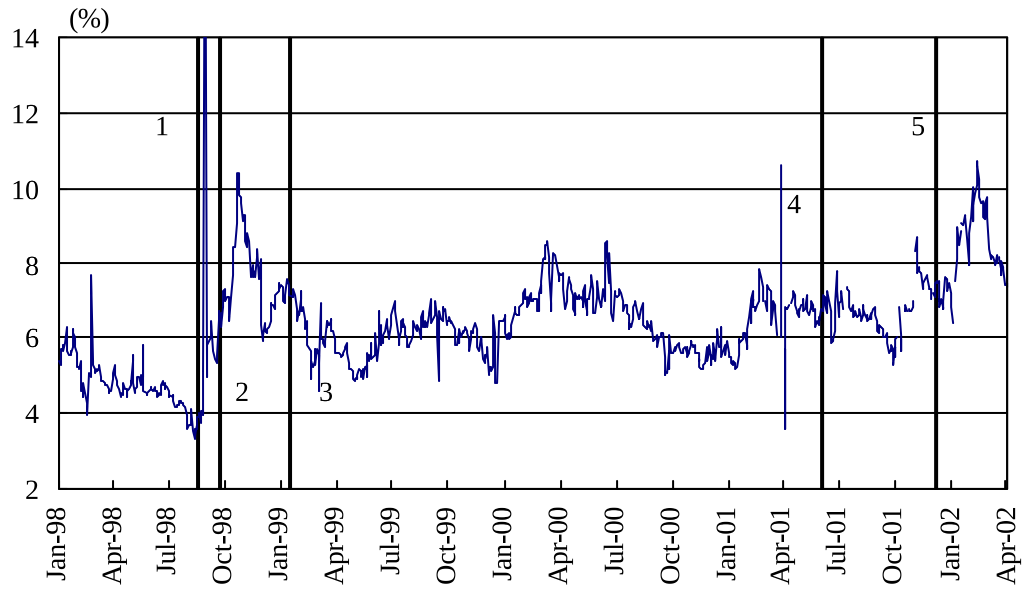
(On-the-run and Off-the-run Treasury bond spread[4])



[3] For example, even the definition of liquidity itself is not clear, such as market depth, or tightness.

[4] On-the-run is the latest issue of bonds. Off-the-run is the bond issued before the on-the-run bond. The on-the-run/off-the-run spread is recognized as the possible tool to reflect liquidity of market. See, Alan Greenspan, "The structure of the international financial system", at the Annual Meeting of the Securities Industry Association, Boca Raton, Florida, November 5, 1998. "(w)e are all familiar with the dramatic rise in late September in the illiquidity premium for off-the-run Treasury securities, or the spreads on government sponsored agency issues."

(Implied volatility of Future 10 year treasury note[5])



(2) Transition of emerging countries' debt from bank loans to bonds

In addition to the difficulties of crisis prevention, the post-crisis efforts, resolution of crisis, has been proved difficult and even getting more difficult. The main reason for this may be the transition of component of emerging countries' debts from bank loans to bonds. Until the late 1980s the main finance source of emerging countries were bank loans, especially by the form of syndicated loans. When the debtor countries found the need to restructure

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[5] If investors would worry about credit risk, they might invest in risk-free government bond. Thus the implied volatility of US Treasury note may be seen one of the possible tools to reflect concern against credit risk in market.

their debt, it was relatively easy to negotiate with creditors, banks. Since, creditors were easily identifiable. And the debtor countries did not have to care about coordination of creditors' opinions, because it was done by so-called "commercial bank advisory committee"[6]. Therefore negotiation for restructuring debts between debtor countries and creditors was not huge obstacle to restructure debts.

(3) Difficulty of restructuring bonded debt

However, the restructuring of sovereign debts has been getting complicated with the transition of sovereign debts from bank loans to bonds, which was seen from early 1990[7][8]. There are two factors why the restructuring of bonds is complicated[9]. First factor is that the mobility of bonds makes the identification of creditors difficult. Given the

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[6] See Lee. Buchheit, *"Sovereign Debtors and Their Bondholders"*, at 11 ("Although these committees were careful to describe themselves as merely "communication links" with the sovereign debtor, in fact they operated as fully-fledged negotiating committees.")

[7] See Liz Dixon and David Wall, *"Collective action problems and collective action clauses"*, Financial Stability Review: June 2000. ("In 1980s, bonds comprised only 2 percent of developing countries' external debt"). (But by 1999, international bonds accounted for 19 percent of developing countries' US$2.6 trillion of external debt.)

[8] Arguably, one may argue that the well-established restructuring technique for bank loans discourage creditors or potential investors to conduct or join syndicated loans to emerging countries. See John Williamson, *"Proposals for curbing the boom-bust cycle in the supply of capital to emerging markets"* (" One of the reasons that helped motivate the switch from bank lending in the 1970s to bond lending in the 1990s was without much doubt **the lesser vulnerability of bonds to restructuring** when a country ran into debt servicing problems"). (emphasis added).

