Collective Action Clauses and the Restructuring of Sovereign Debt

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Preface

The volume contains articles based on presentations given at a conference hosted by the Institute for Law and Finance of Goethe University on October 27, 2011. Collective action clauses are an example of the typical dichotomy of financial regulation: While the problems are economic in nature, the solutions need to be implemented by law. The Institute for Law and Finance strives to bring together law and finance in order to foster a better mutual understanding of both disciplines and to improve the regulation of financial markets. Thus, the organizers are particularly pleased that eminent experts from the fields of law and finance agreed to participate in the event and to share their views on and experiences with collective action clauses. The presentations given at the conference have been updated in 2012 to reflect recent developments.

Andreas Cahn

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The Authors

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Klaus-Albert Bauer is a partner of Freshfields Bruckhaus Deringer specializing in banking and capital markets law. He is based in Frankfurt.

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Klaus-Albert Bauer is the author of a book on international banking supervision as well as of numerous other publications. He has been teaching international business transactions at Bucerius Law School. Since its foundation, Klaus-Albert Bauer is a member of the faculty (Lehrbeauftragter) at the Institute for Law and Finance at the Goethe-University Frankfurt (ILF).

For purposes of disclosure it is stated here that Freshfields Bruckhaus Deringer advised the German Ministry of Finance in connection with the drafting of the model CAC. The views expressed by Klaus-Albert Bauer in his article are entirely his own.

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Andreas Cahn studied law at the Johann Wolfgang Goethe-University Frankfurt/Main and at the University of California at Berkeley, where he earned an LL.M. After his Second State Examination in Frankfurt he worked for 6 years as a research assistant at the University of Frankfurt. During this period of time he wrote his doctoral thesis on problems of managers' liability (published in 1996) as well as his post-doctoral thesis on legal aspects of intra-group financing (published in 1998).

In 1996 he took up the Chair of Civil Law, Commerce Law and Corporate Law at the University of Mannheim. Since October 2002 he is Director of the Institute for Law and Finance at Goethe-University in Frankfurt. He has published extensively on corporate law, capital markets law, the law of products liability, general civil law as well as on civil procedure. He is co-publisher of "Der Konzern", a law journal focusing on company law, taxation and accounting of corporate groups, of "Corporate Finance law", a journal with a focus on current legal issues corporate finance, co-editor of the Institute for Law and Finance Series and member of the editorial board of the law journal "European Company Law".

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Christian Kopf graduated from Witten/Herdecke University in Germany with a Masters degree in Economics and holds the Chartered Financial Analyst designation from the CFA Institute. He was a scholarship holder of Evangelisches Studienwerk, the Protestant institute for the promotion of academic talent, and of the Congress-Bundestag Youth Exchange Program. Christian Kopf grew up in Hessen, Colombia, Minnesota and France and he is fluent in German, Spanish, English and French.

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Cleary Gottlieb Steen & Hamilton LLP advised the EFC Sub-Committee on EU Sovereign Debt Markets on the drafting of the model CAC. The views expressed by Mr. Sabel in this article are solely his own. Mr. Sabel would like to thank David Billington and Matthew Hamilton-Foyn of Cleary Gottlieb for their assistance in the preparation of this article.

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Introduction

Klaus-Albert Bauer

The Euro Area's Collective Action Clause – Some Questions and Answers

During much of the time prior to the ILF conference on "Collective Action Clauses and the Restructuring of Sovereign Debt" held on October 27, 2011, the focus of public attention, was on the second part of the title – "Restructuring of Sovereign Debt". Almost on a daily basis, the destiny of the Euro Area and of individual countries with high volumes of sovereign debt was discussed. Markets were volatile. In the morning hours of the day of the ILF Conference, a deal was made in Brussels providing for a 50 % "haircut" for private investors in Greek bonds on a voluntary basis.[1] Many slides had to be updated virtually in the last minutes preceding the start of the Conference.

At the time of writing these lines (mid December 2012), there is relative calm "out there". Two major international agreements, the Treaty establishing the European Stability Mechanism (ESM Treaty) and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact) are in place.[2] Greece has gone through a successful restructuring of its bond debt including a recent buy-back programme. This is a good time to take a breath and focus more closely on the Collective Action Clauses which gave rise to our conference in the first place. To kick our book off, here are some questions and some answers suggested by this co-editor.

What are Collective Action Clauses?

Generally, one understands collective action clauses (CACs) to refer to a clause in bond terms and conditions which provides inter alia for rules of majority voting to change the terms and conditions themselves. CACs could therefore, for the sake of simplicity and ignoring possible other features of a collective action clause, also be referred to as "majority voting provisions" or, keeping their most important purpose in mind, as "debt rescheduling clauses". The effect of a bondholder vote passed with the required majority is to bind all holders of the respective bonds whether they have participated in the vote or not.

