SOVEREIGN DEBT – NAVIGATING ENTRY AND EXIT STRATEGIES

Negotiating the sovereign debt markets has always been notoriously difficult for banks and funds that wish to lend with a certain degree of control over outcomes. Here, Clifford Chance partners look at the structuring and legal issues to consider when negotiating sovereign and quasi-sovereign debt raisings, and highlight the key terms for entering into such transactions, as well as the arrangements that can be used to allow for a successful exit.

While sovereign debt provides, for many lenders, the most certain path in an uncertain world, every few years such debt hits the headlines, and typically for the wrong reasons. In the past we have seen issues with Argentinian, Russian, Asian and Greek debt, and now attention is shifting to the African economies, which are facing a number of challenges in the form of falling oil prices, current account deficits and liquidity constraints.

As the yields on African sovereign debt decrease relative to more mature economies, at a time when there is pressure on emerging economies to spend more on public expenditure, there are fears of creating the perfect storm. Meanwhile the dollar is also strengthening; typically a harbinger of problems for sovereigns.

Leonard Cleland, a Clifford Chance partner specialising in emerging markets financing, says: “Sovereigns are uniquely placed because they can go bankrupt in the sense of running out of money, but have no option of bankruptcy protection. There is no Chapter 11 for sovereigns. Meanwhile they have the protection of immunities, but those can be turned to dust very quickly in the event of collective actions before the courts that drain them of access to money.”

Therefore, when structuring sovereign debt, it is important that lenders include all the necessary representations and covenants in their documents to protect themselves in the event of the sovereign getting in to difficulties, even though doing so often does little more than strengthen the private lenders’ voice at the table vis-à-vis international financial institutions such as the World Bank and the International Monetary Fund (IMF).

Structuring sovereign debt

When entering into a sovereign debt financing, identifying the correct counterparty to a loan agreement, or indeed any other debt instrument, is key. As such, it is critical first to identify who the sovereign is acting through, often the Ministry of Finance or another public body, and then to ensure that is properly reflected in the loan documentation.

There is then the question of who the documentary protections should extend to, because all states operate through a number of agencies, public bodies and ministries, and the financial health of those often goes hand-in-hand with the health of the sovereign. It can therefore be useful to employ a broad agency definition in key provisions.

Finally, the role of the central bank is critical. Graham Brewer, a senior associate in the banking and finance practice at Clifford Chance, says: “It’s important to have an understanding of the relationship, both legal and contractual, between the sovereign and the central bank. Most emerging market sovereign loans are denominated in a currency other than that of the borrower nation, and frequently the central bank holds the foreign exchange reserves that allow the sovereign to meet its obligations. In some cases, foreign reserves are owned by the state and the central bank holds them, but in others the central bank is more autonomous and may be restricted in what it can do.”

Who should be giving the necessary assurances that funding is available to make an exit feasible will be dependent on the central bank relationship.

When it comes to the representations and covenants that should be included in loan documentation, a checklist can broadly be grouped into three

“Sovereigns are uniquely placed, because they can go bankrupt in the sense of running out of money, but have no option of bankruptcy protection.”

Leonard Cleland, Partner, London

"It's important to have an understanding of the relationship, both legal and contractual, between the sovereign and the central bank."

Graham Brewer, Partner, Dubai

categories: those relating to the validity and enforceability of sovereign obligations; those pertaining to the creditworthiness of the sovereign party; and those concerned with the lenders' exit position.

On the validity and enforceability of sovereign obligations, it's vital to ensure that the counterparty has the necessary authorisations to execute obligations, which may be impacted by procurement and state aid rules, or by other federal or international laws.

In relation to creditworthiness, sovereign loan documentation often includes representations relating to status of the IMF as evidence of ability to pay, while anti-corruption, sanctions and use of funds representations should also be a key area of focus. Finally, when it comes to the lenders' exit position, close attention should be paid to representations relating to private and commercial acts, such as the recognition and enforcement of choice of governing law; to the sovereign immunity position; to the ability of the state to exchange local currency into the currency of the loan; and finally to the World Bank Negative Pledge Clause (where the borrower has entered into lending arrangements with the World Bank).

The World Bank Negative Pledge Clause ensures that any lien created on any public asset as security for external debt that results in priority for a third-party creditor will equally and rateably secure all amounts payable by the borrowing state. That means that the World Bank shares in the amounts paid out to the third party creditor, preventing that creditor enjoying senior creditor status, and is a significant reason why most senior sovereign loans are unsecured. However, it is common also to see negative pledge clauses included by third-party lenders albeit with differing scope, to ensure their protection is also embedded in their loan documentation.

Turning to information undertakings, the four principal clauses to focus on relate to financial information, information relating to sanctions and/or corrupt acts, information regarding change of law and information for the IMF. The last of these should be included as protection against sovereigns failing to disclose appropriate information to the IMF and often to require them to provide lenders with copies of the information disclosed.

When it comes to events of default, sovereign borrowers cannot be subject to insolvency regimes in the same way that corporate borrowers can be, and so cannot be wound up to pay off their debts. From a structuring point of view, that means normal Loan Market Association protections will not be relevant, and instead the events of default typically focus on the occurrence of events such as the declaration of a moratorium; an IMF-linked event triggered either by the sovereign party ceasing to be a member of the IMF or having its IMF programmes suspended; cross-acceleration, as opposed to cross-default; conflicts and unrest; or the imposition of new currency controls.

