CLIFFORD

CHANCE



# Euro area member states take collective action to facilitate sovereign debt restructuring

*A new agreed form of model collective action clause for euro area member states to adopt (the Model CAC) in respect of their sovereign debt was published by the EFC Sub-Committee on EU Sovereign Debt Markets in March 2012. Following the publication, Germany is the first country to have passed legislation to implement a form of model collective action clause into national law. From 1 January 2013, all euro area sovereigns will be required to include the Model CAC in both international and domestic government securities. With the January 2013 deadline looming and some sovereigns already starting to adopt the new Model CAC, other countries are anticipated to follow suit in the near future. This briefing describes the background to the new Model CAC and answers some "Q&A". It also includes a table comparing the new Model CAC provisions with the International Capital Market Association (ICMA) collective action clauses published in 2004.*

## Topics



## BACKGROUND

### What is a collective action clause (CAC)?

A CAC is a contractual provision which can facilitate sovereign debt restructurings by minimising "hold-out" creditor problems and encouraging a voluntary-based approach to sovereign debt restructurings. Modifications to a euro area government's securities which include a CAC will be effected if the modifications proposed are approved by the requisite majority of holders of affected securities. If so, the modifications will bind all holders of the affected securities.

### Why do euro area sovereigns need to include a Model CAC from January 2013?

The new Model CAC forms part of a series of policy measures announced by euro area finance ministers in November 2010 intended to safeguard financial stability in the euro area. The concept of a euro area sovereign CAC has now been enshrined in the Treaty establishing the European Stability Mechanism (the ESM Treaty) signed by the euro area member states in February 2012 and which came into force on 27 September 2012. The primary purpose of the ESM Treaty is to provide for a permanent euro area financial stability fund – taking over from the temporary European Financial Stability Facility. Significantly, though, the treaty also requires its signatories to use collective action clauses from the start of next year: "*Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical.*" - (article 12(3)). The detailed legal arrangements for CACs have been left to be finalised by the EU's Economic and Financial Committee ("**EFC**"): recital (11).

## THE ICMA CAC AND THE NEW MODEL CAC

### History – the evolution of CACs

Collective action clauses are not new to the capital markets – nor are they new to European sovereign issuers. They have been included in a number of sovereign issues over the last ten years or so. CACs were adopted as the contractual solution which was acceptable to both the official and private sector, following the shelving of the IMF's Sovereign Debt Restructuring Mechanism or "SDRM" proposal debated in 2001-2003. A primary conceptual aim of CACs historically has been to promote orderly restructurings in the event of sovereign debt crises and also to address a key difficulty in resolving sovereign debt crises – that of apportioning risk or "burden-sharing" with the private sector, rather than the international community essentially having to bail out private creditors.

In April 2003 – in response to G10 recommendations and an earlier G10 Working Report on Contractual Clauses (which included a model CAC governed by New York law) – European member states agreed to include collective action clauses in their central government bonds issued under a foreign jurisdiction and/or governed by a foreign law.

Significantly, however, historically few issuers included the concept of aggregation in their CACs (that is, gathering investors from different series of bonds from one issuer together at the same time to vote on changes across a number of series). This may, in part, stem from the conclusion reached by the G10 Working Group in their 2002 report, that, whilst desirable, aggregation or "blended voting" would rarely be practicable within a contractually-based mechanism. The G10 CAC recommendations, therefore, did not propose the inclusion of aggregation as a standard element of a CAC.

### History – the IIF Principles

The inclusion of CACs in sovereign bonds formed only one part of the proposed market-based solution to sovereign debt restructuring. In tandem with the development of sovereign CACs, a set of "Principles" (*Principles for Stable Capital Flows and Fair Debt Restructuring*) were agreed between sovereigns and private creditors in the autumn of 2004. The Principles, as they are known, were published by the IIF and welcomed by the G20 Finance Ministers. Whilst their status is one of non-binding guidance, they are designed to enhance transparency and information flows to investors, thus improving dialogue and co-operation and, if necessary, facilitating voluntary sovereign debt restructuring. The Principles are designed to operate at all times – that is, during all phases of the economic cycle (and not just in times of crisis).

### The ICMA CAC

Following the April 2003 agreement by the EU member states and the endorsement of the set of core clauses prepared by the EFC in September 2003, ICMA, working together with other industry associations and market participants, developed a form of collective action clauses for use in sovereign bonds governed by English law and issued under a fiscal agency structure (the "**ICMA CAC**"). The ICMA CAC was published in October 2004. It has been used for many English-law governed debt issuances by European and other sovereigns since then.

### The new Model CAC

In November 2010, as the Eurozone sovereign debt crisis unfolded, a number of policy measures were introduced with the aim of safeguarding financial stability in the Eurozone. One such measure was the proposed mandatory inclusion of standardised collective action clauses, in a manner which would preserve market liquidity in euro area government securities. In March 2011, it was agreed that euro area member states would take all the necessary actions to implement standardised collective action clauses. As a result, the EFC Sub-Committee on EU Sovereign Debt Markets (the "**Committee**") produced and distributed a draft Model CAC for comment by market participants and other interested stakeholders including ICMA, other industry bodies, institutional investors, the European Central Bank, the IMF, the London Stock Exchange and Euroclear. It was initially contemplated that the Model CAC would be introduced into all new euro area government securities from July 2013, but implementation has been brought forward to 1 January 2013. In addition, optional supplementary clauses (which may be used in conjunction with the Model CAC) together with two explanatory notes were published, respectively, prior to and after the consultation with market participants and other interested stakeholders.

