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Debt Restructuring Mechanisms

by

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KEY POINTS

- The fear of holdout creditors has been one of the main reasons why the official sector players have been prepared to use their taxpayers' money to repay – in full and on time – the private sector creditors of distressed Eurozone sovereign borrowers.
- The Treaty Establishing the European Stability Mechanism provides a vehicle through which the Eurozone countries could deflate the expectations of prospective holdouts for a preferential recovery and thus minimise the number of holdouts in any future Eurozone sovereign debt restructuring.
- Such measures, taken together with the other features that have come to characterise Eurozone sovereign debt workouts, replicate the important features of domestic bankruptcy code procedures for corporate debtors.

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The problem of holdout creditors in Eurozone Sovereign Debt restructurings

Notwithstanding the Eurozone official sector's assurance that the restructuring of Greek bonds in 2012 was a "unique and exceptional" event, if another restructuring of the debt of a Eurozone sovereign becomes necessary, can holdout creditors be kept to a minimum? The architects of every Eurozone sovereign bailout program (Cyprus is the one in the oven at the moment) must make a crucial threshold decision: what to do with the sovereign's debt maturing during the program period. Mercifully, there are only two options – pay it or restructure it.

THE "PAY IT" ALTERNATIVE

Paying maturing debt requires the country to borrow the funds from some source. Again, there are only two options: borrow from the market to refinance maturities during the program period or borrow from official sector bailout facilities like the European Stability Mechanism (ESM).

By definition, a country that enjoys market access at tolerably low interest rates would not now be negotiating an official sector bailout package, so genuine market refinancing is foreclosed. One possible solution is to arrange for an official sector actor (the European Central Bank volunteered for this role last September) to soften up the beaches by purchasing the debtor country's bonds in the secondary market in order to depress the yields on those instruments.

This, the theory goes, will allow the country to issue new bonds in the primary market at coupon levels that benefit from official sector intervention.

If necessary, the ESM could also purchase some of those new bonds when they are issued in the primary market. The combination of ECB/ESM intervention would thus operate as an official sector bailout masquerading as a normal market borrowing.

THE "RESTRUCTURE IT" ALTERNATIVE

The obvious question in these affairs is why ever would the official sector entertain the idea of using taxpayer funds to pay out, in full and on time, a debtor country's existing creditors? One might have thought that the official sector's fiduciary duty to its taxpayers would require the architects of these programs to reduce or defer, to the fullest extent possible, the liabilities that will need to be covered by official sector lending. Indeed it is precisely this sense of a fiduciary duty to their own taxpayers that presumably justifies the official sector's insistence that the recipient country pare its budget deficit to the bare minimum by embracing fiscal austerity, and maximise the country's own contribution through privatisation programs, before official sector monies are used to cover the residual shortfall.

But this sense of fiduciary duty has thus far (with one exception) stopped short of asking, or demanding, or for that matter even permitting the recipient countries to reschedule their existing debts in order to remove those liabilities from the list of items that must be paid using official sector bailout funds. The bailout programs for Greece (until the official sector reversed course and permitted a restructuring of private sector

debt in early 2012), Ireland and Portugal have each treated maturing debt as an inviolable component of the recipient country's balance sheet, one that cannot and should not be subjected to any measures that would mitigate the gross amount of official sector funding that must be poured into the recipient country. The single exception to this rule was the belated, but successful, Greek debt restructuring in the spring of 2012; an event that the official sector continues to describe as "unique and exceptional" and never to be repeated in another Eurozone country. If you believe that assurance, you may stop reading this article now¹.

THE JUSTIFICATIONS

Why? If official sector negotiators have learned to steel their hearts against the pleas of the old age pensioners, the unemployed, the homeless, the sick, the blind and the lame in bailout recipient countries, why should they show such solicitude for the country's creditors? Why, to put the question in a lurid way, should the official sector insist that cancer patients in the recipient country forego their medicine in the interests of salutary "fiscal adjustment" but simultaneously recoil at visiting some discomfort on a hedge fund manager in Greenwich, Connecticut who holds the country's debt obligations?

The predictable answer from the official sector negotiators will be, "it's complicated". Here, insofar as we have been given the light to see them, are the complications:

- **National pride:** "Europeans pay their debts", is how former President Nicolas Sarkozy phrased it; a statement that showed a remarkably shallow grasp of

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European history³. Volumes have been written about the serial debt default records of many European countries. But the spirit of President Sarkozy's statement shines through. A sovereign debt restructuring, he believed, would be tantamount to an admission of emerging market status. It would be inconsistent with the dignity, with the *gloire*, of a modern European nation.

