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Briefing note

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New ICMA sovereign collective action and pari passu clauses

ICMA's new model aggregated collective action clauses and pari passu clause for sovereign issuers offer flexibility to sovereigns wishing to restructure their debts while at the same time providing robust protection to noteholders through the procedures and majorities required in order to restructure those debts. The clauses will not solve immediately all the problems in sovereign debt restructuring, but they are a significant step in the right direction. The approach taken by ICMA's new CACs has the support of the IMF.

Key issues

- ICMA's new CACs offer sovereign issuers three restructuring options
- The most innovative option is a single vote across multiple series
- The CACs include protection for minorities against oppression
- The sovereign must provide information to enable informed voting
- ICMA has also issued a sovereign pari passu clause disavowing payment equality

Whatever the rights and wrongs of the travails faced by Argentina since it defaulted on its debts in 2001, no one could describe the subsequent process as orderly. Thirteen years on, the fallout continues to occupy the courts, both in New York and elsewhere, despite over 90% of Argentina's noteholders having agreed to the restructuring of their notes. Argentina remains shut out of the international capital markets, and no permanent solution is in sight.

Argentina is not, however, the norm. Other recent sovereign debt restructurings (eg the Seychelles, St Kitts and Nevis, Belize and Greece) have been undertaken without the same protracted public drama. Nevertheless, numerous ideas (including a "sovereign debt restructuring mechanism" - effectively an insolvency regime for sovereign states) have been floated over the years as to how the sovereign debt restructuring process might be reformed in order to minimise the risk of Argentina-like disorder, but most ideas have been weighed down by the complex politics and (im)practicalities involved.

One pragmatic solution that has garnered support is enhancing the contractual mechanisms already used in the capital markets. Sovereign note issues involve contracts between issuers and noteholders. Why not expand the terms in those contracts that facilitate restructuring, if that is what the issuer wants and the noteholders agree?

The terms in question - collective action clauses (or CACs) - allow noteholders to vote on a restructuring or re-profiling proposal, with the outcome of that vote binding all noteholders. The new development in this area is a recognition that voting need not be confined to one particular series of notes but can extend to multiple series of notes (aggregation) provided that they all contain the necessary contractual provisions.

The members of the euro area committed themselves to including the area's form of aggregated CAC in all new government securities issued after 1 January 2013 with a maturity above one year. The International Capital Market Association, the leading trade body in this area and which represents a broad range of interests in the capital markets, has now published a new model form of CACs with aggregation features that can be used by any sovereign issuer. The publication of these standard form CACs follows two consultations amongst ICMA's members, as well as extensive discussions with other key stakeholders, including the Institute for International Finance and a working group convened by US Treasury staff consisting of representatives from the official sector, including the IMF, legal experts, market participants, practitioners, academics and issuers.

Use of ICMA's CACs is not an overnight solution to all the problems in sovereign debt restructuring. Amongst other matters, it will take some years before a critical mass of any sovereign issuer's notes contains the CACs. But, with the passage of time, the use of ICMA's CACs will assist countries facing financial difficulties to seek an accommodation with their noteholders in a constructive manner and will facilitate debt restructuring, if that is what the sovereign and its noteholders want, while minimising the risks posed by holdout creditors.

The IMF has very recently published a paper (*Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*) recognising that, while it cannot mandate the use of CACs, it should play an active role in promoting their inclusion in international sovereign bonds. The IMF concluded that the design features in ICMA's CACs address collective action problems effectively while affording adequate safeguards for noteholders. ICMA's new sovereign CACs have already been included by Kazakhstan, with other countries expected to follow shortly.

The IIF has also welcomed ICMA's recommendations, commenting that they are fully consistent with the IIF's *Principles for Stable Capital Flows and Fair Debt Restructuring*, the voluntary, market-based code of conduct for sovereign debt restructuring agreed among sovereign issuers and their private creditors and endorsed by the G20.

ICMA's sovereign CACs

ICMA's CACs are standard forms for use in any sovereign note issue. As such, they must be capable of applying to a wide range of circumstances, from a sovereign with only a couple of near identical note issues to a sovereign with hundreds of issues across different markets and in different currencies. A single approach to restructuring is unlikely to be practicable for all situations.