[9] However, until late 1990s, bondholders had been paid, bailout, while bank loans had been restructured and official monetary authorities joined the restructuring process. The reason may be the debtor countries' desire to keep future access to capital market by preventing default of bonds.

development of secondary market, bonds are so actively traded that it is almost impossible to identify the holders of bonds, creditors, timely. Therefore it is difficult for debtor countries to contact with creditors. Second factor is that the difficulty of coordination of creditors' opinions. Even if creditors are identified, still it is difficult to reach consensus among dispersed and diversified creditors on restructuring plan.

(4) Difficulty of restructuring bonds without collective action clauses

This is especially true for sovereign bonds, which do not contain "collecting action clauses" (CACs)[10] enabling a decision made by qualified majority of bondholders to bind all other bondholders. Absence of this kind of clauses makes restructuring of sovereign debts more difficult, because debtor countries have to gather unanimous vote to amend the payment terms in order to restructure bonds. Bonds that contain CACs are still not huge number[11]. Because of this environment, emerging countries' utilize so-called "exchange offer" when they restructure sovereign debts. "Exchange offer" is to issue new bond, which reflects restructuring plan of the debts, and exchange this bond with existing "old bonds". By doing this, debtor countries restructure their debts without getting unanimous or qualified majority of votes from dispersed bondholders. However, this technique still has problem.

[10] CACs has 4 types. (1) Collective representation clauses, (2) Majority action clauses, (3) Sharing clauses, (4) Non-acceleration clauses. See, Dixon and Wall, *"Collective action problems and collective action clauses"*, Financial Stability Review, June 2000.

[11] Bonds issued under New York law typically do not contain CACs, while those issued under UK law do include the provision.

If bondholders of existing bonds reject the exchange offer, there is no legal way to force them to accept it. This problem is called as "Hold-out" problem, and has significant impact on restructuring sovereign debts, by discouraging other majorities who thought to accept the restructuring plan.

3. Holdout problem

The exchange offer generates the so-called "holdout" problems. Exchange offer itself cannot force bondholders of exiting bonds to accept new bonds that reflect restructuring plans. Thus it creates different, sometimes unfair, situation between holders of new bonds and those of existing bonds. Holdout problem is one form of collective action problems. Collective action problem is typical example of game theory's "prisoner's dilemma". This dilemma often shows up when there is a difference between the return of individual and return of group as a whole, if they follow different strategy. For example, in the context of exchange offer, some individual creditors would think that it might be better for him not to join the restructuring process, not to accept the new debt whose amount were reduced. Instead, he may remain holding existing bonds to seek full payment. If he gets paid, other creditors who accept the exchange offer would feel silly. This selfish activity harms the return of group as a whole, because if each investor tries to seek full payment, it may delay the restructuring process and eventually reduce the resource and capacity of debtor country to repay its debt. If each creditor could communicate with each other, or at least knew that the other creditors would join the restructuring process, this kind of dilemma may not show up. However, even if each bondholder knows the other creditors' behavior, still there will be creditors who act as free riders. Reduction of sovereign debts which is granted under the restructuring plan, will improve a debtor countries' capacity to repay under the original terms. It creates the incentive not to join restructuring process and simply take advantage of their improved repayment prospects[12]. The practical impact of holdout problem associated with exchange offer is well described in the article of Mr. Lee C. Buchheit. This article points out that the exchange offer makes bondholders of existing bonds easy to accelerate the old bond and commence legal actions. Since exchange offer removes the creditors who wish to cooperate to restructure of debt from existing bonds, raising the proportion of anti-restructure bondholders. As a result, it makes easy for remaining bondholders to exercise acceleration clause whose typical threshold is at least 25 percent[13].

[12] See IMF, "*Resolving and Preventing Financial Crises: The Role of the Private Sector*", March 26, 2001.

[13] See Lee C. Buchheit, "Sovereign Debtors and Their Bondholders" ("Prior to an exchange offer, the presence of sympathetic creditors in the bondholder group may dilute the voting power of an obstreperous minority below 25 % threshold. By removing the indulgent majority through an exchange offer, however, the sovereign issuer may unintentionally give the hold-out creditors the voting power they need to accelerate the old bond and commence legal actions".)

4. Vulnerability of sovereign against litigation

(1) Elliott Case: Situation is worsening…

The difficulty of conducting exchange offer seems to become more serious especially after the Elliott Associates, a well-known vulture fund[14], won the case against the Banco de la Nacion and the Republic of Peru[15]. Elliott Associates (Elliott) is a New York based investment fund, primarily invests in distressed securities issued by debtor that have defaulted on its payment. Between January[16] and March 1996, Elliott bought debts of Nacion and Banco Popular del Peru, whose debts were guaranteed by Peru government. The face amount of these loans was about US$ 20.7, while Elliott paid only about US$ 11.4 million[17]to get this loan, or become investor. In October 1996, Elliott was offered to exchange its debts to new bond. He refused to the offer and filed lawsuit against Peru, seeking full payment of bond, and pre-judgment attachment. Although the District Court

[14] Vulture funds typically buy "distressed securities", whose issuer have defaulted on its payment on creditors, in the secondary market at the low prices, and then seek full payment sometimes by filing lawsuit against debtor and get high return.

[15] See *Eliott Associates. L.P. v. Banco de la Nacion and the Republic of Peru*, 194 F.3d 363 (2d Cir. 1999)

[16] See id. In January 1996, Newman, independent consultant, recommended that Elliott purchase Peruvian sovereign debt. Elliott had experience that he raised high return when he invested in distressed Panamanian sovereign debt by bringing lawsuit that was recommended by Newman. Defendant argued that Elliott invested in Peruvian debt with intent to raise return by bringing lawsuit.