1 Cf. the details given in *Christian Kopf's* contribution to this volume, p. 149 below.

2 The ESM Treaty has entered into force on September 27, 2012. As of December 14, 2012 eleven countries had ratified the Fiscal Compact.

Are Collective Action Clauses new?

No. They have been used in many corporate bond issues since the 19th century (with English law being the front runner). Many emerging market sovereign bond issues under English law and (since 2003) under New York law contain collective action clauses.

Have Euro Area sovereign bonds traditionally included CACs?

No. The vast majority of presently outstanding sovereign debt issued by Euro Area countries contain no CACs. There are, however, exceptions. In 2003, following the G-10 recommendations, the President of Ecofin had supported the use of CACs for international bond issues. In fact, a number of foreign currency bonds or bonds under foreign law issued by many European countries during the past decade contain collective action clauses.

Are the collective action clauses used in the market today uniform?

No. Many sovereign issues tend to follow one of the existing model provisions for collective action clauses, in particular the model clauses recommended by the Group of Ten in 2002 or the IPMA recommendations of 2004. The actual provisions of CACs used in the market differ to a great extent.

What happens after January 2013?

After this date all **newly issued** sovereign bonds in the Euro Area with a maturity exceeding one year are to contain **identical** collective action clauses. It is important to note, however that the new rules only apply to central government issued securities and exclude regional and municipal bonds which may be issued without inclusion of CACs.

What is the legal basis for this?

In Article 12 of the ESM Treaty all Euro Area member countries have undertaken to include collective action clauses with identical legal effect in their sovereign bond issues. The actual text of the clause is not attached to the Treaty itself. It was developed by the EFC Sub-Committee on Sovereign Debt Markets and approved by the EU's Economic and Finance Committee (EFC) on November 18, 2011.[3]

How long will it take until all outstanding sovereign bonds in the Euro Area contain CACs?

Sovereign bonds with and without CACs will co-exist for a very long time.[4] First, all existing bonds (some of which have a maturity of 30 years) are not affected by the introduction of the Euro CACs. Second, even for newly issued bonds there is a phase-in corridor for cases where the aggregate principal amount of a series of bonds existing prior to January 1, 2013 (with no CACs) is increased (so called "tapping").[5]

What is the purpose of the Euro Area CAC?

There seems to be a double purpose.

First there is the general goal of any collective action clause, i.e. to facilitate restructuring of an issuer's debt. The logic is that if a defined majority accepts the restructuring, then it should also be binding for everyone, thereby eliminating the so-called "hold-out problem".

Second, in a European context, the inclusion of the collective action clause was part of what has come to be known as Private Sector Involvement (PSI). In plain language: Bilateral help (rescue measures) between sovereign states within the Euro Area was conditional on a bundle of measures which should ensure that private investors recognize and bear the risk of their investment decisions. If one follows this logic, collective action clauses would also have a "disciplinary function".[6]

What is the main content of the Euro Area CAC?

The obligations of an issuer to pay principal and interest can be changed with binding effect for all holders by a bondholder resolution. This resolution can be taken in a **bondholder meeting** or **in writing**. Here are the details for the restructuring of a **single series of bonds**:

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3 For the final text of the Euro Area CAC, for supplemental provisions thereto and for an earlier draft see Appendices 2, 3 and 5 below. For an overview of the drafting process see *David Sabel's* contribution in this volume at p. 29 below.

4 See *Wiesmann* p. 103 below.

5 For details cf. Supplemental Explanatory Memorandum, Appendix 4, below.

6 Cf. the contributrion of *Claus Happe* in this volume, p. 25 below.

	Bondholder Meeting	Written Resolution
Majority Requirement	**75 %** of principal amount of outstanding bonds **represented** in the meeting	**66 2/3 %** of principal amount of **all outstanding bonds** of the series concerned
Quorum (minimum participation in meeting required, calculated as percentage of principal amount of **all outstanding bonds** of the series concerned)	66 2/3 %	n.a.