- **Contagion:** With the entire periphery of Europe in the line of fire, might not a debt restructuring in any one of them ignite a conflagration that would soon engulf them all? If you had to restructure the debts of all of them, that would surely destabilise the global banking industry. And from there it is a short path to planetary ruin. This, more or less, is how the contagion argument is typically formulated.
- **Incestuous relationships:** Were all of these debts owed exclusively to Greenwich, Connecticut-based hedge funds, the official sector negotiators might say, then restructuring those liabilities would be permitted, nay gleefully permitted. But they are not. A substantial part of the paper is likely to be held by financial institutions in the sovereign's own country – banks, insurance companies and pension funds. Restructuring those instruments will therefore undermine the health of the domestic financial system. Every euro saved in debt service might need to be spent in bank recapitalisations. Moreover, much of the balance of the paper will be in the hands of banks in northern European countries, the very countries that will be making the largest contributions to the bailout funding. To this extent, what appears to be a generous sovereign bailout of an overextended neighbour is in reality a disguised recapitalisation of the banking sectors in the major contributing countries. (The lesson? All future Eurozone sovereign bond issuances should be placed exclusively with investors domiciled in the township of Greenwich, Connecticut, and secondary

market transfers of those instruments should be confined to the geographical boundaries of that township.)

- **Feasibility:** Finally, there is the matter of the technical feasibility of a debt restructuring in these circumstances. The bane of sovereign debt restructurers over the last 30 years has been the problem of holdout (non-participating) creditors. Creditors left behind in a sovereign debt restructuring cause these problems:

 - If there are enough of them, the financial predicates underlying the entire restructuring may be undone;
 - If holdouts are subsequently paid in full, it makes the participating creditors look silly and this leads, in the next restructuring, to even more holdouts;
 - If holdouts are *not* paid after the restructuring closes, they pose an on-going litigation and attachment threat to the sovereign debtor; witness Argentina's decade-long legal fight with thousands of holders of the Argentine bonds that went into default in 2001.

Various techniques have been deployed in an effort to cajole, seduce, bludgeon or rope recalcitrant creditors into the restructuring process, none of them wholly successful. Holdouts were not a lethal threat in the Greek debt restructuring of 2012 for only one reason: 93% of Greek bonds were governed by local (Greek) law. This permitted the Greek Parliament to retrofit a collective action mechanism on the local law debt stock that operated to sweep potential holdouts into the deal. Greece did have a small holdout population in this restructuring (equal to about 3% of the total eligible debt), but these holdouts were concentrated in the country's foreign law-governed bonds. Not every Eurozone country, however, enjoys this local law advantage. Local law-governed bonds represent a minority of the overall debt stocks in some of the smaller Eurozone countries and in the borrowings by many sub-sovereign entities such as provinces and municipalities. In addition, many Eurozone

sovereigns will have some portion of their debt stock in the form of foreign law-governed bonds; the most fertile ground for the sprouting of holdout seedlings.

The threat of a significant holdout creditor population will therefore haunt the debt restructuring of almost any Eurozone country. The conventional method of minimising such holdouts – threatening to consign all those who refuse the restructuring offer to the outer darkness of permanent default – is unlikely to be effective in this situation. Local holders of such bonds may possibly be persuaded by the government to roll their positions. But foreign holders can literally smell the official sector's fear of a messy sovereign debt workout in Europe. No one is eager to bring Argentina to the belly of Europe. If the market had any lingering doubts about the matter, a surfeit of official sector statements over the last three years have painted such an event as a catastrophe rivaling the Pleistocene ice age³. In short, some creditors will surely call the bluff of a threatened permanent sovereign default in the Eurozone.

WHAT CAN BE DONE?

As shown by the Greek debt restructuring of 2012, with a bit of ingenuity and courage the other concerns about a Eurozone sovereign debt restructuring – national pride, risk of contagion and incestuous sovereign/banking sector linkages – can be satisfactorily addressed. Holdouts, however, will be a ubiquitous problem.

The choice of a foreign law to govern a sovereign debt instrument will place it beyond the reach of the debtor's own legislature. The holder will therefore in all likelihood be able to reduce the claim to a foreign court judgment, sometimes within a matter of months. With that judgment in hand, the creditor can then begin to exert pressure on the sovereign borrower by attempting to attach the sovereign's off-shore assets (other than those, like embassies, that enjoy a special immunity), interfere with the sovereign's fund-raising efforts abroad and perhaps (the subject of pending litigation in New York at the moment) intercept payments made on the borrower's other debt obligations. It is in

this ability to exert post-judgment pressure on the sovereign borrower that the hopes of a holdout creditor for a preferential settlement principally reside.