[17] Since these debts were issued by bankrupt Peruvian bank that liquidity was limited.

for the Southern District of New York[18], dismissed suit on the ground that plaintiff had bought the debt with the intention to bring suit thereon, in violation of New York law[19], the Court of Appeals reversed and granted Elliott receive a judgment of US$ 55.7[20]. Elliott tried to attach the interest payments on Peru's Brady bonds, which were issued in turn of exchange offer. Elliott filed a motion to prevent Euroclear from accepting or paying out cash from Peru government to pay interest on the Brady in the Brussels Commercial Court[21]. Although Elliott lost at the court, he got the restraining order form the Court of Appeals of Brussels[22]. Peru government finally chose to settle with Elliott and paid the Brady coupon in October 2000.

(2) Adverse impact on holdout problem

This case may give vulture funds the incentive not to accept the exchange offer or, to holdout by implying two things. One is by implying the "Champerty" defense may not be effective to protect "vulture fund" from litigating sovereigns. The concept of chapmerty is utilized in Section 489 of the New York Judicial Law, which prohibits the purchase of debt "with the intent and for the purpose of bringing an action of proceeding thereon."[23] Even

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[18] See, 12 F.Supp. 2d 328

[19] Section 489 of the New York Judicial Law

[20] See, 194 F.3d 363. See, Eric Lindenbaum and Alicia Duran, "*Debt Restructuring: Legal Considerations*", Merrill Lynch Global Securities Research. The amount included "face plus interest".

[21] See id.

[22] See, G. Mitu Gulati, Kenneth N. Klee, "*Sovereign Piracy*", Business Lawyer, February 2001

[23] See supra, "*Debt Restructuring: Legal Considerations*".

Elliott is a well-known vulture fund, and the timing of the purchase of Peruvian bank loans implied the intention of litigation against Peru government[24], Court of Appeals did not recognize the "intent" of litigation. This judgment strongly implies that the champerty defense will not be effective to prevent lawsuit filed by vulture fund. Second, more importantly, is by implying the attachment of debtor countries' property is not impossible. Elliott could get the restraining order against Euroclear from the Brussels Court of Appeals, which prevent Peru government from paying to bondholders who accepted exchange offer without paying to Elliott[25]. One of the major deterrents against litigating sovereign is the assumption that it is impractical to attach the property of debtor countries. Therefore, this second phase may reduce the effectiveness of the deterrent.

(3) Elliott's impact on International financial community

Although Peru government chose to settle and did not get ultimate court decision, this Elliott's case may have significant impact on international financial market. Since Eliott case may encourage vulture funds to follow same activity as Elliott, by implying two things that were pointed out above. The significance of this case can be seen in the speech of the Dr. Anne O. Krueger, the First Deputy Managing Director of International Monetary Fund

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[24] See supra, "*Debt Restructuring: Legal Considerations*" ("The timing of the purchases, which occurred after the Brady deal was agreed and days after another creditor successfully litigated against a Peruvian entity, suggests the intent to litigate".)

[25] Elliott successfully argued that Peru's payment to use the Euroclear to pay bondholders without paying Elliott violates the "Pari Passu" clause, the principle of equal treatment of creditors. See, Supra, "*Debt Restructuring: Legal Considerations*" and also see, Supra, "*Sovereign Piracy*".

(IMF). In her speech made on November 26, 2001[26], she pointed out the Elliott case and its potential negative impact on debt restructuring process. "The more recent success of an aggressive legal strategy employed against Peru by a vulture company called Elliott Associates underlines the power that holdout creditors retain." And she clearly pointed out that "(t)his case – and the possibility that rogue creditors will open other legal avenues – shines a spotlight on what is a missing element in the international community's current approach to the roles of the public and private sectors in debt restructuring." It can be said that the Elliott case drive international financial community to figure out the effective ways to deal with holdout problems. In fact, IMF revealed its intention to create new approach to sovereign debt restructuring, namely creation of international bankruptcy procedure. The Elliott case suggests that litigation risk has been underestimated, and makes exchange offer more costly in the future[27].

[26] See, IMF "*International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*", November 26, 2001

[27] See, IMF, "*Crisis Resolution and Private Sector Adaptation*", June 2001

BOX: Impact of Holdout Problem

1. Sovereign faces financial trouble

2. Bank loan→ Negotiation with banks (1980s)

   Bonded debt→ Negotiation with bondholders? (1990s-)

   Difficulties

   Dispersed: Impossible to identify

   Diversified: buy-and-hold, not cooperative

↓ **Exchange offer**

3. Sovereign issues new bonds which reflect restructuring plan
4. Sovereign offers bondholders to switch from old to new bonds

↓ **HOLDOUT PROBLEM** Emerges

5. Selfish bondholders reject the offer, continue to have old bond

   Vulture funds buy old bonds at secondary market
6. Sovereign defaults on its payment of old bond
7. Selfish bondholders of old bond accelerates, seek full payment

↓ **Litigation risk** (see, Elliott case)

8. If sovereign declines, the holders file lawsuits
9. Selfish bondholders get paid, other bondholders accepted exchange offer feel silly

↓ **Worst Scenario**

10. <u>Nobody will accept the exchange offer next time</u>

5. Exit Consents[28]

Several proposals have been made to deal with holdout problem. These are creation of international bankruptcy court, implementation of Collective action clauses, utilizing standstill by IMF. Although these measures may have effective impact on holdout problems, they require time, money and sometimes change of legal system, to be implemented. On the contrary, utilizing the so-called "exit consents", a major restructuring technique of corporate bond does not require any change of current system[29]. Therefore it is worth examining whether this restructuring technique can be used in sovereign debt restructuring and be effective.

