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Briefing note

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Creditor engagement in sovereign debt restructuring

The lack of a regime for sovereign insolvency leaves contractual terms as the prime means to facilitate efficient and fair sovereign debt restructuring (including re-profiling), should it prove necessary. The growing use of aggregated collective action clauses in sovereign bonds represents a major step in this direction. Some believe that the next step should be the inclusion in bonds of terms that facilitate open and meaningful discussions between sovereigns and their creditors. The logic is that information sharing and close cooperation between sovereigns and their bondholders are key elements in quick and successful debt restructuring arrangements. The IMF has said that it will consider later this year debtor-creditor engagement during debt restructuring.

"Sovereign bonds are essentially junk bonds, and it is crazy to buy or sell them without realizing that they are very likely to be restructured", according to a Stanford-based academic. This overstates the position - most sovereign bonds issued on the international capital markets proceed from issue to maturity without incident - but even the IMF has accepted that sovereign debt restructurings are a "pervasive phenomenon".

In a 2012 Working Paper, the IMF identified 186 restructurings in 68 countries with private creditors in the period from 1950 to 2010 (on top of the 447 restructuring agreements in 88 countries carried out under the aegis of the Paris Club, i.e. sovereign to sovereign restructurings). Over the first half of this period, restructurings tended to involve loans by banks to sovereigns, which were restructured through the so-called London Club. This was generally a manageable process as the lenders were both identifiable and relatively homogeneous in outlook. Loan agreements also generally contained sharing provisions that encouraged cooperation. Direct discussion between lenders and the sovereign was both feasible and, in practice, almost unavoidable.

Following the successful issue of Brady bonds in the late 1980s as a response to the Latin American debt crisis and changes in bank regulatory capital rules, sovereign debt moved more into the bond markets. This opened up a new set of issues for restructurings. Bondholders are not only more numerous than bankers, but also more difficult to identify and potentially different in outlook. Sovereign bonds might more easily end up in the hands of distressed debt funds, whose approach to restructuring might not be the same as that of the older school of investors.

This change in structure gave rise to many challenges for sovereign debt restructurings, which in the main have been met. Where necessary, successful restructurings generally do take place. The situation in Argentina should be seen as an outlier rather than the epitome, though it appears at the time of writing that even the protracted litigation arising from Argentina's default may now be reaching a conclusion. Nevertheless, that does not mean that the process of restructuring is always as transparent, efficient and fair as it might be.

Techniques to improve the restructuring process have been suggested. For example, in the early 2000s, a sovereign debt restructuring mechanism – an insolvency regime for states – was proposed. Whatever may have been the merits or otherwise of this proposal, the reality is that it is not going to be adopted wholesale, at least in the foreseeable future. That leaves the contracting parties – sovereigns, trustees, fiscal agents and so on through to the bondholders themselves – to provide through the applicable contractual terms and conditions sensible means of ensuring that bonds can be restructured if it is really necessary. In this, the parties have the encouragement of those concerned to ensure an orderly market as well as economic prosperity, including supra-national bodies such as the IMF, national governments such as the US, the UK and euro area member states and trade organisations like the International Capital Market Association (ICMA).

The first step: aggregated CACs

Sovereign bonds governed by English law have, for more than a century, commonly contained collective action clauses (CACs), i.e. clauses that allow a super-majority of the bondholders (typically 75%) to vote through changes to the terms of the bonds that bind all the bondholders (New York law governed sovereign bonds generally did not include CACs, at least until the 2000s). These CACs could in principle be used to facilitate a restructuring by preventing a small number of bondholders from holding the sovereign, and the other bondholders, to ransom by refusing to agree to terms acceptable to the vast majority.

However, these traditional CACs showed mixed results when it came to assisting restructuring. In particular, these CACs only operate within an individual bond issue. A bondholder or group of bondholders could therefore buy a blocking minority in a particular issue to ensure that it remained outside any restructuring agreed by others (and, the more distressed the bonds were perceived to be, the cheaper it was to do this). Greece provides a relatively recent example of this problem. A sufficient minority of the holders of certain short-dated Greek bond issues voted against Greece's restructuring plan of 2012, keeping their issues outside the restructuring. Greece opted to pay off these holdouts rather than risk the cross-defaults on other transactions that could have followed non-payment. The holders of these bonds therefore recovered in full, while most holders of Greek bonds accepted a large write-down. This situation also resulted from the fact that the holdout bonds were governed by laws other than Greek law so that the holders of these bonds were not bound by the Greek legislation passed to aggregate holders of Greek law governed bonds.