If **more than one issue** of bonds is to be restructured at the same time, a lower **per issue** majority as set out here

	Bondholder Meeting	Written Resolution
Majority Requirement	**66 2/3 %** of principal amount of outstanding bonds **represented** in the meeting	**50 %** of principal amount of **all outstanding bonds** of the series concerned
Quorum (minimum participation in meeting required, calculated as percentage of principal amount of **all outstanding bonds** of the series concerned)	66 2/3 %	n.a.

is sufficient for a particular series concerned if, on an **aggregate** basis over all different series included in the restructuring, the following majority is reached

	Bondholder Meeting	Written Resolution
Majority Requirement	75 % of the aggregate principal amount of outstanding bonds **represented** in all bondholder meetings of the series of bonds included in the restructuring	66 2/3 % of the aggregate principal amount of all **outstanding bonds** of all series of bonds included in the restructuring
Quorum (minimum participation in meeting required, calculated for each series separately as percentage of principal amount of **all outstanding bonds** of the respective series)	66 2/3 %	n.a.

The legal technique to provide for a lower per-issue minimum majority in case of a bondholder vote encompassing several series of bonds has come to be known as **aggregation** or, in the context of the Euro Area CAC, as **cross-series modification**.[7] The issuer may decide whether it proposes one or several single issue restructurings or one or several restructurings on an aggregate basis.

The Euro CAC also deals with the issue of who is entitled to vote in order to avoid corrupting the outcome by having the issuer or certain holders close to the issuer participating in the vote.[8]

Does the Euro Area CAC solve the "hold-out problem"?

To a certain extent but not entirely. An investor or a group of single investors holding 50 % of the outstanding principal amount of a particular bond issue would have a "secure" position to block a restructuring proposal for the respective series even if the restructuring is based on the cross-series modification/aggregation provisions and, over all series of bonds concerned, the required majorities under the aggregation provisions were reached. If a restructuring is attempted on a single issue basis, 33 1/3 % of the outstanding principal amount would give a "holdout" creditor a "secure" blocking position.

Does the Euro Area CAC give better protection against hold-out creditors than collective action clauses traditionally used in the market?

Arguably yes. As set out above, many collective action clauses used by sovereign issuers in some of their foreign law issues follow the standards of the G-10 recommendations or the IPMA recommendations of 2004. All these model clauses provide for majority voting on a **per issue** basis, i.e. with no reduced majority requirements in case of a restructuring of more than one bond issue. For debt restructurings, both the G-10 recommendations and the IPMA recommendations require a majority of 75 % of outstanding principal amount of bonds of a particular series. In other words, a holder of **25** % of the outstanding principal amount of bonds of a series would always be able to block a restructuring resolution concerning the particular series of bonds. The Euro CACs therefore seem to afford

7 For a detailed discussion of these clauses see the contributions of *David Sabel* and *Patrick Kenadjian* in this volume on pp. 29 and 113, respectively.

8 For a detailed analysis of the "disenfranchisement" provisions included in the Euro Area Model CAC and their rationale see the contributions by *Christian Hofmann* and *David Sabel* in this volume, pp. 45 and 29 below.

better restructuring possibilities by requiring lower **per bond** issue majorities in case of written resolutions and, most importantly, in case of cross-series modifications, thereby raising the threshold of a "secure" blocking position from 25 % to **50 %** of the outstanding principal amount of bonds of a particular series.

Did the Greek restructuring of February/ March 2012 use CACs?

Yes. Part of Greece's outstanding debt under **foreign law** had a collective action clause included. Some of these issues were restructured following a bondholder resolution reaching the required majorities. In other issues, an amendment of terms was either not sought or not backed by a sufficient number of votes. As for **Greek law** bonds, they originally had no CACs included. The Greek legislator had "retrofitted" CACs into existing bonds on February 23, 2012 (see next question) which were then used to restructure the Greek law debt.[9]

Were the Greek retrofit CACs for Greek law bonds the same as the Euro Area Model CACs?

No. The Greek retrofit CACs were very simple. The Greek Bondholder Act of February 23, 2012 provided for a **full aggregation** of votes across all series of bonds **without** any counting of votes on a per-issue basis. The overall quorum was 50 %, and the majority required was 66 % of the aggregate nominal amount.

What was the result of the vote of Bondholders for the restructuring proposal concerning Greek law bonds with "retrofit" CACs?

In the actual vote, the retrofit CAC thresholds were easily achieved: of some 177 bn. Euro principal amount outstanding, 161 bn. Euro participated in the vote (91 %) of which 152 bn. Euro (94 %) voted in favour of the restructuring proposal. As a consequence, 100 % of the Greek law debt included in the proposal was restructured.

9 For a detailed description of the Greek restructuring see *Jeromin Zettelmeyer*, *Christoph Trebesch* and *Mitu Gulati* The Greek Debt Exchange: An Autopsy, Draft 11 September 2012, available at http://ssrn.com/abstract=2144932; cf. also the contribution by *Patrick Kenadjian* in this volume, p. 113 below.

If Greece could legislate CACs "ad hoc" into all outstanding Greek law bonds and complete a successful restructuring on this basis, why is it necessary to equip all new European government securities issued after January 1st, 2013 with CACs?

