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STRENGTHENING THE CONTRACTUAL FRAMEWORK TO ADDRESS COLLECTIVE ACTION PROBLEMS IN SOVEREIGN DEBT RESTRUCTURING

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- The **Staff Report** on *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*, prepared by IMF staff and completed on September 2, 2014 for the Executive Board's consideration on October 1, 2014.
- A **Press Release** summarizing the views of the Executive Board as expressed during its October 1, 2014 consideration of the staff report.

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STRENGTHENING THE CONTRACTUAL FRAMEWORK TO ADDRESS COLLECTIVE ACTION PROBLEMS IN SOVEREIGN DEBT RESTRUCTURING

September 2, 2014

EXECUTIVE SUMMARY

Introduction. This paper identifies contractual reforms designed to address collective action problems in sovereign debt restructuring. Since any decisions regarding the design of contractual provisions will need to be made by the sovereign issuer and its creditors, it is recognized that the Fund's primary role will be to facilitate agreement on the design and use of these provisions.

Scope of Debt. Consistent with the approach utilized in the past, it is recommended that the Fund focus on bonds governed by foreign law. While it may be helpful for bonds governed by domestic law to also include the reforms identified in the paper, the collective action problems that these reforms are designed to address are more acute in bonds governed by foreign law, given the greater legal leverage possessed by holdouts under such bonds.

Modifying the *Pari Passu* Clause. The recent litigation involving Argentina has generated significant concerns regarding the impact that the New York court decisions may have on the overall restructuring process. In light of these concerns, there has been considerable progress in both the design and use of a modified *pari passu* clause that explicitly excludes the obligation to pay creditors on a ratable basis. It is recommended that the Fund support the widespread use of such a modified *pari passu* clause in international sovereign bonds.

Strengthening Collective Action Clauses. Over the past eighteen months, staff has worked closely with issuers and market participants on the design of collective action clauses (CACs) that include a more robust "aggregation" feature designed to limit the ability of holdouts to neutralize the operation of traditional CACs, which operate on a series-by-series basis. Broad support has emerged for CACs to include a "single limb" voting procedure that will enable bonds to be restructured on the basis of a single vote across all affected instruments, subject to safeguards designed to ensure inter-creditor equity and minimize the risk of sovereign manipulation. To allow for flexibility, there is also support for these CACs to include a menu of alternative voting procedures (including a "two limb" voting procedure) that will enable the sovereign and its creditors to agree upon the terms of a restructuring that differentiates among creditors.

Promoting Contract Reform and Navigating the Transition. In light of the above progress, the Fund should play an active role in promoting the use of these modified

provisions. With respect to the outstanding stock of international sovereign bonds (a significant portion of which will only mature after 10 years), there is currently little appetite among issuers to accelerate the turn-over of such bonds through liability management operations. This attitude may change, however, if the potential systemic risks posed by the Argentine litigation begin to materialize. Accordingly, it will be important for the Fund to periodically review developments in this area.

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CONTENTS

INTRODUCTION	4
MODIFYING THE <i>PARI PASSU</i> CLAUSE	7
STRENGTHENING COLLECTIVE ACTION CLAUSES	15
A. Overview of Collective Action Clauses	15
B. Introducing the Option of a “Single Limb” Voting Procedure	20
C. Designing a Single CAC with a Menu of Voting Procedures	22
D. Other Design Issues	24
E. Legal Enforceability	28
F. Staff Assessment	30
PROMOTING CONTRACT REFORM AND NAVIGATING THE TRANSITION	32
ISSUES FOR DISCUSSION	36
BOXES	
1. Argentine Litigation in the U.S.	8
2. History and Experience of Collective Action Clauses	17
3. Disenfranchisement Provisions	27
4. Legal Enforceability of Single-limb Aggregation under New York and English Laws	29
FIGURES	
1. CAC with Menu of Voting Procedures	23
2. World: International Sovereign Bonds: Debt Redemption Profiles	33
3. Maturities of Outstanding International Sovereign Bonds	34
ANNEX	
I. Recent History of Pari Passu Clauses in New York Law-Governed Sovereign Debt	37

