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ESM PANEL ON ENSURING DEBT SUSTAINABILITY IN THE EURO AREA – ANYTHING ELSE NEEDED?

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CONTEXT

The legal backdrop

- No insolvency/bankruptcy regime for sovereigns
- Leads to risk of holdout creditors, which can cause problems for
 - The sovereign – litigation and delays restoration of market access
 - The assenting creditors – the holdouts may recover more (inter creditor equity), payment flows on new instruments could be disrupted through litigation, debt relief provided may fail
 - The lenders of last resort, including ESM / IMF – because of impact on debt sustainability which could undermine resolution of basic problem and not want resources used to pay holdouts

THE LESSONS FROM ARGENTINA (2012 LITIGATION) AND GREECE (2012)

- **Argentina action brought by holdout creditors**
 - Successfully argued in NY courts that the *pari passu* provision requires rateable treatment and obtained injunctions
 - whilst the outcome will inevitably be affected by the precise drafting and the context the case highlighted the problems *pari passu* clauses could cause for: the debtor; assenting creditors; international payment systems; lenders of last resort and the official sector
- **Greece PSI**
 - Greek law governed bonds were the subject of the Greek Bondholder Act introducing a collective action mechanism across series of bonds
 - Foreign law governed bonds – some holdouts blocked voting at individual series level and rather than enter payment default, Greece paid holdouts in full

EURO AREA CACS

- Response within the euro area
 - 28 November 2010 Eurogroup Statement
 - Standardised collective action clauses with aggregation features in all debt securities issued by euro area member states (previously recommendation as to CACs applied to foreign law governed bonds only)
 - ESDM sub-committee and consultations
 - ESM Treaty and new clauses as from 1 January 2013
- Used in both foreign and domestic law issuances
- Aggregation achieved through votes
 - At each individual series level; AND
 - Aggregated level across all affected bonds
- Two limb approach in part a response to legal concerns over minority creditors cram down procedures under domestic law
- Relates to debt in the form of securities only
- Legacy stock

IMF PAPER – APRIL 2013

- Focused on recent developments in sovereign debt
- One workstream on contractual aggregation in sovereign bond field
- US Treasury staff group of experts. Two main outputs:
 - New *pari passu* clause disavowing rateable payment interpretation
 - New aggregated collective action clauses allowing bond voting mechanisms to operate across multiple series of bonds (to minimise holdout creditor problem). Includes option for modification of multiple series of bonds with one aggregated vote (single limb) subject to certain safeguards (Uniformly Applicable requirement)
- Does not apply to euro area sovereign issuances
- After consultation published in NY and English law form by ICMA (May 2015)

POINTS FOR FUTURE CONSIDERATION BY THE EURO AREA

- Euro area aggregated CACs represented a powerful innovation
- Similarly new ICMA aggregated CACs also represented a powerful innovation
- Announcement on 4 December 2018 to introduce single-limb collective action clauses by 2022 is a further important development. Issues to consider in this context include:
 - Minority creditor rights – perhaps further legal reform required in some member states
 - The voting thresholds
 - Any safeguards for single limb voting
 - Coupon stripping from sovereign bonds in the euro area
- Addressing *pari passu* provisions

SUMMARY TABLE OF KEY DIFFERENCES AS BETWEEN THE ICMA STANDARD AGGREGATED CACS AND THE EURO AREA MODEL CAC

	Existing euro area model CAC	ICMA Standard CACs (2014/15)	Comments
Voting thresholds	Some set by reference to those voting at quorate meeting	Set by reference to outstanding bonds	Can make a big difference
Single limb aggregation/Cross Series Modification – Single Tier Voting	None	Included in 2014 subject to the Uniformly Applicable condition being met and the information covenant.	
Disenfranchisement for voting	Bonds held by the Issuer are excluded from voting (paragraph 2.7(c)).	Notes controlled by the Issuer are excluded from voting (Para (i) on page 9 onwards).	The concepts used are different and the practical effect is that the test for exclusion is narrower for euro area model CAC.
Information covenant	No requirement.	The Issuer is required to make relevant economic and financial information available as well as information on how debt of other groups is to be treated (paragraph (f) on page 8). This was introduced together with the introduction of single limb aggregation as a creditor safeguard. The IMF legal department and Paris Club Secretariat commented and agreed to the text and there were several reiterations before they signed off on the scope.	Some of the information should be available through EUROSTAT. The expectation in practice is that most other information required under the ICMA clause would be provided by a euro area issuer seeking to vary bond terms.