Three other important areas to be considered when structuring sovereign debt relate to ratings downgrades, transfers and confidentiality. A ratings downgrade provision can be particularly useful: "Before you get into an enforcement situation, there are several other tools to include in documentation that help avoid such a situation," says Brewer. "One is a mandatory prepayment linked to a ratings downgrade, which is particularly useful as it is potentially less politically damaging to call an individual lender's right of prepayment, rather than voting to accelerate the loan." Such a prepayment is therefore a tangible tool that an individual lender can use to exit a deal.

On transfers, sovereigns are sometimes nervous about who holds their debt, and may insist on restrictive transfer provisions. Similarly, on confidentiality, sovereigns may insist that information relating to the terms of a loan and the progress of any underlying projects involved is kept confidential by the facility agent and lenders.

Enforcing sovereign debt

Where things go wrong, and lenders may need to consider enforcing against sovereigns, there are two main exit strategies available: a sale or the launch of legal proceedings. For a sale to be a viable option, a creditor needs to be able freely to transfer its loans following a default, and there may be residual risks for the facility agent or arranger left behind in the deal.

Launching proceedings also comes with challenges. Local litigation is unlikely to be an attractive option, so creditors would typically look to bring a case in the English courts and hope that the local jurisdiction will recognise the judgement. If that is not an option, the next fall-back strategy, which is still a good one, is arbitration. Many states are party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, and once arbitral awards meeting the requirements of the Convention are given, there is a relatively quick process for obtaining recognition of the award. States can still raise defences to arbitral decisions, or attempt to frustrate the process locally, but cases are typically heard in London, Stockholm or Paris, and because there is less adverse publicity than with court based litigation, the process can run more smoothly.

Another option is the International Centre for Settlement of Investment Disputes (ICSID), which provides arbitration and conciliation services for States and investors under the auspices of the World Bank. An ICSID process offers three fundamental advantages: the power of the World Bank is behind any award that is granted, aiding enforcement; there is no appeal process, so decisions are final and binding; and sovereign immunity is no defence against the recognition of an ICSID award.

ICSID therefore achieves a very high settlement rate, and sovereigns are generally compliant with its outcomes. Other options for proceedings include political risk insurance and the use of investment treaty protection.

Immunity

One of the biggest challenges in enforcing sovereign debt involves sovereign immunity, which has a long history. Some states still observe absolute sovereign immunity, such as Hong Kong and Russia. Central banks in particular tend to enjoy special protection.

There are two types of immunity: immunity from jurisdiction, and immunity from enforcement. The former can generally be avoided by submitting to the English courts or a chosen court of arbitration, so it is generally not a problem in practice in the loan and bond context, though care must be taken to ensure a waiver extends to the place where a judgement or award can be enforced. Immunity from enforcement can also be waived, but the correct person needs to give the waiver, and that may not necessarily be the same person who signs the debt documentation. Deborah Zandstra, a Clifford Chance partner specialising in sovereign debt, says: "Under English law, in the context of a state borrowing, the property of that state which is in use or intended for commercial purposes, would typically not enjoy immunity from enforcement".

A few other points to bear in mind are that the state may be restricted in law in what it can waive, in which case the applicable assets remain immune. The state may also place its assets with other immune entities, such as a central bank or the Bank for International Settlements. If the waiver fails or is restricted, commercial assets can be very hard to isolate in practice.

Cleland says: "The key issue here is to try and get an express waiver, to make sure that the correct parties waive it, and to ensure the central bank is also bound. It can be very easy to fall down a black hole."

"For lenders that do find themselves in a sovereign debt restructuring situation, creditor coordination will be a key factor, and hence debtors will need to engage with private sector creditors as well as the official sector to increase the chances of an orderly and timely restructuring outcome."

Deborah Zandstra, Partner, London

Restructuring sovereign debt

There is no insolvency regime for sovereigns and so when it comes to restructuring, reliance is placed on a combination of contractual provisions and practices and conventions used in the field. In the majority of cases the IMF is at the heart of the process and so its approach often shapes any restructuring of sovereign debt that occurs, resulting in other lenders needing to engage heavily with the official sector as well as with the debtor.

The IMF has recently revisited many of its policies as they relate to sovereign debt restructurings, including strengthening the contractual framework to address collective action processes with a view to facilitating orderly sovereign debt restructurings, as well as its lending policies to member states experiencing balance of payment crises and its debt sustainability methodology.

Deborah Zandstra says: "Commercially, the amount of debt relief that may be needed will be benchmarked by reference to the debt sustainability parameters set by the IMF. For lenders that do find themselves in a sovereign debt restructuring situation, creditor coordination will be a key factor, and hence debtors will need to engage with private sector creditors as well as the official sector to increase the chances of an orderly and timely restructuring outcome."

C L I F F O R D
C H A N C E

CONTACTS

Leonard Cleland
Partner
London
T: +44 20 7006 2070
E: leonard.cleland@cliffordchance.com

Deborah Zandstra
Partner
London
T: +44 20 7006 8234
E: deborah.zandstra@cliffordchance.com

Graham Brewer
Partner
Dubai
T: +971 4503 2631
E: graham.brewer@cliffordchance.com

J201708230051349