INTRODUCTION

1. As a follow-up to the Executive Board’s May 2013 discussion, this paper examines potential areas of reform in the contractual framework to address collective action problems in sovereign debt restructuring.¹ While it is in the interest of sovereign debtors, creditors and the system more generally for debt to be repaid under the original terms, there may be circumstances where it is recognized by a sovereign and its creditors that an orderly restructuring is necessary. During the May 2013 discussions, Directors observed that while the contractual, market-based approach has worked reasonably well in securing creditor participation and avoiding protracted negotiations in recent sovereign debt restructuring, it could become less effective in dealing with collective action problems, especially in pre-default cases. In addressing holdout problems, they supported the view that consideration could be given to a more robust form of aggregation clause. In taking the work forward, Directors encouraged staff to pay due regard to creditor rights, inter-creditor equity issues, and other unintended adverse consequences, and highlighted the need for appropriate flexibility to accommodate country-specific aspects.

2. Recent developments in the Argentine litigation in the United States courts underscore the importance of further strengthening the existing contractual framework to more effectively address collective action problems. In June 2014, the U.S. Supreme Court declined to hear Argentina’s appeal of the New York federal courts’ decisions (“the New York Court Decisions”)² which found Argentina in breach of the *pari passu* clause in its defaulted bonds, and then prohibited Argentina from making payments to the creditors holding restructured bonds unless holdout creditors were paid in full. As has been discussed in earlier staff papers—and as will be elaborated below—the New York Court Decisions may exacerbate collective action problems and, accordingly, make the sovereign debt restructuring process more complicated.³

3. To limit the impact of these decisions, there is a growing consensus within the official sector and among market participants regarding the merits of modifying the *pari passu* clause in international sovereign bonds. The clause would be changed in a manner that ensures that the type of remedy provided to holdout creditors in the case of Argentina would not be replicated in future cases.

4. In addition, there have been ongoing discussions regarding the benefits of designing a more robust form of collective action clauses (CACs) than those currently included in

¹ See [The Chairman’s Summing Up—Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework](#).

² See *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012) and *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230 (2d Cir. 2013).

³ See [Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework](#) (the “April 2013 Board Paper”) and [The Fund’s Lending Framework and Sovereign Debt—Preliminary Considerations](#) (the “May 2014 Board Paper”).

international sovereign bonds to more effectively address collective action problems. As discussed in the April 2013 Board Paper, the problem arising from holdout issuances was highlighted in the recent case of the Greek debt exchange. Of the 36 bond issuances governed by English law that were eligible to participate in the debt exchange, and which contained CACs, only 17 were successfully restructured using the CACs. The operation of the CACs in the remaining bond issues was effectively neutralized by holdout creditors, resulting in unstructured claims of about Euro 6.5 billion, accounting for 30 percent of the total value of debt governed by foreign law. The New York Court Decisions have given this problem even greater importance as they risk giving holdout creditors a more powerful enforcement tool to extract preferential terms, which in turn may increase the incentive to hold out.

5. In considering the approach that the Fund should take in support of strengthening the contractual framework in this area, it is useful to draw on the Fund’s successful experience in contributing to the introduction of CACs in international sovereign bonds during the early 2000s.⁴ Working closely with the other members of the official sector and market participants during this period, the Fund contributed to the successful international effort to encourage the introduction of CACs in a number of jurisdictions where they had not previously existed, including bonds governed by New York law, which represented—and continue to represent—the largest portion of the outstanding value of international sovereign bonds.

6. Taking into account this experience, the staff is of the view that the Fund’s approach should continue to be guided by the following considerations.

- **First, since the proposed reforms would be implemented through contract, it should be recognized that any decision regarding their design and use will ultimately be made by the sovereign issuer and its creditors.** The Fund cannot mandate the inclusion of such clauses in international sovereign bonds, nor determine their design. However, the Fund can play an active role in (a) facilitating agreement among sovereign issuers and market participants regarding the design of the proposed clauses, and (b) encouraging incorporation of these clauses into new issuances.⁵ To the extent that the Board supports the incorporation of the key features of the contractual clauses identified in this paper, the modalities that the staff would use to promote such incorporation are set forth in Section IV of this paper.
- **Second, consistent with the Fund’s approach with respect to the design of CACs in the past, the Fund will focus on international sovereign bonds.**⁶ As in the past, the term “international sovereign bonds” is used in the following sense: (i) a bond is “sovereign” if it is issued or guaranteed by a government or a central bank; (ii) a bond is considered “international”

⁴ See [The Design and Effectiveness of Collective Action Clauses; Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use](#); and [Collective Action Clauses – Recent Developments and Issues](#).