## KEY PROVISIONS OF THE MODEL CAC

There are three main points to highlight about the Model CAC. First, it is designed to be utilised in both foreign- and domestic-law securities. Secondly, it has lower voting thresholds than those in the ICMA CAC and other market standard collective action clauses and has removed the requirement of unanimous consent for certain changes to the terms of an issue. Thirdly, the Model CAC includes an aggregation feature (referred to as cross-series modification) to permit changes to be made to more than one series of bonds at the same time. These and the other key provisions of the Model CAC are described in more detail below:

### Reserved Matters

Bond terms and conditions fall into two categories for the purposes of amendment: Reserved Matters and Non-Reserved Matters. "**Reserved Matters**" are modifications which relate to the most important bond terms and conditions (and therefore, require a higher approval threshold). These customarily include proposals impacting on payment terms (e.g. payment dates and amounts due), currency and place of payment, seniority and ranking of the bonds, and the release of any applicable guarantee or security. The Model CAC also incorporates into the scope of Reserved Matters changes in governing law and jurisdiction and waiver of immunity provisions, which have sometimes been subject to unanimity in other forms of CACs. As a result, under the Model CAC there will be no matters for which the unanimous consent of bondholders is required to effect a change. "**Non-Reserved Matters**" are other, less significant terms.

In the Model CAC, a change in the governing law of a bond is only a Reserved Matter if the bond is governed by a law other than the law of the issuer (if the bond is governed by the law of the issuer, the issuer already has the power to implement domestic legislation to effect the modification, although using such a power may in practice cause important concerns).

### Single-Series Modification: thresholds

In relation to a proposed modification of a single series:

- the threshold for Reserved Matter modifications is not less than 75% of the aggregate principal amount of the outstanding bonds represented at a meeting, or not less than $66^2/_3$% of the aggregate principal amount of outstanding bonds for a written resolution.
- the threshold for Non-Reserved Matter modifications is more than 50% of the aggregate principal amount of the outstanding bonds represented at a meeting, or more than 50% of the aggregate principal amount of bonds outstanding for a written resolution.

### Cross-Series Modification: operation and thresholds

In order for modifications to apply across more than one series under the Model CAC, a two-limb threshold test must be satisfied.

First, a threshold relating to all the bonds taken in aggregate:

- an affirmative vote of not less than 75% of the aggregate principal amount of the outstanding debt securities represented at separate duly called bondholder meetings of the holders of the debt securities of all the series (taken in the aggregate) that would be affected by the proposed modification; or
- a written resolution of holders of not less than $66^2/_3$% of the aggregate principal amount of the outstanding debt securities of all series (taken in the aggregate) that would be affected by the proposed modification.

Secondly, a threshold relating to each individual series affected by the proposed modification:

- an affirmative vote of more than $66^2/_3$% of the aggregate principal amount of the outstanding debt securities represented at separate meetings for each series of debt securities (taken individually) that would be affected by the proposed modification; or
- a written resolution of holders of more than 50% of the aggregate principal amount of the then outstanding debt securities of each series (taken individually) that would be affected by the proposed modification.

The proposed cross-series modification may contain more than one proposal as to how the bond terms are to be modified, but each proposal must be addressed to, and capable of being accepted by, any holder of any debt security of any affected series.

Market participants may question what the advantages of aggregation are for either debtors or creditors where the provisions require a two limb approval process and the holding of individual bondholder meetings/passing of a favourable written resolution on a series per series basis in any event; but having an aggregate vote only across all affected series with no series by series approval may have subjected such voting to unenforceability risks in some euro area countries. It is worth noting, however, that where aggregation is to be made use of by an issuer, the series by series voting thresholds for reserved matters are lower than if aggregation is not utilised.

### Partial Cross-Series Modification

The Model CAC provides an additional new feature. If a cross-series modification would have been approved had only certain of the series of bonds been proposed for modification, the Model CAC gives the sovereign issuer the flexibility to effect a partial cross-series modification. However, the sovereign issuer is required to notify the bondholders of the conditions under which a partial cross-series modification may be deemed to apply, prior to the initial vote for the cross-series modification.

### Quorums

The quorum for holding a bondholder meeting for the purposes of a Reserved Matter modification is bondholders representing not less than $66^2/_3$% of the aggregate principal amount of bonds outstanding. This quorum applies to both initial and adjourned meetings. The quorum for holding an initial bondholder meeting for the purposes of a Non-Reserved Matter modification is bondholders representing not less than 50% of the aggregate principal amount of bonds outstanding. This is reduced to a quorum of not less than 25% for adjourned meetings. For these purposes, an adjourned meeting may arise in the event that a quorum is not established within thirty minutes of the time appointed for the initial meeting. It is important to note the quorum thresholds are set by reference to the aggregate principal amount of bonds outstanding whereas thresholds for votes cast at meetings (including cross-series) thresholds are set by reference to those attending the meeting.

### Additional provisions relating to types of securities – e.g., zero-coupon and index-linked notes

The Model CAC introduces some new, technical provisions concerning zero-coupon and index-linked obligations, which enable investors to calculate the principal amount when determining whether the relevant approval threshold has been met for a proposed modification. Given the market for sovereign debt securities (particularly the innovations relating to coupon stripping of debt securities issued by France, Germany and Spain), it was considered important to provide a method for determining the aggregate principal amount for non-standard government debt securities – especially necessary for cross-series modifications. In relation to index-linked debt securities, the aggregate principal amount is determined by reference to the performance of the index up to the record date. In relation to a zero-coupon debt security, the aggregate principal amount is determined using a present value calculation discounting the principal due at maturity using a discount rate determined either by the specified yield to maturity, or if the zero-coupon bond results from a stripped debt security, the coupon previously attached to such bond, or if this cannot be determined, the average coupon of bonds having the same maturity.

