

How collective action is changing sovereign debt

With Uruguay waiting to see if its innovative exchange offer will be accepted by investors, **Anna Gelpern** at the Council on Foreign Relations in Washington DC looks at the new approaches to sovereign debt restructuring and argues that the use of controversial collective action clauses is coming of age

Mexico is once again taking the lead on sovereign debt in emerging economies. Its financial crises in 1982 and 1994 threw the world's markets into turmoil and sparked debate on what became the International Financial Architecture. By issuing the first Brady Bond in 1990, Mexico led the way out of the first wave of crises. And so it seems fitting that the definitive statement in the latest sovereign debt debate would also come from Mexico, and that the statement would come as Mexico gets ready to retire the last of its Bradies.

With a \$1 billion issue in February and two more in April, Mexico became the first emerging market government to place New York-law, SEC-registered debt with so-called collective action clauses (CACs). The clauses are designed to help the borrower and its creditors come to agreement if a restructuring becomes necessary. They have been at the epicenter of the financial architecture discussions since 1995 and, most recently, became the counterpoint to the IMF's proposals to establish a statutory sovereign bankruptcy regime. Whatever one's views on the particulars of Mexico's contracts, the country doubtless did the markets a service by taking the reform initiative beyond the academic-policy domain.

How to leverage this initiative is a key question for market participants – issuers, underwriters and investors. Will CACs prove to be a viable alternative to the IMF's statutory approach? Will Mexico's clauses become the new standard or one of many models? Will weaker economies be able to follow Mexico's lead? And what does recent progress on CACs mean for the policy agenda in battling financial crises?

The sovereign bankruptcy debate

Following the Brady securitizations, the composition of capital flows into emerging markets shifted dramatically from bank loans to tradable securities. It was generally accepted that, in the event of another debt crisis, securities would be harder to restructure because bondholders were harder to coordinate. Anonymous, dispersed and lacking commercial banks' many ties to the country, bondholders were expected to dump the paper, rush to the courthouse or at least hold up restructuring in the hope of securing preferential treatment. New York law



bonds, which by convention could not be amended without the agreement of every single holder, were thought to be particularly vulnerable.

Although Mexico's 1994 crisis originated with domestic law bonds (*tesobonos*) not affected by the New York practice, it spurred intense policy focus on bond contracts as a way to overcome collective action problems. Three types of provisions were mooted in the mid-1990s: majority action, sharing and collective representation (see IFLR July, August and September 1998). The majority action clause would allow a qualified majority of bondholders to amend financial terms over the objection of holdouts. It was already commonplace in English law paper, though not in New York. The sharing clause, drawn from syndicated loan precedent, would deter maverick suits by requiring distribution of litigation proceeds to all holders. The collective representation clause would offer ways for holders to organize and represent themselves in a restructuring, whether through trustees, agents or committees. It later morphed into the engagement clause, which would guide the issuer's engagement with its creditors.

Aggregation: an example based on Uruguay's offer

An issuer has 10 series of bonds outstanding, each in the aggregate principal amount of \$100 million. If the issuer elects to amend all of them using aggregation, it would have to secure the agreement of holders representing \$850 million in aggregate principal outstanding among all bonds, assuming none are held by the issuer or its instrumentalities. In addition, for each bond, holders representing just under \$67 million in aggregate principal outstanding would have to vote in favour of the amendment.

If all holders of bond series one to nine vote in favour, but holders representing \$34 million in aggregate principal of bond series 10 vote against, bond 10 drops out of the transaction – the amendment has no effect with respect to that bond. Because, together with the amendment's supporters in Bond 10, bonds one to nine represent more than \$850 million, the amendment takes effect with respect to the nine bonds. If the full \$100 million of each consenting bond votes in favour, while the dissenting bonds drop out with a blocking vote of \$34 million, it would take five or more dissenting bonds to defeat the amendment for all series.