(1) "Exit consents" and "Exchange offer"

"Exit consents" is the technique, which is often utilized in restructuring U.S. corporate bonds. There are two ways to restructure distressed corporate bonds. One way is to restructure corporations' financial status under the U.S. Chapter 11 of the bankruptcy Code, another way is to re-issue new bonds which reflects company's financial status and exchange with its existing bonds. Under the Chapter 11, a plan of reorganization can bind minority bondholders who oppose the plan[30]. Although restructuring under the

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[28] Sometimes referred as exit amendments

[29] See, Lee C. Buchheit "*Exit Consents in sovereign bond exchanges*", UCLA Law Review 59 (2000), at 83. "Using exit amendments in sovereign bond exchanges to address the holdout creditor problem may thus be less damaging to the fabric of the international financial system than the other alternatives now being discussed."

[30] See, 11 U.S.C. § 1129

proceedings of bankruptcy can bind all bondholders, corporate managers do not prefer this restructuring process. Since corporate managers were often fired during the reorganization proceedings, managers try to avoid bankruptcy proceedings. Instead, corporate managers tend to use "exit consents" when conducting "exchange offers"[31], while exploiting the ability to bind minority bondholders.

As pointed out above, exchange offers cause holdout problem. In order to avoid or reduce this holdout problem, it is necessary to think about the way to raise the acceptance rate of exchange offers. Theoretically, there are two ways to raise it, one way is to make new bonds more attractive, or put sweetener on transactions[32], another way is to reduce the attractiveness of the existing bonds. First one is sometimes difficult for debtors to take, because debtors have to spend additional money. In order to reduce the attractiveness of existing bonds, issuers and majority bondholders drastically change non-payment terms of the existing bonds that potential holdouts might find valuable. Buchheit pointed out that "when this was done in the context of an offer by the issuer to exchange those old bonds for new debt instruments, the disfiguring amendments to the old bonds tended to encourage acceptance of the new bonds and thus reduce or eliminate the likelihood holdouts."[33]

(2) Exit consents in Sovereign Debt Exchanges (Ecuador's case)

How can this "exit consents" be utilized in sovereign debt restructuring? Ecuador was the

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[31] See, supra, Buchheit "*Exit Consents in Sovereign Bond exchanges*"

[32] For example, debtor may buy out existing bonds above the market price.

[33] See, supra, Buchheit, "*Exit Consents in Sovereign Bond Exchanges*".

first sovereign to employ “exit consents” in restructuring its bonded debts[34].

(2-1) Ecuadorian debt crisis

In September 1999, Ecuador became the first country that defaulted on a Brady bonds. At that time, Ecuador had two external bonded debt, one is collateralized Bradys (Pars and Discounts) which totaling about US$3.1 billion, and un-collaterized Bradys (Past-Due-Interest, PDIs) amounting to US$2.8 billion[35]. Ecuador defaulted on its collaterized Discounts Brady and subsequently Pars, the un-collaterized PDIs and Interest Equalization Brady bonds[36]. In May 2000, Ecuador announced their intention to restructure all existing Bradys and other international bonds, insisting that there would be no side deals with particular groups of creditors[37]. On July 27, 2000, Ecuador announced a comprehensive exchange offer to swap the defaulted bonds into a single global U.S. dollar-denominated step-up 30-year bond carrying a 4 percent interest rate that increases 1 percent a year to maximum 10 percent in 2006 and thereafter[38]. The Bradys issued by Ecuador were among the most heavily traded bonds issued by emerging market countries, and widely held by investors with substantial holdings of emerging market debt[39]. These

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[34] See,IMF, “*Involving the Private Sector in Resolution of Financial Crises*”, January 2001

[35] See, IMF, “*Private Sector Involvement in Crisis Prevention and Resolution*”

[36] See, Moody’s, “Sovereign Restructurings: Putting Too much faith in Exit Consents”, March 2001

[37] See, IMF Staff, “*Resolving and Preventing Financial Crises: The Role of the Private Sector*”, March 26,2001

[38] See, supra, IMF, “*Involving the Private Sector in the Resolution of Financial Crises*”

[39] See, Id

characteristics of Ecuador Bradys might imply the difficulties of restructuring.

(2-2) Restructuring strategy taken by Ecuador

Given this situation, Ecuador took innovative restructuring strategy[40]. Among these was the use of "exit consents", weakening the legal rights of bondholders, who decided not to participate in the exchange. Under the exchange offer, bondholders who accepted the exchange offer automatically voted in favor of a list of amendments, making the existing bond less attractive[41]. The following provisions were eliminated in order to make existing bonds less attractive[42].