### Disenfranchisement

As is the market practice for collective action clauses, bondholders that are controlled by the sovereign issuer (or any of its ministries, departments or agencies) are disenfranchised. For this purpose, the central test is whether the government bondholder entity has autonomy of decision with respect to its right to vote on a proposed modification. Such bonds are therefore not considered outstanding when determining whether the relevant approval threshold has been met for a proposed modification. Disenfranchised bonds are also excluded for voting and quorum purposes. This should prevent the sovereign issuer from instructing government-controlled entities to vote in favour of a proposed modification, with the intention that only genuine investors should be agreeing to modifications to the terms of the bonds.

### Acceleration and rescission

The acceleration and rescission of acceleration provisions are presented as supplemental provisions to the Model CAC which the issuer may or may not choose to adopt. Under these provisions, on an event of default, bondholders representing at least 25% of the aggregate principal amount of bonds outstanding may give written notice to the issuer of acceleration, whereby the bonds become immediately due and payable. Bondholders representing more than 50% of the aggregate principal amount of bonds outstanding may rescind such a notice of acceleration on behalf of all bondholders. These provisions were included as supplemental provisions as they would not be consistent with many domestic law instruments which have few terms and conditions and may not, for example, include events of default. However, the Committee does recommend that these provisions be included where they are consistent with the issuer's existing practices.

### Bondholder meetings

The Model CAC includes some provisions for the convening of bondholder meetings. Such rules outline who may convene a meeting (the issuer at any time, or upon the request of bondholders representing at least 10% of the aggregate principal amount of the outstanding bonds where there is an event of default) and the requisite notice period for convening a meeting (21 days (or 14 days for an adjourned meeting)). The Model CAC does not prescribe the complete set of rules for convening meetings and there is flexibility for the issuer to adopt supplementary rules prior to any meetings being called to consider proposed modifications.

### Calculation Agent

A calculation agent is to be appointed by the sovereign issuer to calculate whether a proposed modification has been approved by the requisite percentage of bondholders both on a series by series and on an aggregate basis, as relevant. The Model CAC does not prescribe for such a party to be appointed at the time of issuance but only prior to the Model CAC being utilised.

## Q&A: KEY ISSUES WITH THE MODEL CAC

### Which government bonds will be subject to the Model CAC?

The Model CAC will apply to all new bonds, notes and other debt securities with an original stated maturity of more than one year issued by national euro area governments, irrespective of whether the debt security is listed on a securities exchange, is actively traded or is privately placed.

### Will it apply to debt issued by local or regional governments or to government guaranteed debt?

The explanatory note issued by the Committee on 26 July 2011 stated that the Model CAC will not apply to debt securities issued by regional and local euro area governments, actively traded syndicated loans contracted by covered borrowers, or debt securities guaranteed by covered guarantors on the basis that these represent a very small part of the euro area governmental indebtedness as a whole. Retail savings instruments such as non-transferable bonds or certificates sold to retail without fees or commissions being payable are also to be excluded from any obligation to include the Model CAC in such instruments.

However, the explanatory note merely indicated those entities for which the application of the Model CAC is not mandatory but it does not preclude such entities from voluntarily opting to adopt the Model CAC. It is anticipated that some euro area member states that have large regional government debt issuers will choose to expand the application of the Model CAC in their jurisdiction to capture such issuances by including the Model CAC in debt instruments issued by such entities.

Each euro area member state will need to consider the portfolio of securities it has issued and evaluate whether any should be exempt from the mandatory application of the Model CAC as a result of the application parameters referred to above.

The scope of debt securities that may be subject to the Model CAC is important for investors. They will wish to understand which debt securities might be aggregated for the purpose of any cross-series modification. This is especially important, as the discretion as to whether to use the new aggregation feature or not and which series of debt securities to include has been left to the sovereign issuer.

### How will "identical legal effect" CACs be achieved across the euro area?

Where necessary, member states must pass local legislation to implement the Model CAC. Germany, for example, passed an act amending the Federal Act on Debt Management (*Gesetz zur Änderung des Bundesschuldenwesengesetzes*) to implement the Model CAC provisions in September 2012.

### Will any euro area governments include the new Model CAC in bonds issued before 1 January 2013?

The Committee stated that it did not envisage that the Model CAC would be introduced into euro area government securities issued prior to 1 January 2013. However, some sovereign issuers may voluntarily opt in before 1 January 2013 as was the case in respect of the English-law governed bonds issued by the Hellenic Republic as part of its Private Sector Involvement ("**PSI**") transaction, in February 2012, which include a form of collective action clause based on the new Model CAC. Also, interestingly, the Republic of Slovakia chose to include the Model CAC in its English law governed May 2012 issue of USD1,500,000,000 4.375% Notes due 2022 and the Republic of Slovenia chose to include the Model CAC in its issue of USD 2,500,000,000 5.5 % Notes due 2022. We are aware of other issuers currently contemplating including the Model CAC in prospective deals.