The first step in assessing the potential legal threat posed by holdout creditors is to read the underlying debt instruments to see what defences the documents might provide to a sovereign defendant in a fire fight. The Republic of Cyprus Euro MTN documentation (17 June 2011), for example, offers a good illustration. Condition 7(c) of the Terms and Conditions of the Cypriot Notes provides:

"All payments are subject in all cases to any applicable fiscal or other laws, regulations and directives, but without prejudice to the provisions of [the tax gross-up clause]."

Does this include Cypriot laws, regulations and directives? *Nota bene* that the provision does not say "laws, regulations and directives in the place of payment". Read literally, therefore, it makes all payments subject in all cases to any Cypriot laws, regulations and directives. Our research suggests that in approximately three-quarters of the other sovereign bonds that contain this provision, the crucial words "in the place of payment" modify the phrase "laws, regulations and directives". The absence of this qualifying phrase in Cypriot bonds is thus both noticeable and arguably significant.

Sticking with the Cypriot MTNs for a moment, Condition 19(e) of the Notes states that:

"The waivers [of sovereign immunity for Republic property] and consents [to enforcement proceedings in foreign courts, including enforcement against Republic assets] ...do not apply to the Republic's title or possession of property ... necessary for the proper functioning of the Republic as a sovereign state."

This is a very unusual way to phrase a carve out from the waiver of immunity for sovereign property devoted to a public purpose. It is hard to imagine that an issuer

benefiting from such a carve out would not, in a litigation scenario, argue that all of its property held abroad was necessary for the proper functioning of the sovereign state and therefore immune from seizure by a disgruntled creditor.

While a close textual analysis of the sovereign's bond documentation may yield some potential litigation defences, such defences are obviously useful only in an enforcement proceeding commenced by a holdout creditor. The whole point of the exercise is to persuade creditors in advance not to stay out of the restructuring and litigate. A more generally applicable legal tool may be required for this purpose.

- We believe that the Eurozone has within its power a unique ability to deflate expectations on the part of prospective holdouts that they will realise a higher recovery by staying out of the sovereign restructuring. The goal of such a measure would be to affect the creditor calculus of whether to stay out of a Eurozone sovereign debt restructuring in the first place. Nothing can realistically be done to keep a holdout from obtaining a judgment in a foreign court on a foreign law-governed debt instrument. Attempting to unseat basic tenets of contract law in countries like the UK (most foreign law-governed Eurozone sovereign bonds choose English law) will meet fierce resistance. But the Eurozone governments could immunise from creditor attachment the assets of a Eurozone country (held within the Eurozone) if the country was engaged in an ESM-supported adjustment program.

The appropriate mechanism, we believe, would be an amendment to the 2012 Treaty Establishing the European Stability Mechanism (T/ESM). Something along these lines:

ARTICLE

Immunity from judicial process

1. The assets and revenue streams of an ESM Member receiving stability support under this Treaty which are held in, originate from,

or pass through the jurisdiction of an ESM Member shall not be subject to any form of attachment, garnishment, execution, injunctive relief, or similar forms of judicial process, in connection with a claim based on or arising out of a debt instrument that was eligible to participate in a restructuring of the debt of the beneficiary ESM Member after the effective date of this Treaty.

2. The immunities provided in the preceding paragraph shall automatically expire when all amounts due to the ESM from the beneficiary ESM Member have been repaid in full.

The objectives of such an amendment to the T/ESM would be:

- to ensure that the financial support being provided by the ESM to one of its members is not diverted to the repayment of an existing debt obligation of that member that was eligible to participate in a debt restructuring but declined to do so;
- to assist the beneficiary member state in any ESM-approved restructuring of its debt by deflating the expectations of prospective holdouts that they will be able to extract a preferential recovery through the pursuit of legal remedies after the restructuring closes; and
- to provide a safe harbour in the Eurozone for the recipient state to hold its assets and conduct its financial affairs without fear of harassment by holdout creditors.

An amendment of the T/ESM for this purpose would become effective within the jurisdiction of each of the Eurozone countries. The potency of the measure would obviously be enhanced if other EU members, particularly the UK, were to enact comparable immunities in their domestic law. A country such as the UK might for selfish reasons wish to incorporate such immunities into its own law; failure to do so could drive financial transactions away from London.