The limitations of CACs within individual bond issues shifted the focus to aggregated CACs, i.e. CACs that apply not within a single bond issue but across a number of issues (ideally, over time, all issues), making the acquisition of a blocking minority far more difficult. Aggregated CACs were discussed as early as the 1990s, and included in isolated issues by, for example, Uruguay (2003) and Argentina (2005). However, impetus has been given to the use of aggregated CACs by two recent events.

First, since 1 January 2013, the Euro area has required that bonds issued by euro area governments contain a standard aggregated CAC.

Secondly, the ICMA published in August 2014 a standard form of aggregated CAC, for inclusion in sovereign bonds (including, ultimately, versions for issuances governed by English law and by New York law). This form of aggregated CAC resulted from work undertaken by an Expert Group convened by US Treasury staff and consisting of representatives of the official sector (including the IMF), the ICMA and a number of debtor countries, as well as buy-side stakeholders, legal practitioners and academics. (See our client briefing entitled *New ICMA sovereign collective action and pari passu clauses,* October 2014.)

Use of the ICMA form of aggregated CAC has been encouraged by ICMA, the IMF, the IIF and the G20, and there has been significant take up of the new provisions. As at September 2015, over 90% of new bond issues under New York law and approximately 75% of new bond issues under English law included the new enhanced CACs (*see* IMF Staff Paper *Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts,* September 2015). It will take some time, however, for aggregated CACs to have full impact. It is only when all bonds issued by a particular sovereign include aggregated CACs that the holdout problem will be removed, giving a majority of all bondholders the ability to bind a dissenting minority - until that time, the risk of particular issues holding out against a restructuring agreed by others remains. Nevertheless, the inclusion of aggregated CACs in sovereign bond issues unquestionably represents a major step forward towards more orderly debt restructuring.

Engagement with creditors

"All available evidence indicates that information sharing and close consultations with banks and bondholders go hand-in-hand with quick and successful restructuring" according to the IMF in a review of literature on sovereign debt restructurings.

The benefits of engagement between creditors and debtors observed by the IMF has been matched by institutional support. For example, in 2004 the IIF's *Principles for Stable Capital Flows and Fair Debt Restructuring* urged that, if restructuring proved necessary, debtors and creditors should "engage in a restructuring process that is voluntary and based on good faith." In a 2012 Addendum to its *Principles*, the IIF went further. It said that private creditors "should organise themselves in a broadly based representative creditor committee as early as possible in the debt restructuring process, certainly before default" and that "early discussion is necessary between the representative private creditor committee and the sovereign debtor, in close consultation with the official sector".

In 2014, the IMF recognised that it would be wise for a sovereign issuer to engage with a properly representative creditor committee in order to achieve a high participation rate in a debt restructuring. It noted that high participation had also been reached without a creditor committee in some cases and added that the "modalities of creditor engagement" would be discussed in greater detail in a subsequent staff paper (we understand that IMF staff are currently working on this paper). On 10 September 2015, the UN General Assembly adopted nine principles on sovereign debt restructuring (A/RES/69/139) *Basic Principles on Sovereign Debt Restructuring Processes*, including that "good faith by both sovereign debtor and all its creditors would entail their engagement in constructive sovereign debt restructuring workout negotiations."

This institutional support for creditor engagement has not so far been matched by the inclusion of bond terms designed to facilitate this engagement. The ICMA published in 2004 a template noteholders' committee provision for use within a single issue. This provision was updated in 2014 for use across issuances in conjunction with the ICMA aggregated CAC and deals with matters associated with the formation of a committee rather than detailed matters governing its operation once formed. Whilst ad hoc creditor committees have been formed many times in the sovereign context, express creditor engagement provisions in the terms and conditions of sovereign bonds have, with the exception of Belize in 2013, followed the ICMA 2004 form or the ICMA 2014 form.