**What about Medium Term Note programme updates? Should I be including the Model CAC in this year's update, ready for use after 1 January 2013?**

It is likely that changes will be added into MTN programmes only once any necessary relevant legislation to introduce the Model CAC is in place in the relevant jurisdiction or if domestic legislation will not be necessary. The European Stability Mechanism included the Model CAC in its Debt Issuance Programme which signed on 3 December 2012.

**Will non-euro area member states adopt the new Model CAC in their international and domestic debt?**

It will not be mandatory for other EU member states to adopt the Model CAC, however, it is possible that some may choose to do so. Non-euro area member states participated in the discussions on the new Model CAC. Other European official sector institutions may also choose to adopt the Model CAC.

**Taps and fungible tranches. After 1 January 2013, will it be possible to "re-open" (or "tap") a bond issued prior to 31 December 2012 (which did not include the Model CAC)?**

The supplementary explanatory note of 26 March 2012 accompanying the Model CAC allows euro area member states, upon agreed conditions, to issue further tranches of debt securities outstanding on 1 January 2013 without having to include the Model CAC. This is to preserve the fungibility of the debt issuance and to encourage market liquidity. The supplementary explanatory note limits the percentage of sovereign debt securities that may be issued by a country in each year using this tapping mechanism (reducing from 45% in 2013 to 5% from 2023 onwards). These tapping percentage levels will be reviewed in 2015.

**Aggregation: will bonds with different governing laws (for example, domestic law and English law) be aggregated for cross-series modifications?**

In the provisions relating to cross-series modification, the Model CAC does not distinguish between series governed by different laws. In a cross-series modification each individual series will have its own bondholder meeting. As a result, it should be possible to satisfy the bondholder meeting requirements in the different governing laws on an individual series basis, while applying the provisions for cross-series modification in the aggregate.

**Will the potential partial cross-series modification make it unattractive for bondholders to vote for cross-series modification?**

There has been significant debate about the impact of a partial cross-series modification in the draft stages of the Model CAC and whether it would discourage investors from approving modifications if they were concerned about voting in favour of modifications which potentially may not be shared with others. In the final Model CAC, an issuer is required to notify holders of the bonds and other affected debt securities of any conditions which will apply prior to the deemed approval of any cross-series modification in the event that a proposal cross-series modification is not approved in relation to a reserved matter.

**How "super" a majority is actually needed to approve modifications?**

The threshold percentages required for the approval of any modifications are broadly consistent with collective action clauses previously seen in the market (albeit, lower). It is notable, however, that there is a difference in how the percentage is applied depending on whether the approval is sought at a meeting or through a written resolution. At a meeting, the percentage only relates to the aggregate principal amount of bonds **represented at the meeting**, rather than aggregate principal amount of bonds **outstanding**. Taking into consideration the quorum requirements, which, however, are set by reference to the aggregate principal amount of bonds outstanding, there is therefore the potential for modifications of Reserved Matters to be approved by just over 50% of the outstanding aggregate principal amount of the relevant bonds (by multiplying the minimum quorum for a Reserved Matter by the minimum percentage threshold for a Reserved Matter). This is lower than many collective action clauses currently being used in the market. In contrast, the threshold percentages relating to written resolutions are applied to the outstanding aggregate principal amount of the relevant bonds. Accordingly, the modification of a Reserved Matter by written resolution will require, at a minimum, the approval of bondholders representing not less than $66^{2}/_{3}$% of the aggregate principal amount of bonds then outstanding.

**Bondholder meetings: Is there a clear procedure and process for bondholder meetings? Will the voting be run by independent and impartial entities?**
While the Model CAC contemplates the appointment of a calculation agent by the sovereign issuer to determine whether the relevant approval threshold has been met, the Model CAC does not specify which entity should carry out other roles relating to the meetings and approval process (roles the capital markets would expect to be performed by a bondholder representative, trustee or fiscal agent).

It is unclear which party will be responsible for performing all the relevant steps relating to the convening of meetings of bondholders, including compliance with applicable voting procedures at meetings and compliance with procedural steps related to the passing of a written resolution (eg receiving/providing voting certificates, collecting proxy votes, collecting blocking confirmations).

We would expect these provisions to be addressed by each euro area member state's implementing legislation and/or regulations and/or contractual provisions in the relevant documentation additional to those in the Model CAC, although euro area member states will need to ensure the provisions are drafted so that the Model CAC has an identical effect across the euro area. Member states may also consider appointing a calculation agent up-front to give certainty to investors as to the agent's independence from the sovereign issuer.

**Who is disenfranchised?**
The question of which "sovereign-controlled" entities will be disenfranchised is an important one to all private investors.

An element that will provide some transparency (though not necessarily comfort) is the obligation in the Model CAC on the sovereign issuer to certify to the calculation agent which government controlled bondholders do not have autonomy of decision, are controlled by the issuer or a department, ministry or agency of the issuer and have reported to it that they hold bonds. That certification will be binding unless an affected bondholder objects in writing to the certification (and subsequently follows up with legal action within 15 days of the publication of the results of the vote or written resolution) and the objection would affect the outcome of the vote or written resolution.