What if the issuer proposes amendment terms that favour bonds one to nine, but penalize bond 10? Without aggregation, a holder or group of holders representing \$26 million in aggregate principal of bond 10 has a blocking position. With aggregation, that holder needs a position closer to \$34 million to take bond 10 out of the deal. To stop the entire deal, it needs more than \$150 million in affected bonds. If all the bonds trade at 20 cents on the dollar, the required investment is \$30 million to block the aggregated deal, just under \$7 million to opt out and just over \$5 million to block the amendment of bond 10.

That said, it is extremely unlikely that two-thirds of bond 10 holders would vote in favour of a discriminatory amendment that allows bonds one to nine to gang up on 10.

Collective action clauses gained remarkable prominence in the global financial reform agenda, featuring in countless G-7 finance ministers' statements alongside traditional subjects like currency regimes and strengthening financial systems. The *Financial Times* and *The Economist* editorialized in their support. But investors and issuers alike remained reluctant to adopt them. Investors claimed that clauses making restructuring more orderly would also make it easier and hence more likely. They threatened to charge a premium for New York-law debt with clauses. Issuers refused to pay it, claiming they would never default. Few heeded economists' research suggesting no across-the-board price penalty for English-law debt with clauses.

The landscape changed dramatically in late 2001, when Anne Krueger, the IMF's new deputy-head, proposed the Sovereign Debt Restructuring Mechanism (SDRM), an international law device based on elements of domestic bankruptcy. The proposal included many of the same features as CACs, such as majority action and collective representation, along with a dispute resolution forum. It would be implemented by amending the IMF charter, enacting sovereign bankruptcy into the domestic laws of member states. More comprehensive and

intrusive than CACs, the proposal drew vigorous criticism from the markets. However, the SDRM got some of its credibility from the fact that CACs had not caught on despite six years of official, academic and editorial exhortation.

It would be wrong to suggest that the SDRM's traction came entirely from the apparent failure of the CAC campaign. Even as it was watered down in response to market opposition, the SDRM retained two key features that were difficult if not impossible to replicate by contract. First, it could operate on instruments issued before its creation. CACs only apply to new issues. Countries with 30-year CAC-less Bradies would arguably get little benefit from the innovation in a comprehensive restructuring. However, these long maturities are the exception. New medium-term issues, buybacks and exchanges make for reasonably frequent turnover in sovereign debt stock. Last summer, the IMF concluded that if countries had started issuing with CACs after the G-10 first endorsed them in 1996, within five years about 70% of all international sovereign bonds would have had the clauses.

Secondly, the SDRM could coordinate a restructuring across different instruments, aggregating them for comprehensive, equitable treatment on the domestic bankruptcy model. CACs coordinate creditors under one agreement. These creditors could affect the treatment of other instruments only by conditioning their concessions on those of others. Aggregation by contract might be feasible where multiple series of securities are issued under one master document, for example, as in medium-term note programmes. Such a document could establish procedures for coordination across series, including blended voting requirements. Wholesale debt exchanges, such as the ones expected in Uruguay and Argentina, can also help bring disparate instruments under the umbrella of one fiscal agency agreement, trust indenture or trust deed. Uruguay is the first to test the waters with an aggregation clause in its April 10 exchange offer.

It is hard to envision a contractual solution that could fully replicate a bankruptcy regime. In addition to addressing retroactivity and aggregation, a statutory regime could help stem litigation and promote inter-creditor equity, transparency and good-faith dealing by all parties. But the ability of the SDRM to deliver these benefits is proportionate to the autonomy debtors and creditors are willing to cede to an outside authority – be it the IMF or the creditor collective. The more a statutory regime comes to depend on agreement among the parties, the easier it is to replicate through contract.

Clause models

Ironically, before it died at the IMF meetings last month, the SDRM breathed life into the flagging CAC initiative. While maintaining that the two approaches were complementary, in spring 2002 the US Treasury took up the CAC mission with unprecedented vigour. Last autumn, a US-led G-10 working group circulated model clauses prepared by specialists from large financial jurisdictions (www.imf.org/external/np/g10/2002/cc.htm). An intense outreach campaign aimed at issuers, underwriters and end investors had the effect of positioning CACs as an alternative to the SDRM. To the markets, they suddenly looked a lot more attractive by comparison.