⁵ The IMF-World Bank Revised Guidelines for Public Debt Management recommend the inclusion of CACs in international sovereign bonds, as defined herein. See [Revised Guidelines for Public Debt Management](#), paragraph 46.

⁶ See footnote 4, above.

if it is governed by a law other than the law of the issuer or gives a foreign court jurisdiction over any claims that may arise under the bond;⁷ and (iii) “bonds” are freely traded debt instruments with fixed maturities, normally in excess of one year. The focus on bonds governed by a law other than that of the sovereign has been motivated by a recognition that, with respect to bonds governed by domestic law, the legal leverage possessed by holdout creditors is more limited given the capacity of the sovereign debtor to modify its domestic law. This approach does not necessarily mean that the Fund would support a retroactive modification of domestic law governed contracts through legislation (as was done in the case of Greece in 2012). Indeed, the inclusion of modified contractual provisions in domestic law governed bonds may, depending on the circumstances, limit the need for such legislation. Rather, the focus on foreign-law governed bonds simply reflects the fact that holdout creditors possess greater legal leverage in that context.

- **Third, the Fund has traditionally focused on those jurisdictions under the laws of which international sovereign bonds are most commonly issued.** For the purposes of this paper, staff has focused on the market acceptability and legal enforceability of the proposed contractual provisions in international sovereign bonds governed by the laws of New York and England, which are estimated to represent approximately 48 percent and 40 percent of the notional amount of the outstanding stock of international sovereign bonds, respectively.⁸
- **Finally, while it is appropriate for the Fund to promote the key design elements of contractual provisions, it should be recognized that specific features may vary across jurisdictions.** These variations may arise either because of legal requirements or because of a longstanding practice designed to ensure market acceptability in that jurisdiction. These differences should be accommodated to the extent that they do not significantly undermine the provisions’ ability to achieve their objectives.

7. Taking into account the above considerations, Fund staff has consulted closely over the past eighteen months with a broad range of stakeholders on the possible direction of reform, including: (a) the authorities of the key jurisdictions where international sovereign bonds are most commonly issued—in particular, the U.S. and U.K. authorities; (b) market participants; (c) sovereign issuers; and (d) legal experts from relevant jurisdictions. At the outset, a primary avenue for consultation was through a working group convened by U.S. Treasury staff consisting of a diverse group of representatives from the official sector (including Fund staff), legal experts, market

⁷ For purposes of this paper, when a bond is described as being “governed by” the laws of a country, it means that the terms of the bond include a provision that specifically provides that the laws of that country will apply. Whether, in fact, a court will give effect to such a choice of law will depend on the private international law rules of the country where the court is located.

⁸ There is no single or complete source for data on outstanding international sovereign bonds and their breakdown as to jurisdiction of issuance. To estimate the total amount of international sovereign bonds outstanding and the amounts outstanding in key jurisdictions, staff has relied on the Bloomberg and Dealogic databases, which may be subject to inaccuracies. In addition to England and New York, other key jurisdictions in which international sovereign bonds are issued include Japan, Germany, and Switzerland.

participants and sovereign issuers. As more specific options for reform were identified, this avenue led to discussions with the International Capital Markets Association (ICMA), a trade association representing debt capital markets participants that has traditionally taken a leading role in the development of model contractual clauses for international sovereign bonds. ICMA has recently published new model contractual clauses that broadly take into account the conclusions reached during this consultation process (“ICMA Model Clauses”).⁹ Finally, staff has also had direct dialogue with issuers and market participants regarding contractual reform in this area, including through the Fund’s annual public debt management forum.

8. The remainder of the paper is structured as follows. Section II identifies modifications to the *pari passu* clause that would limit the impact of the New York Court Decisions. Section III presents an overview of existing CACs and their strengths and limitations in addressing collective action problems, and identifies reforms that would address these limitations. Section IV discusses possible ways to promote the inclusion of the proposed provisions in international sovereign bonds and to address the outstanding stock issue. Section V summarizes issues for Directors’ consideration.