**What about national central banks or the ECB – can they vote or will they be disenfranchised?**
The supplemental explanatory note dated 26 March 2012, states that neither the European Central Bank nor euro area central banks should be excluded from voting. The rationale? Article 130 of the Treaty on the Functioning of the European Union and Article 7 of the Statute of Eurosystem of Central Banks prohibit euro area central banks from seeking or taking instruction from EU institutions or member state governments. In the supplemental explanatory note of 26 March 2012, the Committee states that *"…. a euro area national central bank's decision to vote for or against the proposed modification of securities acquired in connection with, for instance, its Eurosystems operations must, as a matter of law, be made by the bank acting in its own interest, even though the bank may well be owned or, for other purposes, controlled by its government …. In the Committee's view, euro area national central banks accordingly have autonomy of decision in deciding how to vote on the proposed modification of any euro area government securities so acquired, and their holdings of these securities will be enfranchised under the Model CAC."*

Continuing market sensitivities regarding preferred creditor status issues remain, however, and this may be a debate beyond the introduction of the new Model CAC, which, in the midst of the current crisis, needs to take place at an official sector level.

**I am familiar with the ICMA CAC, is the Model CAC any different?**
The ICMA CAC has been used in many foreign law governed sovereign debt securities over the years. However, there are a number of differences that parties familiar with the ICMA CAC should be aware of. These are summarised in the box titled "***Moving away from the ICMA CAC***". The primary differences are the removal of unanimity matters, the introduction of aggregation modifications, the lowering of certain thresholds and the fact that the Model CAC does not cater for the appointment of a noteholder committee to represent the interests of holders.

Moreover, the Model CAC is to be introduced in all relevant domestic law governed government securities (whether issued by syndication or auction) which is an important innovation and will impact the euro area sovereign markets substantially, as a large stock of euro area debt instruments previously unaffected by collective action clauses will include them in the future.

## NEXT STEPS FOR THE MODEL CAC AND SOVEREIGN DEBT

### Continuing debate around areas of market concern

Market participants continue to be concerned about various issues relating to the Model CAC. One worry is the absence of a requirement for noteholder unanimity to approve certain specified changes to the terms and conditions of bonds (a provision which was in the ICMA CAC) but, in practice, the type of changes for which unanimity is required under the ICMA CAC are rarely proposed. In addition, the lower thresholds under the Model CAC have raised questions about whether we might see more use by issuers of so-called "exit consents". As described in the recent Clifford Chance briefing "Liability Management: Exit Consents and Oppression of the Minority" from July 2012, it is worth noting, however, that, even if there are no protections for the minority built into the terms and conditions of an instrument, there are protections under English common law and in other jurisdictions which prevent resolutions which are palpably unfair or prejudicial to a minority of holders from being effective. Other market concerns focus on the scope of the disenfranchisement provisions and preferred creditor status issues; the perceived complexity of the Model CAC; the discretions left to the issuers in the operation of the cross-series modifications; and the operation of the Model CAC, historically, in the context of instruments with few terms and conditions. The introduction of CACs (or similar collective action mechanisms) retrospectively into government securities governed by domestic law, or their amendment thereafter through the passing of domestic legislation, have also raised some concerns. Whether the latter actually impact on pricing and / or liquidity (especially in respect of the government securities of euro area periphery members) will only be determinable in due course – one of the reasons for the planned review of the schedule of "tapping" percentages in 2015.

### Implementation: Identical legal effect, transparency and enforceability

The policy objective set out in the ESM Treaty is that the collective action clauses which are to be adopted are to have identical legal impact across the euro area. This is likely to be challenging given the diversity of debt instruments issued by the euro area member states, the different governing laws applicable to such instruments, and legislative framework as well as the varying sovereign debt issuance processes used throughout the euro area, and is likely to result in wider considerations of the terms and procedures under which euro area sovereign issuers issue their government securities.

Most collective action clauses currently used in the capital markets are governed by English law or New York law and there is substantial jurisprudence underpinning their functioning. The Model CAC, however, will be introduced into legal systems where a number of the principles have not previously been considered by legislators or tested in the courts.

In order to implement the Model CAC so that it has identical effect and **is enforceable**, legal principles such as those relating to the fair treatment of investors (which will inevitably vary from jurisdiction to jurisdiction) will need to be considered by each euro area member state. The possibility of actions taken by a majority being prejudicial to the interests of a minority of holders is often of concern with collective action provisions – and such concerns are heightened in the case of aggregation. Indeed, in certain jurisdictions, aggregation provisions such as those proposed may currently, without supporting legislation, not be enforceable. It is likely that a number of euro area member states will, therefore, need to implement legislation (particularly in view of the cross-series modification provision) to override investors' protections which might otherwise apply and ensure the Model CAC is introduced in a way which complies with other legal principles applicable in that member state's legal system.

One key feature will be the transparency of the incorporation of the new Model CAC into the terms applicable to a state's sovereign debt securities and the extent of the relevant disclosure.

There is surprisingly little information available on the legal terms relating to many euro area sovereign debt securities, especially those issued under auctions. Many domestic issues of treasury securities (local law governed, locally settled and cleared) typically do not have as full a set of terms as international bonds issued by the same sovereigns (it is worth remembering that many investors holding Greek debt were not aware, as the Greek crisis unfolded, that their bonds were governed by Greek law). Moreover, sovereign issuers are exempt from the EU Prospectus Directive.

One of the challenges, therefore, will be to ensure the Model CAC applies to domestic law instruments in an appropriate manner.

Member states may consider, either individually or collectively, improving the transparency of such terms, for example, by ensuring:

(a) the terms of sovereign debt securities are consistently disclosed (both in form and content) and available to investors throughout the life of the securities;

(b) translations of the terms of sovereign debt securities that are being offered on a cross-border basis are made available; and

(c) disclosure on any applicable statutory provisions which would affect the rights of a bondholder are easily accessible (and in convenient translations).