Mexico's February issue took markets by surprise because, months earlier, its financial spokesmen publicly all but foreclosed the possibility of adopting CACs. Its decision to go forward makes sense against the background of two developments. First, the SDRM proposal was scheduled for discussion at the IMF's spring meetings in April. A credible issuer could take away a justification for the SDRM and take some credit for its demise by showing the contractual approach was viable. Secondly, seven financial industry associations made public in early February their comprehensive proposal for contract modification and a code of conduct for sovereign debt restructuring (www.emta.org/ndevlop/Final_merged.pdf).

This industry initiative was significant in that it brought together buy-side investors and the sell side, engaged the official sector and presented a well-articulated worldview on sovereign restructuring. This made change more likely. Moreover, while earlier initiatives were about creditor coordination, the regime proposed by the industry groups focused on protecting enforcement rights and guarding against debtor mischief. A top-notch credit like Mexico could preempt the emergence of unfavourable market standards by issuing on its own terms.

Mexico's innovation was relatively surgical (see Table 1). Of all the CACs, it used only the majority action provisions. Its 75% threshold for amendment of key terms (called reserve matters) falls between the industry's effective 90% and the present English-law practice. Both Mexico and the industry groups apply the threshold to aggregate principal amounts outstanding. English-law bonds usually count votes cast at a meeting, where typically 75% of a quorum may amend key terms. The quorum can range from 75% to as low as 25% of principal outstanding at a postponed meeting. In theory this permits amendment by less than 20%.

Mexico, the G-10 and the industry models disenfranchise instruments directly or indirectly controlled by the government and its instrumentalities. These are not considered "outstanding" for voting purposes. Though disenfranchisement provisions had been used before, the new models tend to exclude more votes than past practice. Some in the industry had proposed going even further to exclude the debt held by regulated institutions, such as domestic banks and pension funds. This could disenfranchise large portions of Argentina's, Turkey's and Lebanon's debt stock, to name a few, and yield control of restructuring terms to a minority of creditors.

In response to the industry groups, Mexico elevated governing law, jurisdiction and waiver of immunity to reserve matters. Adding reserve matters can complicate the use of exit consents in a debt exchange. Common in corporate reorganizations and used in Ecuador's 1998 Brady restructuring, exit consents take advantage of lower amendment requirements for non-reserve matters to make the old paper unattractive and encourage participation in the exchange. A holder accepting the new instrument may vote to amend the old one to emasculate covenants, events of default or enforcement provisions.

Beyond Mexico

Despite some investor complaints, Mexico's February issue was oversubscribed and priced generally in line with its yield curve.

Traders described the use of CACs in Mexico's April issues, a total of \$2.5 billion, as a "non-event". Yet many also pointed to Mexico's stellar economic performance and prospects, and to the importance of crossover accounts among its investors. This could mean that investors see CACs as irrelevant where they do not expect them to be deployed in the near future. Crossover investors, unlike dedicated emerging markets funds, are also less steeped in the sovereign bankruptcy debate.

A weaker economy marketing to dedicated investors might be a better test case for CACs' viability. Market segmentation might result if such an issuer could not sell debt with CACs, had to pay a price premium or used clauses more favourable to the creditors. Paradoxically, countries unlikely to restructure would have the most flexible contracts; those expected to do so would be the most constrained.

In a restructuring that is inevitable and disorderly, creditors suffer as the value of their holdings plummets to near-nothing on uncertainty, rumour and delay. Those that agree to debt reduction might also subsidize holdouts collecting in full. CACs can help mitigate these problems

This is why so many eyes are glued on Uruguay's \$3.7 billion SEC-registered exchange offer, which closes in mid-May. Shaken by Argentina's troubles and a succession of banking crises, Uruguay is attempting a preemptive restructuring to avoid default. It is hard to imagine investors ignoring the CACs in this case, even if they might have done so in Mexico.