(a) The requirement that all payment defaults must be cured as a condition to any recision of acceleration,

(b) The provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing,

(c) The covenant that prohibits Ecuador from seeking a further restructuring of Brady bonds,

(d) The cross-default clause,

(e) The negative pledge covenant,

[40] See, Id, "The restructuring had a number of innovative features, including creditor's choice of instruments, the mandatory prepayment arrangement, the mandatory reinstatement of principal in the event of a subsequent sustained default in the first ten years of the life of the new instruments, and the use of exit consents (also known as "exit amendments")"

[41] See, Id.

[42] See, Id.

(f) The covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange

In addition to that, the completion of the exchange offer is predicated on bondholders holding the requisite majority agreeing the amendment. As a result, even if the bondholders who refused to accept the "exchange offer" became a majority of the original bond, they cannot reverse the amendments without the consent of sovereigns. By taking this strategy, using exit consents, Ecuador almost successfully conducted exchange offer,[43] though there still remained few bondholders[44]. It can be said that exit consents played the leading role to conduct exchange offers successfully, by discouraging bondholders to remain in existing bond, prevent potential vulture fund from causing holdout problem.

6. The validity of Exit consents

Exit consents is criticized by its coercive nature. Since it discourages bondholders to hold existing bonds by reducing the attractiveness of bonds, otherwise they may find attractive. The leading case which deal with this problem is Katz v. Oak Industries.

[43] See, supra Moody's, "approximately 98% of the original holders had accepted the exchange".
[44] Ecuador paid to these bondholders who did not accept the exchange offer. See, id, "(b)ecause of the possibility of legal action from those holders who had not participated in the exchange, Ecuador has opted to pay the interest arrears and is, at the same time of this comment's publication, presently servicing the outstanding Bradys, under the original terms."

(1) Katz v. Oak Industries case

Oak industries, "Oak", a Delaware corporation, was seeking to restructure its financial status. Oak tried to reduce burdensome annual cash interest payments on its outstanding debentures, by offering exchange these debentures for a combination of notes, common stock and warrants[45]. Bondholders who accepted the exchange offer were required to consent to amendments that would exclude all binding financial covenants. "Katz", one of the bondholders, who did not accept the exchange offer filed the lawsuit alleging that the exchange offer was "coercive" that violate the company's duty to act in good faith to bondholders[46]. Katz sought a preliminary injunction to restrain Oak from completing exchange offer. The court rejected the preliminary injunction and granted the validity of the exchange offer.

(2) Requirement for valid exit consents in corporate bond restructuring

The points of the Katz' case may be summarized as follows.

(a) <u>No implicit fiduciary duties for the relationship between a corporation and the bondholders</u>

The court recognized that the relationship between a corporation and the holders of its

[45] See, 508 A.2d 873

[46] See, id

debt securities is contractual in nature[47]. The level of duty of corporation owes to its bondholders is a matter of interpretation of its indentures. In other words, broad or high standard of fiduciary duty, which corporate directors owe to their shareholders, is not applied to the relationship between a corporation and the bondholders. Instead of this, corporation owes duty to bondholders of good faith and fair dealing[48].

(b) Only the "wrongful" coercion should be prohibited

Given the contractual nature of the relationship, coercion is sometimes justified[49]. The legal norm must be whether such coercion is wrongful or not.

(c) Foreseeability[50] of exit consents

In order to decide whether certain exit consents is wrongfully coercive, the court looked the intention of bondholders. Had the party who entered the original bond contract foreseen the exchange offer and the exit consents, would have forbidden such

[47] See, id

[48] See, id. "The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders." However, the court also stated that: "To say that the broad duty of loyalty that a director owes to his corporation and ultimately its shareholders is not implicated in this case is not to say, as the discussion below reflects, that as a matter of contract law a corporation owes no duty to bondholders of good faith and fair dealing."

[49] See, id. For example, "employers may "coerce" regular attendance at work by either docking wages for time absent or by rewarding with a bonus such regular attendance."

[50] See, Moody's, "*Sovereign Restructuring: Putting Too Much Faith in Exit Consents*", March 2001

an action[51].

> " (i)s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter."

(d) Whether there is enough compensation

In response to the plaintiff's assertion that issuer "force" all bondholders to tender their securities a less than the redemption price constitutes a breach of an implied covenant of good faith and fair dealing, the court pointed out that the present offer is not the functional equivalent of a redemption. The court pointed out that "the exchange offer's success ultimately depends upon the ability and willingness of the issuer to extend and offer that will be a financially attractive alternative to holders." In other words, if there is enough compensation that makes bond exchange attractive for bondholders, then this fact supports the validity of bond exchange and exit consents.

Therefore, in order to confirm the validity of exchange offer and exit consents, it is

[51] See, 508 A.2d 873. "Applying the foregoing standard to the exchange offer and consent solicitation, I find first that there is nothing in the indenture provisions granting bondholders power to veto proposed modifications in the relevant indenture that implies that Oak may not offer an inducement to bondholders to consent to such amendments."

necessary to meet the following requirements.

Foreseeability

Enough compensation

This criteria first asks what kind of provisions can be amended, foreseeability. If the provisions can be amended, the next test will be whether there is enough compensation. However, these requirements themselves are not clear. Therefore courts will have to compare the status of issuer and bondholder case-by-case basis.