Without appropriate disclosure there could be a risk that an investor may be able to contest the enforceability of the Model CAC, particularly where a cross-series modification is used to bind a potentially substantial minority, pursuant to terms which may not have been sufficiently detailed, transparent and freely available.

### Requirements of the Committee

In the supplementary explanatory note of 26 March 2012, the Committee states that each euro area member state will be required to deliver a legal opinion to the Committee confirming that the Model CAC will be legal, valid and binding and enforceable in accordance with its terms under the laws of the member state.

The Committee has stated that it intends to publish a report on the progress each euro area member state has made in implementing the Model CAC prior to 1 January 2013. Moreover, the Committee has indicated that each legal opinion is due to be published on the debt management office website of each jurisdiction to promote accessibility. This is a very welcome step which should be well received by the market. However, most euro area member states have to date still to follow the example of Germany in drafting and implementing legislation to implement the Model CAC.

## CONCLUDING COMMENTS

### Delayed impact

One fairly obvious (but significant) point to highlight is that, although the new Model CAC has been announced in the midst of the current Eurozone crisis, there will be a long "lead time" before the Model CAC is included in a substantive amount of member states' securities. It is therefore of limited value for any sovereign debt restructurings in the short term, notwithstanding that its implementation has been brought forward to 1 January 2013.

Moreover, at a time when market access at sustainable levels is of great importance to a number of euro area member states, the introduction of the Model CAC will be an additional factor prompting increased scrutiny by market participants of the framework under which euro area government debt is raised, especially where such debt is issued under domestic law. The use of a retrospective collective action mechanism in the context of the Greek PSI transaction, has shown that, in certain circumstances, the sanctity of contracts is more vulnerable in a domestic context.

In practice, whilst collective action clauses are a contractual tool aimed at facilitating sovereign debt restructurings, the reality is that they have not been used as extensively as bond exchanges in the recent past (although it is worth noting that CACs were recently used successfully in the reschedulings of the debt of The Republic of Seychelles and St. Kitts and Nevis).

It is still unclear to some market participants the extent to which the Model CAC will facilitate orderly restructurings, especially where they are being juxtaposed to domestic law documentation, which also has a different issuance framework. Moreover, some commentators have highlighted that the bulk of the EU sovereign debt problem relates to these domestic law bonds and that the Model CAC fits rather "awkwardly" into the terms and conditions of those bonds.

### October 2012 IIF Report

The Principles were published in 2004, shortly after the EU first embraced CACs. In an interesting historical parallel, the IIF has chosen, following its key role in the Greek PSI transaction, to update its output in this area. Its Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution has, following a review of the Principles against the backdrop of the recent Greek PSI experience, chosen to publish a further report and recommendations in October 2012.

The Report includes an Addendum to the Principles. It recommends that sovereign issuers take a voluntary approach to pursuing good-faith negotiations with creditors to achieve agreement on fair debt restructuring, should it become unavoidable. The

Report favours the use of collective action clauses in international bond terms and conditions on the basis they strengthen the "resilience of the system". The Report recommends that sovereign debt issuers in both mature and emerging market countries should incorporate CACs in new bond issues, whether denominated in a foreign currency or a common regional currency and, further, echoing the Model CAC, that the CACs should include appropriate aggregation clauses.

The Report expresses concern, as a matter of principle, on the "worrisome" nature of making retro-active changes in the legislative framework. It is, though, interesting to note that it makes the rather surprising comment that the retro-active introduction of CACs (with terms and conditions consistent with market practice) can be considered to facilitate debt restructuring when a voluntary agreement with private creditors has already been reached, especially considering the different interpretations that may be applied to determine what constitutes a "voluntary agreement".

### No differentiation?

In the Eurozone, the policy objective seems to be that the introduction of the Model CAC should be a market neutral event with no pricing or investment decision implications. It remains to be seen whether this is achievable in view of the climate in which such a provision will be adopted. Early indications are that some differentiation may well result in respect of the debt of some countries, as investors increasingly focus on whether they are purchasing government securities issued under domestic or foreign law, with or without collective action clauses.

### CDS

Another aspect of CACs which has received a great deal of investor focus in the recent past is the impact of CACs on credit default swaps (or CDS). Might the introduction of a CAC trigger a "Restructuring" credit event under a CDS? However, as was discussed at the time of the Greece PSI, the existence or introduction of a CAC – even retrospectively – should not, by itself, trigger a Restructuring credit event. The trigger would only occur at a later date, should the CAC actually be used in a restructuring.

### Argentine "hold-outs"

Finally, whilst the spotlight on sovereign debt restructuring has been firmly on Europe and the Eurozone in recent months, the United States Court of Appeals for the Second Circuit has brought Argentine debt into focus once again.

Might the judgment in *NML Capital Ltd. v Republic of Argentina* (26 October 2012) and ongoing appeals have any impact on investors' views on the Model CAC? The arguments being made by all relevant parties in the case and the US judgment raise many interesting issues, but the basic underlying question – that is, the relative merits of participating in a sovereign debt restructuring (possibly for a lesser return) versus "holding-out" in the hope of payment in full – remain unchanged. It is a classic "risk / reward" equation. As the judge in the US District Court commented about the investors who took part in the 2005 and 2010 bond swaps: "*[they] bargained for certainty and the avoidance of the burden and risk of litigating"*. However, the hold-out creditors' strategy and the decisions of the US courts could now put at risk that certainty by disrupting the payment flows due to those who participated in Argentina's restructurings in 2005 and 2010.