There were over 50 sovereign bond issuances between October 2014 and July 2015, but only a few contained the updated version of the noteholders' committee clause (e.g. Kazakhstan, Bulgaria, Croatia, Montenegro and Pakistan). Hungary, Jordan, Namibia and Zambia, which had included the provision in earlier issuances, dropped it. This limited use of the clause led the IIF to emphasise in November 2015 that it "strongly encourage[s] sovereign issuers and investors to include a creditor engagement clause in bond contracts to help guide market expectations in case a debt restructuring becomes unavoidable". Historically, with the exception of Côte d'Ivoire in 2010, Qatar in 2011 and Belize in 2013, New York law governed sovereign debt issues have not included creditor engagement provisions, but a significant number of English law governed bond issues have done so in the past (including, by way of illustration, issues by Albania, Belarus, Bulgaria, Croatia, Czech Republic, Denmark, Ghana, Kazakhstan, Kenya, Montenegro, Pakistan, Poland, Romania, Rwanda, Serbia, Seychelles and Sweden). Evidence seems to suggest therefore that at a time when private sector involvement in debt crises will increasingly be the norm (pre- as well as post- default) and collective action mechanisms have been strengthened, the accompanying procedure to deliver majority acceptance in a more streamlined way has not continued to gain traction. This could in part be because, pending its paper on creditor engagement, the IMF specifically did not endorse the inclusion of creditor engagement provisions, because of varying practices in the English and New York law capital markets, or because there may simply be a greater difference of opinion on the matter.

Creditor engagement in general can occur, and the establishment of a creditors' committee in particular can take place, if and when the need to restructure a sovereign's debt arises (without any express clause in the terms and conditions of the bonds). But that will usually be in a time of stress, when it may be significantly more difficult to secure cooperation than it is in the more optimistic time of issue, particularly if a financial crisis coincides with or is precipitated by a political crisis (which is often the case). Common objections to including creditor engagement clauses in bond documents (and, indeed, to creditor engagement at all) include the following:

- Reluctance to pay the potentially open-ended costs of a creditors' committee. The ICMA creditor engagement clause provides for the debtor to meet those reasonable costs incurred by the creditors' committee which are agreed with the debtor. These need to be evidenced and might include legal advice and economic analysis. If a sovereign issuer wants its creditors to agree to a departure from (and, typically, a reduction in the value of) the terms originally agreed, it is not unreasonable to expect the issuer to pay the costs involved. Further, in practice the costs of a creditors' committee are likely to be lower than the debtor's additional costs of dealing with creditors individually, still more so if the lack of a creditors' representative body with which to negotiate results in a greater number of holdouts or, ultimately, in the rejection of the sovereign's restructuring proposal.
- Reluctance to create a structure that might help creditors' negotiate a better deal. This assumes that the process is effectively a zero sum game: what is good for creditors must be bad for debtors. The ultimate aim is, however, to secure a consensual restructuring. If a creditors' committee helps to achieve that aim, then it should be a worthwhile investment. Further, even if a debtor considers that it can refuse to negotiate with creditors and, instead, can impose a restructuring, that debtor is likely to find it more difficult to secure subsequent market access on good terms than another debtor that has dealt fairly and openly with creditors; the speed of new market access, the quantum, tenor and price are all likely to be adversely affected. Support for a restructuring from a creditors' committee will in practice be of huge influence, as well as offering comfort, to creditors who are not on the committee.
- Reluctance to bring creditors together for fear of giving them greater collective bargaining power. Bilateral discussions might enable the debtor to divide and rule the creditors and thereby secure a better deal. However, a sovereign cannot prevent creditors from coalescing into a committee, nor does the existence of a committee necessarily rule out bilateral discussions. A degree of control over, or at least knowledge of, the way in which creditors interact could be advantageous, as well as enabling the sovereign to identify those creditors who may play a significant role in forming opinions in the market as a whole.
- Concerns linked to credit default swaps (CDS). In particular the debtor may feel that potential committee members who have purchased CDS protection should not participate or that if a Credit Event occurs prior to the restructuring being launched the composition of the committee would need to change radically. In reality hedging in various different forms has been part of the landscape in sovereign and corporate restructurings for many years, and sovereign debtors are likely to gain greater insight into the potential impact of CDS in their particular circumstances by discussing this openly as part of the committee process.
- Reluctance to share information with creditors for fear of creating a privileged class of investors and of misuse of the information by the creditors on the inside, ultimately market abuse. That is, however, an issue for any interaction between a debtor and its creditors. If a debtor has so little trust in its creditors' representatives, it may make anything other than an imposed solution impracticable. The benefits of engaging with creditors need to be weighed against the risk that one creditor might misbehave. The debtor will, in any event, always be in control of what information it passes to a committee and when.
- Debtors have also raised concerns that if the committee does not agree unanimously with a restructuring proposal, it may be held to ransom. However, the ICMA creditor engagement provision is silent on this - there is no requirement that the committee should unanimously agree with a proposal or that it should express public support (or otherwise) for a proposal at the end of the discussions. It is for the parties to succeed in their discussions at the time and agree any outcomes. The obligation is merely for the debtor to engage with creditors. The incentive is for both parties to cooperate so that any restructuring deal can succeed without holdouts undermining the outcome. Moreover, it is counter-intuitive that prior to an issue of sovereign debt, sovereigns will meet with investors on tailored roadshows, and thereafter will, in most