In fact, not everybody agrees on the necessity of having the Euro Area CAC. Christian Kopf argues in this volume that the Euro Area CAC is not necessary as foreign law bonds by Euro Area member states tend to already have CACs included in the terms and conditions and as the overwhelming majority of Euro Area member states' debt is governed by local law which would allow "Greek-style" retrofit CACs should they ever be needed. Claus Happe and Matthias Wiesmann take a different view as they stress the disciplinary function of the Euro Area CAC. As to Christian Kopf's premise, namely that a national legislator can introduce CACs with effect for outstanding bonds at any time, see next question.

Can a national legislator introduce ("retrofit") CACs for its outstanding bond issues governed by its own law at any time?

Arguably yes. There are, however, limits as to what a legislator can "legally" do. These limits could be found in the sovereign's constitution, in bilateral investments treaties (BITs), in multi-lateral conventions (e.g. human rights) and in general principles of international law.

In this volume, Lachlan Burn[10] forcefully argues that "Greek-style" retrofit CACs violate the rule of law. Boris Kasolowsky and Smaranda Miron[11] point out that many BITs may provide protection against retrofit CACs. A recent article in the Harvard Business Law Review examines under which circumstances retrofit CACs might qualify as an expropriation which would give rise to claims in a US court.[12] Finally the constitutional issue would need to be carefully explored on a case by case basis. So, stopping short of trying to give a concise answer to the question, we surmise that the Euro Area's approach of providing new sovereign

10 p. 73 below.

11 p. 85 below.

12 See *Melissa Boudreau* Restructuring Sovereign Debt Under Local Law: Are Retrofit Collective Action Clauses Expropriеtary, Harvard Business Law Review (Online Edition) available at http://www.hblr.org/2012/05/retrofit-collective-action clauses/See also *Christian Kopf*, p. 173 below. For an ex ante analysis of the Greek situation see *Mitu Gulati/Lee Buchheit* How to Restructure Greek Debt, Duke Law Working Papers, No. 47, Duke University (2010).

debt securities with collective action clauses is certainly more “civilized”[13] than ignoring the issue and legislating post factum.

Once the Euro Area CAC is in use, could a national legislator change it unilaterally in case of need?

Following the Kopf / Gulati analysis set out above, the answer seems to be yes. So, in a number of years, a state wishing to restructure its debt might try to change the rules if it finds that a “Greek-style” retrofit full aggregation would increase the chances of success for a restructuring. As we have seen, under the Greek-style full aggregation approach no blocking position for any particular bond issue would work if a certain (rather low) **overall** majority of bondholders approved the proposal. There are, however, two important considerations: first, while a retrofitting introduction of collective action clauses may raise eyebrows it would be an even stronger breach of investor confidence to unilaterally change the rules after they have been explicitly set out in the terms of the bonds. Second, Article 12 of the ESM Treaty obliges the Euro Area member states to issue all bonds with identical collective action clauses. A natural understanding of this clause would seem to prohibit not only the issue of bonds with non-conforming collective action clauses but also the later unilateral amendment of Euro Area CACs to suit a particular issuer’s needs in times of crisis.

If an issuer issues otherwise identical bonds including the Euro Area Model CAC under its own law and under the law of another jurisdiction, will bondholders be treated in the same way in case of a restructuring?

Basically, this is just another way to ask the preceding question once more. If a proposal for a debt restructuring is made to all bondholders, the Euro Area CAC requires counting of votes on a per issue basis. Therefore, depending on the outcome of bondholders’ votes, the destiny of each bond may be different. If the same percentage of holders votes in favour of the proposal for each of the bonds concerned, the result will be the same for each issue. However, if the state in question decides to change the rules for its domestic law governed bonds in its favour, the results may be different.

13 *Antonio Sáinz de Vicuña’s* article (see p. 15 below) emphatically describes insolvency law as “a triumph of civilisation over force”.

Concluding Remark

Just a few years ago, very few people would have foreseen the present crisis of sovereign debt in Europe. At the same time it would have been hard to imagine that, in responding to the crisis, all countries of the Euro Area would commit to using uniform collective action clauses in their debt issuances. Having gone through this experience, one is well advised to exercise modesty when it comes to predicting what lies ahead. *Antonio Sainz de Vicuna*, in his contribution below,[14] sees collective action clauses as an interim step towards a new order which would eventually include a sovereign debt resolution mechanism.[15] While it may take rather long to go down that road, this author also believes that the Euro CAC is an important first milestone on the way to a new governance for the Eurozone.

14 p. 15 below.
15 See also *Paulus* p. 181 below.