So, the Argentine case brings us full circle. One of the main drivers behind the evolution of sovereign CACs was to minimise the risk of creditor "hold-outs". Indeed, it was the default by Argentina in 2001 that generated much of the original debate in relation to CACs.

The United States Court of Appeals commented that its decision would not have longer term implications for sovereign debt restructurings because of the prevalence of CACs. It remains to be seen whether or not this confidence is justified, but the desire for orderly sovereign debt restructurings remains at the heart of the engagement by the official sector with the private sector in this area. The increased use of CACs will continue to be seen as a key cornerstone of this engagement.

The ongoing litigation against Argentina demonstrates once again the importance of a tool such as CACs that can bind all holders into a sovereign restructuring that has the acceptance of the majority. In this respect, the euro area Model CAC may be a timely policy measure.

## ANNEX 1

## MOVING AWAY FROM THE ICMA CAC

| Clause | Position under Current ICMA Standard CAC (ICMA CAC) | Position under Model CAC (Model CAC) | Comparison |
|---|---|---|---|
| **Meeting of Bondholders** | (a) May be convened by the issuer or fiscal agent at any time.<br>(b) Shall be convened by the issuer or fiscal agent if at least 10% of bondholders (based on the aggregate principal amount outstanding) so request in writing. | (a) May be convened by the issuer at any time.<br>(b) Will be convened by the issuer if an event of default occurs and is continuing and if not less than 10% of bondholders (based on the aggregate principal amount outstanding) so request in writing. | The ICMA CAC provides for a fiscal agent, who will be appointed under a fiscal agency agreement. The fiscal agent will act on the issuer's behalf and does not represent the bondholders, who retain their individual rights against the issuer.<br>The Model CAC does not contemplate the role of a fiscal agent or, indeed, a trustee and the right of no less than 10% of bondholders to call a meeting is limited to circumstances where an event of default has occurred. However, issuers may issue with a fiscal agent or trustee in the issuing structure if they wish to. |
| **Notice of Meetings** | Not covered. | A notice shall be published by the issuer at least 21 days prior to the meeting, or 14 days prior to an adjourned meeting. | The ICMA CAC does not include provisions relating to notice requirements. The Model CAC addresses this by introducing standardised notice provisions. |
| **Noteholders' Committees** | Bondholders representing at least 50% of the aggregate outstanding principal amount of notes may appoint any persons as a committee to represent the bondholders' interests during certain circumstances e.g. on an event of default or an announcement by the issuer that it seeks to restructure the notes. | Not covered. | The Model CAC discards the provisions relating to noteholders' committees set out in the ICMA CAC – the Explanatory Note to the Model CAC states this has been removed on the basis that these provisions have not been used extensively by the market. |

| Clause | Position under Current ICMA Standard CAC (ICMA CAC) | Position under Model CAC (Model CAC) | Comparison |
|---|---|---|---|
| **Quorum** | **Reserved matter modification:** bondholders representing at least 75% of aggregate outstanding principal amount of notes for an initial meeting or an adjourned meeting. | **Reserved matter modification:** bondholders representing not less than $66^{2}/_{3}$% of aggregate outstanding principal for an initial meeting or an adjourned meeting. | The ICMA CAC provides for a higher quorum for modification of reserved matters. The lower threshold in the Model CAC is designed to enable sovereigns to more easily facilitate approval of the modification at a meeting. |
| | **Non-reserved matter modification:** bondholders representing at least 50% of aggregate outstanding principal amount of notes for an initial meeting and at least 25% for an adjourned meeting. | **Non-reserved matter modification:** bondholders representing not less than 50% of aggregate outstanding principal for an initial meeting and not less than 25% for an adjourned meeting. | |
| **Reserved Matters** | Includes (among others) proposals to change the following:-<br>(a) Date for payment<br>(b) Amount due<br>(c) Currency of amount due and location of payment<br>(d) Quorum requirements | Includes (among others) proposals to change the following:-<br>(a) Date for payment<br>(b) Amount due<br>(c) Currency of amount due and location of payment<br>(d) Release of any applicable guarantee/security<br>(e) Seniority or ranking of the bonds<br>(f) Governing law and jurisdiction | The ICMA CAC distinguishes between reserved matters and matters requiring unanimity. The Model CAC does not require unanimity to agree any modification (incorporating such matters as reserved matters). (Please see below). |
| **Unanimity Matters** | Provides that the following proposals require unanimous consent of bondholders:-<br>(a) Change in governing law and jurisdiction<br>(b) Acceptance of an exchange, substitution or conversion of the bonds into an instrument less favourable to bondholders. | N/A | Under the Model CAC no matters require unanimous consent of bondholders on the basis that it is contrary to the concepts of majority consent which underpin the revised Model CAC thereby making it easier for sovereigns to obtain approval.<br>Item (b) is not specifically covered in the Model CAC. |