MODIFYING THE *PARI PASSU* CLAUSE

9. As a result of a recent U.S. Supreme Court decision, it is now clear that a key feature of the New York Court Decisions will remain final. In June 2014, the Supreme Court declined to hear Argentina’s appeal of the New York Court Decisions, thereby leaving in place the lower courts’ rulings in favor of the holdout creditors (See Box 1). Under these rulings, Argentina was found to have violated the *pari passu* clause in its New York law governed sovereign bonds. As a remedy for its breach of the *pari passu* clause, the courts prohibited Argentina from making payments on its restructured bonds unless it paid the holdouts on a “ratable” basis. The courts defined “ratable” to require that when Argentina pays 100 percent of the amount owed to the restructured bondholders (i.e., the periodic coupon payment), it must also pay 100 percent of any amount owed to the litigating holdout creditors (i.e., all past due principal and interest in an amount now aggregating approximately US\$1.6 billion).¹⁰ The courts also barred the indenture trustee and other parties in the payment chain from facilitating any payment on the restructured bonds unless payment was also made to the holdout creditors.

⁹ <http://www.icmagroup.org/resources/Sovereign-Debt-Information/>. ICMA has around 460 members drawn from both the buy and sell-sides, made up of issuers (including sovereign issuers), primary and secondary market intermediaries, asset managers, investors and capital market infrastructure providers. Its activities include promoting best market practice through the development of standard documentation, which is normally sent to its membership for consultation before publication.

¹⁰ The effective result of these decisions is that the holdout creditors are entitled to receive the full value of the defaulted bonds (purchased on the secondary market at a deep discount) plus past due interest while those who accepted the restructuring settled for a net present value of approximately 27 cents on the dollar.

Box 1. Argentine Litigation in the U.S.

In June 2014, the Supreme Court of the United States refused to hear Argentina's appeal of the New York federal courts' decisions (the "New York Court Decisions") which found that Argentina had violated the *pari passu* clause in its defaulted bonds by making coupon payments to bondholders who participated in debt exchanges in 2005 and 2010, without also paying non-tendering holders of the defaulted bonds. As a remedy for the breach, Argentina was prohibited from making future payments on restructured bonds unless it paid the defaulted bondholders on a *ratable* basis. An overview of the key points in the litigation is set forth below.

Following its 2001 default on external debt payments, Argentina undertook two debt exchanges (in 2005 and 2010) that restructured approximately 93 percent of its external debt. Creditors holding the remainder of the defaulted bonds (the "holdout creditors") did not participate in the exchanges.

In 2011, a subset of the holdout creditors, led by NML Capital Ltd., with principal and past-due interest claims (now aggregating approximately US\$1.6 billion) filed an amended complaint against Argentina in the United States District Court for the Southern District of New York. They alleged that Argentina had violated the *pari passu* clause in the defaulted bonds and sought specific performance of the clause, which they characterized as an equal treatment clause.

The case led to the following key rulings by the New York federal courts and the United States Supreme Court:

- December 2011: United States District Judge Griesa rules in favor of the holdout creditors, finding that Argentina had violated the *pari passu* clause in its defaulted bonds by: (1) failing to make the payments due to the holdout creditors when it made payments to the holders of Argentina's restructured bonds (the "restructured bondholders"); (2) enacting the so-called "Lock Law" and "Lock Suspension Law" that prohibited Argentina from reaching a settlement with the holdout creditors or offering them better terms than those offered to the restructured bondholders.
- February 2012: As a remedy for these violations, Judge Griesa issues: (1) an order requiring Argentina to make a "ratable payment" to the plaintiff holdout creditors prior to or at the same time as it makes its next payment on the restructured bonds; and (2) a parallel order effectively blocking the indenture trustee and third-party financial intermediaries, including Euroclear and Clearstream, from servicing any prohibited payments on the restructured bonds, cutting off all channels for Argentina to pay its restructured bonds without paying the holdout creditors. Judge Griesa stays enforcement of the orders pending appeal, and Argentina appeals to the United States Court of Appeals for the Second Circuit (the "Second Circuit").
- October 2012: The Second Circuit affirms the lower court's February 2012 decision, holding that Argentina had violated the *pari passu* clause in the defaulted bonds. The Court sends the case back to the lower court to clarify how its "ratable payment" formula will work, and the application of the order to third parties.
- November 2012: Judge Griesa defines "ratable payment" to mean that Argentina must pay the plaintiff holdout creditors in full whenever it makes a coupon payment on the restructured bonds. Judge Griesa also confirms that the indenture trustee and third-party financial intermediaries could face contempt of court if they were to process prohibited payments made by Argentina on the restructured bonds. Argentina appeals to the Second Circuit, which grants a stay of enforcement of the orders pending determination of the appeal.
- February-April 2013: Argentina is denied a rehearing of the October 2012 decision and is ordered, following argument of its appeal, to submit a proposal for paying the holdout creditors. Argentina presents a payment plan essentially equivalent to payments made to restructured bondholders. The holdout creditors reject Argentina's payment plan, and the Second Circuit does not accept it.
- June 2013: Argentina appeals the Second Circuit's October 2012 decision to the United States Supreme Court.