instances, engage in investor relations and yet, at a time of crisis, would prefer to bring the shutters down. Indeed, the new aggregated CACs require certain information to be provided to bondholders, the very same information which the creditor engagement clause also requires - no more, no less.

- Concerns have been raised that multiple committees could result at a time of crisis if different series of bonds have creditor engagement provisions. The ICMA creditor engagement clause addresses this concern by stating that, if more than one committee is formed, a steering group should be created from the various committees. This is beneficial to the sovereign debtor, especially in a world where aggregated CACs become the norm, because inevitably a series by series approach to creditor engagement would cut across the advantages of any aggregated approach.
- Some have argued that the sovereign debtor should have a veto right over the members of the creditor committee. It is difficult from the creditors' perspective to contemplate express provisions to this effect, particularly in an environment in which sovereign bonds are freely tradeable. Creditor engagement clauses included in bonds to date are not prescriptive on the process of formation or composition of the creditor committee, and this approach provides helpful flexibility. In practice most creditor committees result from an informal dialogue between a small number of creditors, advisers and the sovereign debtor which is unfettered by the contractual provision itself. Where there are understandable concerns as to the participation of a particular institution, inevitably common sense prevails resulting in a mutually acceptable outcome.

Other objections have been raised, such as that once a committee is formed, it is hard for the sovereign to "divorce" the committee (but a refusal to marry because divorce might prove difficult displays an unduly pessimistic outlook, and is scarcely the best reason for remaining resolutely single), it may be difficult to coordinate the different constituencies of bondholders (that is a problem in any event) and membership of a committee may change over time (a necessary feature to ensure that those economically interested in the outcome remain those with whom engagement takes place).

Some have suggested that engagement in good faith creates an unclear standard for the sovereign debtor to meet. However, there is a significant body of learning and judicial guidance on 'good faith' requirements from the English Courts which can be drawn upon by advisers to guide the sovereign debtor in case of need.

The bottom line is that good faith engagement between sovereign debtors and creditors is a helpful feature of successful restructurings. If engagement is not built into the transaction documents at the outset, reliance must be placed on ad hoc arrangements created at a time of crisis, which may prove to be problematic.

Ad hoc arrangements, although they can work well, raise many of the same issues at the inception stage as the creditor engagement provision. This is because the provision itself is high level and not prescriptive. The protection its inclusion gives bondholders is that it will ensure some engagement with them, albeit the formation of a formal committee or an ad hoc committee will require the agreement of further ground rules.

Conclusion

Creditor engagement is, as most now recognise, a vital part of securing a fast and fair sovereign debt restructuring. Engagement is vital both for creditors in order to ensure that their representatives have access to necessary information and can negotiate a satisfactory resolution, and for debtors in order to maximise the prospects of a successful restructuring and to reduce the risk of being bound up in litigation for years. While creditor engagement can be organised when the need arises, it is prudent to seek to put in place a structure in the good times rather than to wait until the crisis is at hand. One simple way to achieve this outcome is for there to be increased use of the ICMA standard form creditor engagement clause or similar provisions that operate alongside the ICMA aggregated CACs. If a sovereign has concerns with particular elements of the ICMA standard form creditor engagement clause, then those could be raised with the lead managers of the issue and appropriate revisions from the standard form agreed prior to issuance. This is preferable to omitting the creditor engagement provisions altogether.

Authors



Deborah Zandstra
Partner, London

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

Andrew Yianni
Consultant to Clifford Chance

T: +44 20 7006 2436
E: andrew.yianni
@cliffordchance.com

Simon James
Partner, London

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