As a result, ICMA's CACs offer a sovereign three options to restructure its debts:

- Modification of a single series of notes
- Modification of multiple series of notes, with a requirement that the restructuring be approved both by all noteholders voting together and by noteholders voting within their particular notes (two limb voting)
- Modification of multiple series of notes, with one aggregated vote amongst all noteholders (single limb voting)

ICMA's CACs are intended primarily for use in foreign law note issues, where the restructuring problems are greatest. If notes are governed by the sovereign's home law, the sovereign is able, subject to constitutional and other constraints, to change that law to impose collective action provisions on noteholders. Greece did this in 2012, passing a law that applied a collective action requirement to its existing Greek law governed notes. However, as the IIF has noted:

> "Retroactive legal changes to unilaterally modify the terms and conditions of financial contracts may undermine the integrity of financial markets and the sanctity of contracts and should be avoided. However, in exceptional cases and after a voluntary debt exchange agreement has been reached, such modifications of the governing legal framework to introduce a collective action mechanism on a timely basis with terms and thresholds consistent with market practices may be necessary in facilitating a voluntary debt exchange and achieving a fair outcome for all bondholders." (*Report on Implementation of the Principles for Stable Capital Flows and Fair Debt Restructuring*, IIF, 2013)

In part reflecting the recent work by euro area members on their own form of CAC, which applies to both domestic and foreign law issuances, as well as their ESM Treaty obligations, euro area members are expected to continue to use their own aggregated CAC.

Modification of a single series

This is the conventional form of CAC, which has been used in sovereign debt issues for over a decade. It allows a majority of the holders of any particular series of notes to agree changes to the terms of their notes in a manner that is binding on all noteholders, even those who vote against the changes.

Without a CAC, a sovereign would be very unlikely to achieve one hundred per cent acceptance of any proposal, whether because a minority of noteholders object to the offer or because some simply do not respond, and would therefore be likely to face some creditors continuing to demand payment on the original terms (holdout creditors). Through the use of a CAC, the requisite majority of noteholders can approve modifications or other actions with respect to their notes in a manner that will bind all noteholders, thereby removing the threat of holdout creditors.

ICMA's CACs set the required majority for significant changes (eg the dates, amounts and currency of payment) at 75%. As with the majorities required for each of the other means of restructuring, this 75% majority is calculated by reference to the outstanding principal amount of the notes, not by reference to those who vote. As a result, there is no need for a quorum requirement for noteholder meetings, which would have been needed if the majority had been determined by reference to the noteholders who actually voted.

In order to protect noteholders, notes held by or on behalf of the issuer, by or on behalf of any person owned or controlled by the issuer or by any public sector instrumentality of the issuer are excluded from the calculations. The sovereign cannot vote for its own proposal, which remains the prerogative of independent noteholders.

The risk to a sovereign using single series modification, particularly for a small series trading at a discount, is that an investor may be able relatively cheaply to buy a blocking minority (25% plus one) in the notes. If so, the investor can prevent acceptance of the sovereign's restructuring offer, even if a majority agree to it.

This happened with some series of notes issued by Greece and governed by foreign law. Rather than default on these notes, Greece paid the holders in full (giving the holders a large profit if they bought the notes at a discount); in contrast, the holders of the vast majority of Greece's debt, who accepted Greece's restructuring offer, suffered a significant haircut.

The possibility of noteholders in some series gaining an advantage in this way could make other noteholders reluctant to vote in favour of a restructuring package.

Multiple series, two limb voting

This method broadly follows the form of the euro area's CAC (though, for example, the majorities differ slightly), and allows modification or other action in respect of more than one series of notes at the same time. To achieve this, the proposal must pass two hurdles

- holders of at least 66⅔% of the aggregate principal amount outstanding on all series of notes, taken in aggregate, must vote for the restructuring, and
- the holders of at least 50% of the aggregate principal amount outstanding on each individual series of notes must also vote in favour.

The requirement for majorities across both the notes as a whole and within each series offers protection to noteholders. A majority of the sovereign's noteholders as a whole cannot force on an individual series terms that are unacceptable to the majority of the holders of that series.

The need for a majority within each series of notes leaves the risk that an investor could buy a bare majority of a particular series of notes in order to block the restructuring. This will be a harder and more expensive task than with single series modification. The sovereign can avoid this risk through the use of single limb voting.

Multiple series, single limb voting

This represents the most radical development in CACs. Use of this method allows a proposal for any modification or action with respect to multiple series of notes to be approved in a single vote amongst the holders of all notes affected by the proposal. The majority required is 75% of the aggregate principal amount outstanding of all the affected series.