(3) Requirements for exit consents in sovereign debt restructuring

The legality of exit consents in the context of sovereign debt has never been challenged. In order to draw some implications for requirement for sovereign bonds from requirements for corporate bond, first I will examine the difference between sovereign and corporate. Then I will argue that courts will likely to use stricter standard to decide the legality of sovereign debt restructuring.

(3-1) Difference between sovereign bonds and corporate bonds

The major difference between the default of sovereign bonds and corporate bonds is the presence of bankruptcy law, especially the liquidation risk[52]. In case of corporate bonds, there is always a threat of liquidation under which creditors can pick up all assets of defaulted corporation. On the contrary, sovereign does not face with this liquidation risk.

[52] Liquidation cannot be applied to sovereign by definition.

If a sovereign defaulted on its payment, it is impossible to initiate bankruptcy proceedings which allow bondholders to seize all assets of sovereign. The risks with which sovereigns face are the reputation risk in the international financial market, and litigation risk which was pointed out above. Reputation risk in the financial market is that once sovereign defaults to its bonds, it will be required higher premium on its following issuance of bonds. The worst scenario will be that nobody will invest in the bonds. In other words, the lack of future access to the capital market. However, these risks are also involved with corporate sector that defaults on its bonds. This suggests that deterrent to sovereigns which prevent issuer from defaulting is much weaker than that to corporate sector. In other words, compared to corporate sector, sovereign has more incentive to default strategically, even if it has sufficient resources to repay its debt. This difference about liquidation risk, may affect the condition of exchange offer by which issuer try to restructure its debt. The threat of liquidation drives corporate sector to offer more attractive condition of exchange offer, than sovereign[53]. Corporate sectors have incentive to offer more favorable condition of exchange offer than sovereigns, if both of them have to restructure their debt by conducting exchange offer. Therefore, it may distort the balance between cost and benefit of restructuring, if sovereign will be granted to use exactly same restructuring technique which is permitted for corporate bond restructuring. Since, while corporate sector has incentive to offer more attractive exchange offer due to liquidation risk, sovereign is not in such situation. Given this loose situation for sovereign, courts may be

[53] See, Mchael Westphalen, *"Valuation of Sovereign Debt with Strategic Defaulting and Rescheduling"*, July 10, 2001

sensitive to the condition of the exchange offer provided by sovereign. Also it should be noted that, it is beyond the ability of courts to decide whether sovereign is providing reasonably favorable condition on exchange offer. Since court is not capable of deciding availability of funds, nor appropriate restructuring plan for the debtor country. Therefore, at least, it is prerequisite that IMF and debtor country should provide precise and timely information regarding debtor country.

(Incentives, disciplines for issuers to pay debts in a timely manner)

	Corporation	Sovereign
Liquidation Risk	Yes	No
Reputation Risk (Future access to mkt)	Yes (Hard to restore confidence)	Yes (IFIs[54] may provide money)

(3-2) What kind of provisions can be amended in sovereign debt restructuring?

Because of the lack of liquidation risk of sovereigns, courts may use stricter standard when applying above two requirements, foreseeability and enough compensation. I would like to examine what kind of provisions can be amended in connection with exit consents. This is a matter of foreseeability. Buchheit and Gulati categorize bond provisions into

[54] International Financial Institutions, such as IMF, World Bank.

three in order to analyze the possibility to use exit consents[55].

(1) **Category 1** is the provisions that require the consent of each affected bondholder to amend. These are payment amount, due date, interest rate, currency of payment and amendment requirements such as the percentages required for votes to amend the instrument. The reason why payment terms of bonds issued under New York law typically require unanimous vote of bondholders to change, is just a matter of convention or contract. The U.S. Trust Indenture Act of 1939, Section 316 (b), expressly requires unanimous vote to change payment terms. Although, this Act applies only to corporate bonds, standard sovereign bond documentation tends to follow this Act[56]. There is no legal reason why payment terms of sovereign bond cannot be amended by qualified majority vote of bondholders[57].

(2) **Category 2** is the provisions that have the practical effect as Category 1 if amended or removed from the bond. These are governing law clause, and acceleration clause.

(3) **Category 3** is the all other provisions of the bonds. These are waiver of immunity, submission to jurisdiction, financial covenants, and listing clause.

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[55] See, supra, Buchheit "*Exit consents in sovereign bond exchanges*"

[56] See, Lee C. Buchheit, "*Majority Action Clauses May Help Resolve Debt Crises*", Int'l Fin. L. Rev., August 1998, at 13. In addition, it's worth to note the legislative history of the Trust Indenture Act of 1939. 'SEC was concerned that majority action clauses in public bonds could permit corporate insiders to gain control of a bond issue and then vote to forego payments on the bond to the detriment of the minority bondholders." In other words, the Act prevent stockholders from inverting normal bankruptcy priorities which require that bondholders get paid before stockholders.

[57] See, supra, "*Sovereign Debtors and Their Bondholders*" at 23

(Category 1)

The amendment of Category 1 is out of question. Since it requires unanimous consent to change its terms. Thus, it is obvious that amendment of Category 1 does not meet the foreseeability requirement.