Considering Uruguay's distressed circumstances – its heavy debt burden relative to the size of its economy – the offer's financial terms are rather moderate. It would bring medium-term maturity extensions for most bonds, with no principal or coupon reduction. The legal terms of the new bonds would build on Mexican precedent but go beyond it. Uruguay adopts Mexico's approach to majority action, but adds a few safeguards for the creditors: a limit on future exit consents to amend reserve matters, a bar on issuing new debt to dilute a restructuring vote and tighter non-reserve amendment rules (see Table 1). If its existing bonds had these features, Uruguay would have a harder time securing the exit consents it is soliciting in this exchange. Of course, its need to resort to exit consents might be limited with the adoption of CACs.

Consistent with the G-10 model, Uruguay would issue the new bonds under a trust indenture. The trust structure has been used in English-law issues and in exempt US issues, including Uruguay's until 1997. It can help deter litigation by barring individual holder suits and requiring that recoveries be shared among all holders. Uruguay also introduces disclosure provisions in response to the G-10 and industry group proposals, addressing the issuer's financial condition, IMF programmes, Paris Club agreements and restructuring arrangements with other creditors.

Table 1: New approaches

	G-10	Industry	Mexico February and April 2003	Uruguay April 2003
Reserve matter amendments	Over 75% of outstanding principal; except over 66⅔% required to alter trustee enforcement powers and over 66⅔% of quorum to appoint holder representatives (New York law)	85% of outstanding principal, provided 10% of outstanding principal do not object, and except 100% required to change governing law, jurisdiction, waiver of immunity	75% of outstanding principal	75% of outstanding principal
Other amendments	Over 66⅔% of outstanding principal in writing or over 66⅔% of quorum at a meeting	75% of outstanding principal (New York law); 75% of quorum at a meeting (English law)	66⅔% of outstanding principal in writing or 66⅔% of quorum at a meeting	66⅔% of outstanding principal
Quorum	Over 50% of outstanding principal	75% of outstanding principal (New York law); two persons representing over 50% of outstanding principal or any amount if meeting is adjourned; raised to 85% for reserve matters (English law)	50% of outstanding principal; 25% if meeting is adjourned; raised to 75% for reserve matters	50% of outstanding principal; 25% if meeting is adjourned twice
Aggregation	Recommended for further consideration in the report; no model language	No	No	At issuer's discretion, with 85% of outstanding principal of all affected series and 66⅔% of outstanding principal of each affected series
Debt ineligible to vote	If known by the trustee to be owned or controlled, directly or indirectly, by the issuer or any public sector instrumentality	If owned or controlled, directly or indirectly, by the issuer or any public sector instrumentality	If known by the fiscal agent to be owned, directly or indirectly, by the issuer or any public sector instrumentality (entity where the issuer has ownership or effective management control)	If certified by the issuer to the trustee as owned, directly or indirectly, by the issuer or any public sector instrumentality (entity where the issuer has ownership or effective management control)
Other amendment restrictions	No	No	No	Issuer to ensure that reserve matters amended in conjunction with a debt exchange (using exit consents) are not less favourable to the holder of the old instruments than corresponding provisions of the new instruments; issuer barred from deliberately issuing new securities to holders expected to support its amendment request (diluting existing holders)
Reserve matter definition	Financial terms, voting provisions, debt exchange authorization, enforcement powers of the trustee, appointment of holder representatives	Financial terms, voting provisions, status/ <i>pari passu</i> , governing law, jurisdiction, waiver of immunity, events of default, negative pledge	Financial terms, voting provisions, status/ <i>pari passu</i> , governing law, jurisdiction, waiver of immunity, events of default if amended in connection with an exchange offer	Financial terms, voting provisions, status/ <i>pari passu</i> , governing law, jurisdiction, waiver of immunity, debt exchange authorization
Collective representation/engagement	Trustee or bondholder representative for the life of the bond; appointment of bondholder representative to engage in restructuring talks with the issuer	Fiscal agent (New York law); trustee or fiscal agent (English law). In the event of default or restructuring, over 50% of outstanding principal may appoint a committee, provided 25% of outstanding principal do not object; issuer pays committee expenses	Fiscal agent	Trustee
Additional disclosure	In the event of default or restructuring: regular reporting on economic and financial condition, proposed treatment of other creditors, IMF programme and other as requested by the trustee or at the direction of 10% of outstanding principal	For as long as the debt is outstanding: compliance with IMF special data dissemination standard (SDDS) (including non-mandatory matters), quarterly rolling 12-month forecasts, arrangements with other creditors, IMF programme and other as requested by the trustee or fiscal agent at the direction of 5% of outstanding principal	No new provisions added for this issue; Mexico subscribes to SDDS	Before seeking reserve matter modification: economic and financial rationale for the modification request, proposed treatment of other creditors, IMF programme