The protection for noteholders, against a majority imposing on any particular series terms that might be unfair or oppressive to that series, is that any proposal with single limb aggregated voting must meet the Uniformly Applicable requirement. This requirement is that the terms offered to the holders of the notes affected by the restructuring must be the same or, at least, involve a choice from the same menu of options. As a result, the holders of notes in a series that form an overall majority cannot vote that their series should receive, say, new notes equal to 80% of the face value of their existing holding while other series receive only 1%.

The Uniformly Applicable requirement does not mean that a net present value calculation must be made in order to ensure that the financial outcome for the holders of each series of bonds is identical. That would have been complicated given the infinite number of possibilities and would leave a risk of disputes. Rather it means that, after the restructuring, all noteholders must hold the same instruments (or have had the option to hold the same instruments).

Single limb voting is most likely to be of use when noteholders are offered new notes in exchange for their existing notes or a choice from the same menu of new notes. The Uniformly Applicable requirement does, however, allow for different series of notes to be amended provided that the result of the amendments is that the amended instruments have identical provisions. In practice, amendment is likely to be useful only in those cases where a small number of very similar note issues are being restructured.

In order to calculate the par value of notes for these purposes (and for voting purposes), the same methodology must be used for all the series involved (the same applies to two limb voting). So, for example, if notes are in different currencies, the same conversion date to a common currency should be used in order to count the votes and calculate the face amount of new notes issued.

Under both multiple series, two limb voting and multiple series, single limb voting, the sovereign may choose to proceed on a sub-aggregated basis by activating the provisions separately in respect of two or more separate series notes drawn from the larger group of all series of notes which may be aggregated (ie the sovereign could aggregate issues A, B and C, the holders of which would vote together, whether on a single or two limb basis, and, separately, aggregate issues D, E and F, the holders of which would vote together). Those sub-aggregated transactions could proceed simultaneously. This approach could prove to be useful in practice, if, for example, the sovereign felt that zero coupon long dated note issuances should receive treatment different from simple interest bearing notes that were issued with a shorter maturity.

Use of the options in ICMA's CACs

A key feature of ICMA's CACs is the flexibility they offer sovereigns. In order to achieve a comprehensive restructuring, a sovereign must decide which of the means offered by ICMA's CACs is appropriate to its circumstances, including the possibility of using two, or even all three, of the means offered at the same time. What is appropriate will depend upon the circumstances faced

Practical aspects of using ICMA's new sovereign CACs

Questions that can arise as to the use of ICMA's new sovereign CACs include the following:

Governing law ICMA's sovereign CACs have been drafted on English law lines, but they can be used with minor adaptation for issues governed by New York law. English or New York law is used in almost 90% of international sovereign bond issues. The CACs can, however, also be used for issues under other governing laws, including the sovereign's own law. Legal advice is required with regard to any note issue.

Drafting Most note issues are based on the documents used last time by the same issuer, often with considerable resistance to change. ICMA's sovereign CACs can generally be slotted into existing documents without any need to re-draft radically the rest of the terms, particularly as the CACs are based on ICMA's commonly-used 2004 CACs in order to ease transposition.

Instruments ICMA's CACs can be used both in individual series of notes and in MTN programme documentation.

Extent of usage ICMA's sovereign CACs can be used for some issues but not others. However, the more issues that the CACs are used in, the more powerful the tool becomes. Once a sovereign starts using the CACs, it makes sense to continue to do so.

Risk factors Where CACs are used now, it is common to include as a risk factor in an issuing memorandum that the terms of the instrument can be changed by majority vote. Issuers and their advisers will need to consider whether a risk factor on these lines is required for ICMA's sovereign CACs. This will depend upon, for example, the credit position of the issuer, the extent of the use of CACs and other factors. Past experience tends to show that the use of CACs in a single series has generally been positive for countries with a good rating, but more mixed for countries with weak ratings; over time, any effect has tended to wear off.

Exercise of the options ICMA's sovereign CACs offer the sovereign three options - single series modification, multiple series modification with two limb voting and multiple series modification with single limb voting. The sovereign does not need to choose which option it might use at the time of issue. The aim is to provide flexibility in restructuring, and allow an assessment to be made as to which of these options is suitable at the time the need to restructure arises. Indeed, the sovereign can choose to use all three methods simultaneously with regard to different issues.

by the sovereign at the time.