(Category 2)

Amendment of Category 2 is not clear[58]. As to **governing law**, it should be impossible to amend without unanimous consent. Since it is so fundamental that nobody foresees the amendment.

As to amendment of **acceleration clause**, which requires early payment and termination in the event of default, is significant and controversial. The reason why Ecuador government removed the acceleration clause from old bonds when conducting bond exchange[59], was to prevent holdouts from seeking full payment of old bonds. The significant impact of this amendment is that, bondholders who did not accept exchange offer could only seek missed payments when those payments fall due according to their original terms[60]. If bondholders have bond, whose maturity is 10 years later and the issuer continues to service, these bondholders should wait 10 years to seek redemption of principal. They can only seek each missed payments of interests. This outcome must significantly discourage bondholders to remain in holding old bonds. Although this amendment has significant

[58] See id at 80.

[59] See, supra, IMF.

[60] See, supra "*Exit consents in sovereign bond exchange*" at 80.

impact to conduct exchange offer successfully, courts may not permit this amendment, if the legality of amendment of acceleration clause in connection with exit consents will be challenged[61]. The reasons are as follows. First, the acceleration clause is a kind of payment terms, which are not allowed to amend without unanimous consent. Since, removal of acceleration clause changes the due date of payments in case of default. Second, courts may find this amendment and its impact will be inefficient for the use of judicial resources[62]. For example, in case of default of bond whose maturity will be 10 years later, courts will be asked to issue order of payment several times. It is likely that courts will avoid this redundancy of suits. Third, as pointed out above, courts may use stricter standard in case of sovereign debt workout than in case of corporate bonds. While there is no bankruptcy court dealing with sovereign debt default, bondholders have only two remedies, acceleration and litigation. Thus, it is hard to imagine courts will grant the validity of the amendment of acceleration at the expense of bondholders. Therefore, Category 2, governing law and acceleration clause cannot be amended in connection with exit consents.

(Category 3)

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[61] Needles to say, this problem will not occur, if there is the clause which explicitly permits bondholders to amend the provision.

[62] See, supra *"Sovereign Restructuring: Putting too much faith in exit consents"* at 9 "It is probable that the courts will quickly identify such suits as tedious and ineffectual use of valuable judicial resources…one would assume that the courts would through some, no-doubt, interesting and imaginative legal reasoning, opt to reinstate the acceleration clause."

In light of foreseeability requirement, the provisions, which can be categorized in Category 3, may be amended in connection with exit consents[63]. Let me analyze the effectiveness of amending these provisions. There are several candidates for the amendments, I will examine waiver of sovereign immunity clause, listings clause and negative pledge clause. First, as to **sovereign immunity clause**, there may be certain impact on holdout creditors, though this impact will be limited in near future. Some sovereign bonds have waiver of sovereign immunity for lawsuits[64], though the United States Sovereign Immunities Act[65] provides that sovereign immunity does not apply if the subject of the lawsuit concerns a commercial activity. The issuance of bonds is considered commercial in nature, regardless of the ultimate use of funds[66]. Thus sovereign can be sued whether or not there is waiver of immunity in bond contracts. The reason why some sovereigns include waiver of immunity may be to ensure investors that issuers are confident not to default or just a matter of drafting convention. The significance of removal of sovereign immunity clause may be that it requires bondholders to make clear the definition of the creditor's access to "property which is physically located in the United States, and which was used for the commercial activity upon which the claim is based"[67]. Thus, the impact of the amendment depends on how courts will define "the commercial activity upon which the claim is based". Courts have not made clear this definition. However, as Eliott case suggests, it is highly

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[63] See, supra *"Exit consents in sovereign bond exchanges"* at 81
[64] Ses, id at 81
[65] See 28 U.S.C. § 1602-1611
[66] See, Moody's *"Sovereign Debt: What Happens If A Sovereign Defaults?"*, July 2000 at 4
[67] See, 28 U.S.C. § 1610 and See, id Moody's at 5

likely that courts will extend the coverage of attachment for satisfying the sovereign investor's claim. Therefore, the amendment of waiver of sovereign immunity may have limited impact on holdout creditors.

Second, as to amendment of **listings clause**, it also has limited impact on holdout creditors. The significance of the amendment is to eliminate the liquidity of old bonds. Once the bonds are eliminated from the listings of exchanges, bondholders will face the difficulty to find the buyers of their bonds. Therefore the amendment may discourage the bondholders, who manage their portfolio by mark-to-market basis, to hold old bonds whose listings clauses are stripped. However, the amendment has no impact on the investor whose investment strategy is buy-and-hold. And it is especially true for vulture fund whose strategy is to buy illiquid bonds at distressed price and hold these securities until they will be redeemed.

Third, as to **negative pledge clause**, issuer may make old bonds to be subordinated to new bonds or make old bonds to be collateral of new bonds. These amendments will reduce the attractiveness of holding old bonds. However, if old bonds still have acceleration clause, the amendment will have limited impact on holdout creditors. Since, if sovereign stops to service the old bonds, while continues to pay new bonds, bondholders of old bonds can immediately seek the redemption by declaring the acceleration. Therefore the amendment will be ineffective unless the acceleration clause of old bonds will be stripped.