¹¹ Creditors agreed to the inclusion of the single limb aggregation mechanism (as well as the inclusion of the two limb aggregation mechanism introduced in both the euro area model CAC and the 2014 ICMA Aggregated CACs for the first time) because of the inclusion of the Uniformly Applicable Condition and the Information Covenant as well as the voting threshold for the single limb aggregation mechanism being set at 75% of outstanding.

SUMMARY TABLE OF KEY DIFFERENCES AS BETWEEN THE ICMA STANDARD AGGREGATED CACS AND THE EURO AREA MODEL CAC (CONTINUED)

Obligations in multiple currencies; zero-coupon and index-linked obligations	Technical issues relating to the appropriate face amount for voting purposes and coupon stripping are dealt with in paragraph 2.6.	No corresponding detailed provisions. Paragraph (9) on page 9 allows methodology to be adopted for calculation of par value.	In the euro area, some issuers routinely issue bonds of this type and coupon stripping does occur. In the Emerging Market context this has less relevance.
Aggregation Safeguard	Alternatives are permitted if all holders may accept each of them (paragraph 2.3).	Uniformly Applicable test (paragraph (v) on page 5).	The Uniformly Applicable requirement provides more assurance of a comparable deal being offered to holders of different instruments.
Sub Aggregation Permitted	Partial aggregation is permitted if the possibility is identified at the outset in paragraph 2.4 (a).	Paragraph (vii) on page 5 allows aggregation to occur by reference to some series only at the Issuer's discretion.	In the euro area context partial aggregation was contemplated because the individual series threshold of two limb aggregation may not be met. The ICMA clause provides more flexibility to the Issuer.

IMPLEMENTATION

- Objective for introduction of enhanced euro area model CAC to be market neutral event
- Legacy bonds
- Debt in the form of debt securities only (e.g. do risks reside in loans with *pari passu* clauses)
- Sovereign debtors only or also SOEs and sub-sovereigns (Provinces / Regions)
- The use of a trustee / legal representative (generally only the trustee / representative can sue and proceeds are shared)
- Creditor engagement – how encourage, ad hoc approach, contractual entrenchment of a provision encouraging formation of a committee, supporting policies at level of ESM

When should CACs be used?

- Pre and post-default
- Refinancing
- Restructuring

But also other tools

- Debt buy backs
- Liability management

DEBT TRANSPARENCY

- Through EUROSTAT reporting euro area member states are subjected to high levels of transparency by international standards
- There are official sector initiatives in this field, e.g.
 - G20 efforts to improve transparency in public sector borrowing
- Development of IIF Principles for Debt Transparency – private sector initiative
 - Promote disclosure by providers of finance
 - Generally not a problem in public bond markets
 - Focus on loans and other types of debt
 - Sovereign and all public sector users of finance
 - Work ongoing, client confidentiality needs to be waived

SOME FRAGMENTATION - LEGISLATIVE MEASURES

- All aimed at limiting conduct of holdout creditors but legislation different
- United Kingdom
 - Debt Relief (Developing Countries) Act 2010
 - Made permanent in 2011
 - Only applies to old debt (pre 2004) owed by HIPC countries
 - Recoveries through the UK courts are limited to that payable to other creditors under the HIPC Initiative for the applicable country
 - Safeguard – country must have offered to settle on HIPC terms
- Belgium
 - 12 July 2015 Law on combating the activities of Vulture Funds
 - Applies to all debtor countries
 - Applies where a creditor pursues an illegitimate advantage by the purchase of a State's debt obligation
 - Recovery limited to the price paid
 - Test of illegitimate advantage

LEGISLATIVE MEASURES (CONTINUED)

- France

- 9 November 2016, Law on Transparency, Anti-corruption and Modernisation of Economic Life (Loi Sapin 2)
- Article 60 sets out a regime specific to vulture funds
- Following the introduction of the Loi Sapin 2 no interim measures and no enforcement action against property belonging to a foreign State can be authorised by a French judge if:
 - The foreign State was receiving aid from the Development Assistance Committee of the OECD when it issued the debt document
 - The holder of the debt obligation acquired that security when the foreign State was in default on that debt obligation or proposed a change in the terms of the debt obligation
 - The default status on the debt obligation is less than 48 months at the time the holder of the debt obligation seeks a court order authorising him to enforcement
- Note focus on limiting enforcement measures
- Only applies to debt acquired after 9 September 2016

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