For example, a sovereign may put a proposal to the holders of multiple series on the basis of single limb voting and, at the same time, a different proposal to the holders of one or more other series. This might be appropriate if the holders of the other series are domestic banks which, if they were to receive the terms offered to the other noteholders, would immediately require recapitalisation by the sovereign concerned and the resulting financial drain on the sovereign would worsen the deal for all noteholders.

Where any proposal affects multiple series, the sovereign is required to appoint an aggregation agent, who must be independent of the sovereign. The role of the aggregation agent includes agreeing any methodology for the calculation of the par value of the notes for voting and exchange purposes and determining whether any resolution has been passed by the requisite majorities.

Information for noteholders

Noteholders should be able to cast their votes on an informed basis. As a result, ICMA's CACs include a covenant that requires the sovereign to publish relevant information before it puts any proposals to the vote.

This information includes a description of the economic and financial circumstances that have led to the proposal, as well as a description of the sovereign's existing debts and its policy reform programme. The sovereign must also indicate whether it has entered into an arrangement with multilateral lenders or other creditor groups (eg the IMF and the Paris Club) and, if possible, provide copies of the documents setting out those arrangements, and say how it is proposing to treat any series of notes that will not be included in any particular proposed modification. The notice convening the meeting of noteholders must also contain this same information.

This information requirement should enable noteholders to assess the financial condition of the sovereign and also to see how the holders of other series of notes are to be treated in the restructuring, whether or not those other notes are intended to be aggregated for voting purposes with their own series.

Noteholders' committee

Noteholders can appoint a committee to represent their interests in certain circumstances. If, for example, the sovereign announces that it intends to seek a restructuring of its notes, the holders of at least 25% of the aggregate principal outstanding of the notes affected can appoint a person or persons as a committee to represent their interests. If this happens, the sovereign is required to engage with the committee in good faith and to provide to the committee the information referred to above, subject to any legal restraints (eg insider trading).

At the level of 25%, there is the possibility that more than one committee may be formed. In that case, the expectation is that a single steering group (comprised of representatives from the committees) would be formed and the sovereign would engage with that steering group only.

The committee provisions are in the form of supplementary provisions in ICMA's CACs.

Pari passu clauses

Alongside the publication of its CACs, ICMA has also published a new sovereign pari passu clause that has been drafted to avoid the difficulties that Argentina has faced in the New York courts.

Argentina's pari passu clause that was the subject of *NML Capital Ltd v The Republic of Argentina* has two elements, split into two sentences. According to the New York courts, "[t]he first sentence... prohibits Argentina, as bond *issuer*, from formally subordinating the bonds by issuing superior debt. The second sentence... prohibits Argentina, as bond *payor*, from paying [other] bonds without paying on the [holdout] Bonds." It was the second sentence that gave Argentina's holdout creditors the rights they have used to such effect in the US, namely the ability to prevent Argentina paying the bondholders who accepted Argentina's restructuring without at the same time paying in full the bondholders who did not.

Whether any particular pari passu clause has the same meaning and effect as Argentina's depends upon its drafting, construed in accordance with its governing law, as well as the remedies available in the relevant courts. There are many subtly different pari passu clauses in the market. Not all of them - perhaps even very few of them - will be interpreted in the same way as Argentina's clause, and other sovereigns may not have acted in the way that Argentina has done.

However, in order to put the matter beyond doubt, ICMA's new sovereign pari passu clause clarifies expressly that it only includes the first of the two elements in Argentina's clause. It does not prevent a sovereign issuer

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from paying one creditor without at the same time paying others, ie it affects only the ranking of bonds, not their payment.

The IMF has also supported the use of modified pari passu clauses in line with ICMA's new clause.

Conclusion

No contractual mechanisms can immediately smooth away all the difficulties that can arise in sovereign debt restructuring. But the use of ICMA's new sovereign CACs and pari passu clause will, over time, facilitate orderly restructuring processes between sovereigns and their creditors, and will enable the majority to prevail to the benefit of both sides. As such, ICMA's new contractual enhancements are one giant leap in the right direction.

ICMA's new model aggregated collective action clauses and pari passu clause can be found at http://www.icmagroup.org/resources/Sovereign-Debt-Information/.

The IMF's paper entitled *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* can be found at http://www.imf.org/external/np/pp/eng/2014/090214.pdf.

Clifford Chance LLP acted for ICMA in relation to its new sovereign collective action and pari passu clauses.

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