Box 1. Argentine Litigation in the U.S. (concluded)

- August 2013: the Second Circuit upholds Judge Griesa's definition of ratable payment, finding that Argentina must pay the plaintiff holdout creditors in full when it makes any coupon payment on the restructured bonds. The Second Circuit continues to stay enforcement of the injunctions pending Argentina's filing of an appeal to the Supreme Court.
- October 2013: the Supreme Court declines to hear Argentina's appeal of the Second Circuit's October 2012 decision without comment.
- February 2014: Argentina appeals to the Supreme Court the Second Circuit's August 2013 decision affirming the injunctions.
- June 2014: the Supreme Court refuses to hear Argentina's appeal, again without comment, thereby rendering the lower court decisions final. On June 18, 2014, the Second Circuit lifts its prior stay and the injunctions take effect.
- June 2014: In response to Argentina's statements that it wants to negotiate a resolution of the impasse to avoid a default on its restructured bonds, Judge Griesa appoints a Special Master to oversee settlement discussions among Argentina, NML and the other similarly-situated holdout creditors.
- July-August 2014: In connection with the coupon payment on Argentina's restructured bonds due June 30, 2014, Judge Griesa holds that, although Argentina's attempt to make a payment to the indenture trustee on its restructured bonds is illegal and in violation of his orders, his orders did not prevent Citibank's Argentine branch office, which is a local custodian for certain U.S. Dollar-denominated Argentine law bonds payable in Argentina, from making payments on such bonds. On July 28, Judge Griesa reverses his determination as to Citibank, authorizing the June 30 payment only on a one-time basis. Judge Griesa also permits Euroclear, Clearstream and JPMorgan Chase Bank to forward, on a one-time basis, the coupon payment they had received from Citibank on such Argentine law bonds. Citibank has filed a notice of appeal from Judge Griesa's July 28 order on the grounds that the orders should not be construed to prevent payment on bonds subject to Argentine law and payable solely in Argentina. The appeal has been scheduled for argument on September 18, 2014. On July 30, at the end of a thirty-day grace period, bondholders did not receive interest payments due and payable on Argentina's restructured debt. On August 6, Judge Griesa issued an order permitting Bank of New York Mellon (BNYM), the indenture trustee, to hold the payment it received from Argentina in connection with the June 30 coupon payment in its account with the Central Bank of Argentina, and also determined that it would incur no liability for doing so. On August 15, 2014, the Euro Bondholders filed a notice of appeal from that order insofar as it prevents BNYM from transferring funds paid by Argentina to holders of the Eurobonds. On August 19, 2014, Argentina announced proposed legislation that would replace BNYM with an Argentine indenture trustee and authorize a voluntary exchange offer intended to change the governing law and place of payment on its restructured bonds. At a hearing on August 21, Judge Griesa determined that such an exchange offer would be illegal and in violation of his order. Also on August 21, several holders of Argentina's restructured debt denominated in Euros and governed by English law filed a suit in the High Court of Justice in London against BNYM, as well as the trustee's English nominee, seeking the approximately €239 million interest payment that was received by the trustee in connection with Argentina's attempt to make the June 30 coupon payment on its restructured debt.