(3-3) Limited application of exit consents in sovereign debt restructuring

As examined above, courts may use stricter standard when addressing the validity of exit consents in sovereign bond exchanges. Because sovereigns are not exposed to the risks of liquidation, it is unlikely that courts will grant the sovereign to conduct exit consents which will have greater impact on bondholders to discourage holding bonds, such as amendment of acceleration clause. Sovereigns may be able to amend following provisions which are all categorized in Category 3 as described above. Those are the amendment of waiver of sovereign immunity, listings clause, and negative pledges. If acceleration clause still exists in old bonds these amendments will have limited effectiveness, and will be insufficient to discourage holdout creditors, namely vulture funds, not to accept bond exchanges. If there are no Collective action clauses that allow qualified majority of bondholders' consents to bind other bondholders legally, the only way to avoid litigation by vulture funds is to continue to service old bonds.

(Provisions can be amended for exit consents)

Provisions		Corporate Bond	**Sovereign Bond**
Category 1		No	No
Category 2	Governing Law	No	No
	Acceleration Clause	Yes	No
	Cross-Default Clause	Yes	No
Category 3	Waiver of Immunity	Yes	Yes
	Negative Pledge Covenants	Yes	Yes
	Listing Clause	Yes	Yes

7. What should we do to deal with holdout problem in sovereign debt restructuring?

(1) Basic stance

Exit consents may work well when restructuring sovereign bonds. However, the application of this technique will be limited compared to corporate bonds restructuring. Since once the validity of exit consents in sovereign bond exchange will be challenged in courts, courts will highly likely to apply more stricter standard than to corporate bond exchange case. The main reason for this is the lack of liquidation risk for sovereign, which give sovereign the negative incentive to conduct strategically defaults and set less favorable condition on exchange offering. Therefore, the effectiveness of exit consents which discourage vulture funds to holdout, remain in existing bonds will be limited in sovereign bond exchange offers.

The effective way to exclude holdout problem will be the implementation of Collective Action Clauses (CACs). This approach which is describe below, may be more cost effective than to create international bankruptcy court which is proposed by IMF officials.

(2) Proposals to implement CACs

In order to deal with Holdout problem and conduct exchange offer easily, I propose following strategy.

(1) For new bonds, encouraging the implementation of Collective Action Clauses (CACs)

(2) For existing bonds, conducting exchange offer under which replacing all existing bonds with new bonds contain CACs,

(3) In order to prevent concern about possible default from arising, monetary authorities should announce the support to implement CACs. Since, investors may think that the implementation of CACs is a signal of financial trouble of debtor country.

(4) IMF should encourage debtor countries to implement CACs, by providing favorable Credit Contingent Line[68] temporally to the countries, which encourage implementation of CACs to their bonds. Just setting the favorable credit line does not require IMF to spend money, while it may be effective to reduce the investors' concern about possible default[69].

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[68] Contingent Credit Line: "The CCL is aimed at preventing the spread of a financial crisis enabling countries that are basically sound and well managed to put in place precautionary financing in the event a crisis should occur." See, IMF, "Glossary of Selected Financial Terms", http://www.imf.org./external/np/exr/glossary/show/Term.asp?term_id+20

[69] Eichengreen also propose the international financial institutions to encourage the implementation of CACs. See Barry Eichengreen, Christof Ruhl, "*The Bail-In Problem: Systematic Goals, Ad Hoc Means*", NBER Working paper series 7653, April 2000 at 31. "It (IMF) can make the adoption of collective action clauses a precondition for qualifying for the Contingent Credit Facility." "The Basle Committee of Banking Supervisors can key the risk weights on cross-border bank lending to the presence or absence of such provisions. The World Bank can provide resources to countries to

8. Conclusion

The international financial crises have significant impact on financial market and world economy. These crises have often been triggered by default of sovereign debt. Unlike the default of corporate bonds, there is no clear-cut legal infrastructure, such as bankruptcy court, to deal with default of sovereign debt. The absence of legal infrastructure complicates and deteriorates the workout process. One of the major problems is that holdout problem. Several suggestions have been made to deal with this problem. One of those suggestions is utilizing exit consents, which is well utilized in corporate debt workout. This technique can be used without any legal changes. However, the effectiveness of exit consents may be reduced if it is utilized in sovereign debt restructuring. Due to the lack of liquidation risk of sovereigns, courts may use stricter standard to approve the validity of this technique. Under this stricter standard, courts may not grant the amendment of acceleration clause. If acceleration clause cannot be amended, the effectiveness of exit consents will be drastically undermined. Under this limited application, exit consents cannot exclude holdout creditors. The more effective and practical measure would be implementation of Collective Action Clauses (CACs), which enable qualified majority of consents to bind other bondholders legally. Although sovereign bonds issued under New York law typically do not contain CACs, implementation of CACs is not prohibited.

buy up old bonds lacking such provisions and replace them with new, renegotiation-friendly instruments."

Therefore, the implementation of CACs can be achieved by issuing new bonds which contain CACs and conducting exchange offers with existing bonds. Major problem would be that the implementation of CACs to existing bonds raises concern about default of these bonds. One of ways to deal with this concern would be providing favorable term of Credit line by IMF to country implementing CACs. Under this approach, no one should pay cost unless actual default occurs.

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