| Clause | Position under Current ICMA Standard CAC (ICMA CAC) | Position under Model CAC (Model CAC) | Comparison |
|---|---|---|---|
| **Single-Series Approval Thresholds** | **Reserved matter modification**: At least 75% of the aggregate principal amount of outstanding notes or by written resolution signed by bondholders holding at least 75% of the aggregate principal amount of outstanding notes. | **Reserved matter modification**: consent of bondholders of not less than 75% of aggregate outstanding principal represented at a meeting, or by written resolution signed by bondholders holding not less than $66^2/_3$% of outstanding principal. | The Model CAC introduces lower thresholds for proposed modification in order to facilitate obtaining investor approval to sovereign debt restructurings and reduce further holdout problem. |
| | **Non-reserved matter modification**: consent of bondholders of not less than $66^2/_3$% of aggregate outstanding principal at a meeting, or by written resolution (for which at least $66^2/_3$% of aggregate principal amount of outstanding notes is also required). | **Non-reserved matter modification**: consent of bondholders of more than 50% of outstanding principal represented at a meeting or by written resolution signed by bondholders holding more than 50% of outstanding principal. | The Model CAC requirements are lower. |
| **Cross-Series Approval Thresholds in respect of Reserved Matters** | N/A | More than one series of bonds may be modified in relation to a reserved matter with the consent of bondholders of not less than:-<br>(a) not less than 75% of the principal amount of the outstanding bonds represented at separate duly called meetings of the holders of all of the series **taken in the aggregate** that would be affected (or not less than $66^2/_3$% of the outstanding principal amount if by written resolution); and<br>(b) more than $66^2/_3$% of the principal amount of the outstanding bonds represented at separate duly called meetings of the holders of each series **taken individually** that would be affected (or more than 50% of the outstanding principal amount if by written resolution). | The ICMA CAC does not provide for aggregation. The inclusion of an aggregation provision by the Model CAC is designed to allow an issuer to effect a single restructuring where it is has issued a multiple series of debt securities. Such provisions are unusual in the current sovereign debt market, although there are examples of these having been used in a handful of sovereign MTN programmes in some Latin American countries and securitisations.<br>N.B. If a vote is put to creditors by using the cross-series modification (aggregation) feature, the individual series approval threshold (that is, the second part of the two limb test) is lower than the approval threshold for Reserved Matters applicable to single-series modifications. |

| Clause | Position under Current ICMA Standard CAC (ICMA CAC) | Position under Model CAC (Model CAC) | Comparison |
|---|---|---|---|
| **Partial Cross-Series Modification** | N/A | Yes. | |
| **Acceleration and Rescission of Acceleration** | (a) On an event of default, bondholders of at least 25% of aggregate principal of outstanding notes may give written notice of acceleration to the issuer and fiscal agent.<br>(b) Bondholders of at least 50% of aggregate principal of outstanding notes may withdraw any declaration of acceleration on behalf of all bondholders. | (a) On an event of default, bondholders of not less than 25% of principal outstanding may give written notice of acceleration to the Issuer.<br>(b) Bondholders of more than 50% of principal outstanding may rescind or annul any notice of acceleration on behalf of all bondholders. | In relation to the Model CAC, the acceleration provisions are supplementary provisions which are not incorporated into the main clause, thereby giving member states the choice whether or not to adopt such provisions. |
| **Governing law**[1] | Designed for use in English law transactions. | Intended for use with any foreign and domestic law. | |

1 This is implicit; not in the actual clause provisions.

## Authors


**Marc Benzler**
Partner, Frankfurt

T: +49 697199 3304
E: marc.benzler
@cliffordchance.com

**David Dunnigan**
Partner, London

T: +44 20 7006 2702
E: david.dunnigan
@cliffordchance.com

**Eric Green**
Senior Associate, London

T: +44 20 7006 4538
E: eric.green
@cliffordchance.com

**Simon James**
Partner, London

T: +44 20 7006 8405
E: simon.james
@cliffordchance.com

**Thomas Lockley**
Senior Associate, London

T: +44 20 7006 1279
E: thomas.lockley
@cliffordchance.com

**Julia Machin**
Managing Senior PSL, London

T: +44 20 7006 2370
E: julia.machin
@cliffordchance.com

**Sebastian Maerker**
Partner, Frankfurt

T: +49 697199 1510
E: sebastian.maerker
@cliffordchance.com

**Tim Morris**
Partner, London

T: +44 20 7006 2676
E: tim.morris
@cliffordchance.com

**Deborah Zandstra**
Partner, London

T: +44 20 7006 8234
E: deborah.zandstra
@cliffordchance.com

## Links

Link to Europa webpage with Model CAC material and background:

http://europa.eu/efc/sub_committee/cac/index_en.htm

Link to Clifford Chance Eurozone Crisis webpage legal issues and publications:

http://www.cliffordchance.com/publicationviews/publications/2012/01/eurozone_crisis_legal_issues.html

## Q&A covered within briefing

- Which government bonds will be subject to the Model CAC?
- Will it apply to debt issued by local or regional governments or to government guaranteed debt?
- How will "*identical legal effect*" CACs be achieved across the euro area?
- Will any euro area governments include the new Model CAC in bonds issued before 1 January 2013?
- What about Medium Term Note programme updates? Should I be including the model CAC in this year's update, ready for use after 1 January 2013?
- Will non-euro area member states adopt the new model CAC in their international and domestic debt?
- Taps and fungible tranches. After 1 January 2013, will it be possible to "re-open" (or "tap") a bond issued prior to 31 December 2012 (which did not include the Model CAC)?
- Aggregation: will bonds with different governing laws (for example, domestic law and English law) be aggregated for cross-series modifications?
- Will the potential partial cross-series modification make it unattractive for bondholders to vote for cross-series modification?
- How "super" a majority is actually needed to approve modifications?
- Bondholder meetings: Is there a clear procedure and process for bondholder meetings? Will the voting be run by independent and impartial entities?
- Who is disenfranchised?
- What about national central banks or the ECB – can they vote or will they be disenfranchised?
- I am familiar with the ICMA CAC, is the Model CAC any different?