Aggregation or blended voting provisions are Uruguay's most interesting innovation (see box). The goal is to facilitate orderly comprehensive debt treatment while respecting inter-creditor equity. Uruguay could elect to use these provisions to amend multiple bond series in one vote with the support of 85% of the aggregate principal amount outstanding of all affected series (subject to disenfranchisement on the Mexico model) and two-thirds of each individual series. If a series falls short of the two-thirds threshold, it drops out of the aggregated deal. The amendment would hold with respect to the other participating series, provided the 85% threshold is met. Even though this threshold is higher than the 75% needed to amend a single instrument, blocking an aggregated restructuring would probably require a larger investment (15% or more of all affected series) than one needed to block amendment of a single series (25% or more of that series) without aggregation.

Investors with principled concerns about the proposed terms might want to stop the entire deal. Hold outs that want to extract preferential treatment would focus on blocking one issue in hope that others would go into the restructuring. With aggregation, a single series can be restructured despite the objection of 25% or more; over one-third of the vote is needed to opt out. A series that opts out of aggregation could still be restructured individually with 75% approval.

If Uruguay succeeds, we may never know whether it paid a price penalty for using CACs. In this exchange to avoid default, the financial terms are established in advance to secure needed debt reprofiling, not to market legal innovation. Participation is the only variable, with a minimum of 80% required for the deal to proceed at Uruguay's discretion.

The way forward

It has been argued that making default unspeakably horrible was a necessary counterpart to the challenge of collecting from a sovereign government, most of whose assets are inaccessible to creditors. In that sense, most of today's sovereign bond

contracts are children of the Brady bonds, bruised with recent default and laced with never-agains. Yet Ecuador's Brady exchange in 1998 showed that there are ways around these promises. In a restructuring that is inevitable and disorderly, creditors suffer as the value of their holdings plummets to near-nothing on uncertainty, rumour and delay. Those that agree to debt reduction might also subsidize holdouts collecting in full. CACs can help mitigate these problems.

It is far from clear which if any of the recent CAC models will become market standard. Moreover, the English-law convention is still going strong: most of Russia's external debt, wildly popular with US and European investors, is governed by English law. Just last month, Pemex issued €750 million (\$808 million) in English-law bonds with CACs for the first time since 1997.

The recent issues by Mexico and Uruguay mark the coming of age of the CAC debate and, together with the work of the industry groups, the shifting of reform initiative to market participants. Academics and policy makers helped change the sovereign debt world by focusing attention on risks from contracts that few in the markets had read before 1995. After the G-10 initially endorsed CACs in 1996, it is only fitting that they would sponsor last year's model documents.

Yet even if Uruguay succeeds, it would be premature to declare victory over sovereign debt crises. New York-law bonds are hardly the only, or even the biggest, barrier between emerging market countries and financial stability. Wobbly financial systems, over-leveraged corporate sectors, unsustainable currency regimes and heavy burdens of short-term domestic-law debts have contributed to crises the world over. If others follow their lead, Mexico and Uruguay will have helped move the policy focus on to these and other pressing challenges. ■

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