10. The New York Court Decisions have had an important impact on a longstanding debate regarding the meaning of the *pari passu* clause in international sovereign bonds. *Pari passu* is a Latin phrase meaning "in equal step", and these clauses are virtually ubiquitous in both cross-border corporate and international sovereign bond contracts. In unsecured cross-border corporate bonds, the meaning of the *pari passu* clause is well-established: in the event of liquidation, such a clause ensures that the debt in question will have the same priority as the debtor's other unsecured debt. Since there are no liquidation proceedings for sovereigns, the meaning of the *pari passu* clause in international

sovereign bond contracts has been subject to considerable debate (Annex 1 provides an extensive discussion of the history of this debate). According to most legal practitioners and academics, it is exclusively a legal “ranking” clause, designed to protect a creditor from legal subordination of its claims in favor of another creditor. Some have argued, however, that the *pari passu* clause goes further to encompass a payment obligation requiring the sovereign to pay its creditors on a *pro rata* or “ratable” basis. Specifically, to the extent that a debt is due and payable to one creditor, the clause would prevent a debtor from making payments to that creditor unless it makes ratable payments to other creditors whose debts are also due and payable. The New York Court Decisions have had an important impact on this debate because they lend support to the ratable payment interpretation of the *pari passu* clause, although, as discussed below, there is some uncertainty as to how these decisions will be interpreted going forward.

11. The New York Court Decisions are also significant because of the nature of the remedy they provided to holdout creditors. Having determined that Argentina violated the *pari passu* clause in its defaulted bonds, the New York District Court was presented with the question as to what type of remedy would be appropriate to address this breach. Instead of giving effect to the contract remedy of acceleration or providing a monetary award for the breach, the court provided a remedy that effectively requires Argentina to perform its obligations under the *pari passu* clause. Specifically, the court issued an order prohibiting Argentina from making payments on its foreign currency-denominated restructured bonds unless it paid the holdout creditors on a “ratable” basis. As a means of enforcing this prohibition, the court also prevented the indenture trustee and other parties in the payment chain from facilitating any payment on the restructured bonds unless payment was also made to the holdout creditors. The nature of the above-described remedy has been the subject of considerable controversy. For example, and as is discussed further in Section IV of this paper, it relies on an interpretation of the U.S. Foreign Sovereign Immunities Act (the “FSIA”).

12. From a systemic perspective, the key issue is the breadth of the precedent created by the New York Court Decisions. The resolution of this issue is complicated by the fact that while certain elements of the New York Court Decisions are potentially far reaching in terms of the impact they may have on the overall restructuring process, other elements are potentially more limiting. Specifically:

- **On the one hand, the U.S. Court of Appeals for the Second Circuit (the “Second Circuit”) construed the text of Argentina’s *pari passu* clause in a way that will be difficult to limit to Argentina.** Specifically, the Second Circuit concluded that the language of the *pari passu* clause set forth in the defaulted bonds established two distinct prohibitions.¹¹ First, Argentina, as “bond issuer”, was precluded from formally subordinating the defaulted bonds by issuing superior

¹¹ The *pari passu* clause in Argentina’s defaulted bonds reads as follows: “The Securities will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness (as defined in this Agreement).”

debt. Second, Argentina, as “bond payor”, was prohibited from paying on other bonds without paying on the defaulted bonds.¹² This analysis is consistent with the broad ratable payment interpretation of the *pari passu* clause discussed above. Importantly, and as discussed further in Annex I, academic research reveals that most international sovereign bonds issued after 2000 have *pari passu* clauses that include language that is functionally similar to that in the relevant Argentine bonds.

- **On the other hand, the basis for concluding that Argentina had actually breached this clause was potentially narrower.** The Second Circuit specifically declined to decide whether the clause was breached by Argentina making *any* payment on the restructured bonds while not paying the holdout creditors. Rather, it affirmed the lower court’s decision that Argentina’s “course of conduct” and “extraordinary behavior” had breached the *pari passu* clause, without specifying the particular conduct it was relying on.¹³ The district court’s order stated that Argentina had violated the clause through each of two courses of conduct. In the first place, Argentina breached the clause by “persisting in its refusal to satisfy its payment obligations” currently due to the holdout creditors-while making payments currently due under the restructured bonds. Secondly, Argentina breached the clause when it enacted the “Lock Law” and the “Lock Suspension Law” which precluded the authorities from offering more favorable treatment to the holdouts than what is offered to the restructured bondholders.¹⁴

13. The ramifications of the New York Court Decisions will thus depend on how future courts interpret the Argentine precedent and, in particular, the “course of conduct” analysis.