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The policy justification for such an amendment of the T/ESM is self-evident and compelling. The ESM member states will be pouring taxpayer resources into a recipient country. If a restructuring of private sector claims is deemed essential to restore that country to a sustainable position, the members funding that bailout should not wish to see the assets and revenue streams of the recipient sovereign being seized by creditors who elect not to participate in the restructuring. Every euro that is so seized and applied toward the immediate repayment of such a claim will logically require a corresponding one euro increase in the amount of ESM bailout assistance. To put the matter into the geographic terms used earlier in this paper, this would amount to a funds transfer from Stuttgart, Germany to Greenwich, Connecticut. The ESM members have a legitimate interest in minimising such transfers.

THE PRECEDENT

There is a precedent for just this sort of measure.

In May 2003, following the coalition invasion of Iraq to oust Saddam Hussein, the United Nations Security Council adopted Resolution 1483 (22 May 2003)⁶. Among other things, that Resolution encouraged the new government in Iraq to restructure the roughly \$140bn debt stock that Saddam had accumulated during his tenure. In the context of "the desirability of prompt completion of the restructuring of Iraq's debt", the Resolution immunised all petroleum assets of Iraq against "any form of attachment, garnishment, or execution", and clothed the proceeds of Iraqi oil sales (as well as the bank account into which the proceeds of all such oil sales were to be directed) with privileges and immunities identical to those enjoyed by the United Nations itself.

Resolution 1483 was enacted pursuant to Chapter VII of the Charter of the United Nations. It was therefore binding on all members of the organisation and the Resolution instructs each member state to "take any steps that may be necessary under their respective domestic legal systems to

assure this protection" of Iraqi oil and financial assets. These UNSC-mandated immunities were periodically renewed and eventually expired on 30 June 30 2011⁴. In Europe, the immunities for Iraqi assets were implemented through EU Regulation 1210/2003 (7 July 2003) and amended from time to time thereafter in response to UNSC Resolutions⁷.

It worked. In late 2004, Iraq negotiated an 80% nominal writeoff of its debt owed to Paris Club countries and a long-term restructuring of the balance of the claims. This translated into an 89.75% reduction in the net present value of those claims. That same NPV (net present value) haircut was then offered to the holders of roughly \$21bn of Saddam-era debt owed to private sector creditors and virtually all of those holders accepted it. The UNSC-mandated immunisation of Iraqi assets undoubtedly helped to dampen any hope that a better recovery could be achieved at the sharp end of a litigation.

BROADER IMPLICATIONS

An amendment of the T/ESM along the lines suggested above would, together with the other measures already taken within the Eurozone, substantially replicate the key features of most corporate insolvency regimes and would cover much of the ground that the IMF's proposed Sovereign Debt Restructuring Mechanism sought to address in 2002. Specifically:

- Supermajority creditor control of a future Eurozone sovereign debt workout will be effected through the use of the aggregated collective action clauses that the T/ESM mandates be included in all Eurozone sovereign bonds issued after 1 January 2013. Control of the workout process by a supermajority of affected creditors, and the ability to bind any dissident creditors to the will of that majority, is a fundamental feature of most insolvency regimes.
- Supervision of the workout process will in practice be the province of the Troika (the ECB, the IMF and the European Commission) in much the same way as they have been doing in the bailouts of Greece, Ireland and

Portugal. This supervision implicitly covers issues such as assessing whether a debt restructuring is required in the debtor country, whether the terms proposed in any such restructuring are proportional to that country's needs, whether the country is undertaking appropriate macroeconomic adjustment measures, and whether the burden of the adjustment is being shared equitably among all stakeholders (citizens, creditors and official sector sponsors).

- Although there will be no "automatic stay" preventing the initiation of creditor lawsuits against the sovereign debtor, the amendment to the T/ESM proposed above would effectively shield the debtor country's Eurozone-based assets from compulsory seizure by holdout creditors. ■

- 1 Of course, if the Eurozone members really believed this assurance, there would have been no need for them to mandate the inclusion of an aggregated collective action clause in every Eurozone sovereign bond issued after 1 January 2013. Those clauses serve only one function – to facilitate a future restructuring or amendment of the affected stocks.
- 2 The full statement was: "We will show that Europeans pay their debts." Upfront, at p 1, *International Financing Review* (10 December 2011)
- 3 See, for example, the spectacularly ill-timed and ill-titled IMF Staff Position Note, "Default in Today's Advanced Economies: Unnecessary, Undesirable and Unlikely" (1 September 2010) (available <http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf>). This paper was released ten months before Greece, largely at the insistence of the IMF, was told to restructure what remained of its private sector debt.
- 4 The place of payment will typically be a foreign location such as Luxembourg or London.
- 5 http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1483%282003%29
- 6 See http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1956%282010%29
- 7 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:169:0006:0023:En:PDF>