If, for example, courts decide that a sovereign’s course of conduct only breaches the *pari passu* clause if it adopts the type of legislation adopted by Argentina, the impact of the New York Court Decisions will be rather narrow. If, however, the courts determine that the standard is met if a sovereign simply fails “persistently” to make payments to holdout creditors while making payments on restructured bonds, the decision could have a broader impact.

14. If future courts interpret the New York Court Decisions broadly, there is a significant risk that the sovereign debt restructuring process will become more complicated.

As discussed in both the April 2013 Board Paper and the May 2014 Board Paper, since the type of remedy provided to the holdout creditors in the New York Court Decisions enhances the leverage of holdouts, these decisions have increased the risk that holdouts will multiply, as they now have the ability to extract a preferential recovery outside of a debt exchange. Certain creditors may now also have increased incentive to obtain through secondary market purchases a dominant position in a given bond series, with a view to holding out. In addition, because the New York Court Decisions increase the risk that holdout creditors will be able to interrupt the flow of payments to those

¹² See *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d at 259.

¹³ See *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d at n.16; see also *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d at 247.

¹⁴ See *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978, at 4 (S.D.N.Y. filed Dec. 7 2011).

creditors who have participated in a consensual debt restructuring, there would be an even greater disincentive for creditors to participate in the restructuring. For inter-creditor equity reasons, creditors who would otherwise be inclined to accept the terms of a restructuring may now be less likely to do so.

15. The general reaction to the New York Court Decisions demonstrates that a wide array of commentators and interested parties have concerns that these decisions may, in fact, have a broad impact on the restructuring process. Brazil, France and Mexico, for example, filed *amicus curiae* briefs with the U.S. Supreme Court in support of Argentina, arguing that the decision would have a negative impact on the orderly and timely conduct of sovereign debt restructurings.¹⁵ The U.S., at earlier points in the litigation, raised concerns that the New York courts' interpretation of Argentina's *pari passu* clause to require ratable payments contradicts the settled market understanding of such clauses and could undermine longstanding U.S. efforts to promote the orderly resolution of sovereign debt crises. Major international law firms, academics, policy groups, and various international bodies have highlighted the potential impact of the New York Court Decisions on sovereign debt restructuring generally.¹⁶

16. The views of market participants about the effect of the New York Court Decisions appear to be mixed. Some have emphasized the importance of the "course of conduct" analysis and believe that the outcome will be limited to the facts of Argentina. Others have stressed that the broad interpretation of the *pari passu* clause set forth in the New York Court Decisions will have adverse consequences for the restructuring process. This latter group is of the view that the New York Court Decisions may lead sovereigns to delay restructurings, thereby increasing the total cost to the system. They also expect that, unless future bonds are modified to prevent the interpretation that has been given by the New York courts, bond issuance under New York law may diminish in favor of other jurisdictions. It has also been noted that any assessment of "course of conduct" that relies on the exercise of considerable discretion risks undermining the general objective of promoting the predictability of contract enforcement, which in itself can have systemic implications.

17. In the end, the extent to which the New York Court Decisions will, in fact, have broader repercussions will most likely be determined by future litigation. While there is

¹⁵ Brief of the Federative Republic of Brazil as *Amicus Curiae* in Support of Petitioner, Republic of Argentina v. NML Capital, Ltd., 189 L. Ed. 2d 234 (2014) (No. 13-990); Brief for the Republic of France as *Amicus Curiae* in support of the Republic of Argentina's Petition for a Writ of Certiorari, Republic of Argentina v. NML Capital, Ltd., 189 L. Ed. 2d 234 (2014) (No. 13-990); Brief of the United Mexican States as *Amicus Curiae* in Support of Petitions for Writs of Certiorari, Republic of Argentina v. NML Capital, Ltd., 189 L. Ed. 2d 234 (2014) (No. 13-990).

¹⁶ See e.g., *Sovereign pari passu clauses: NML Capital 2, Argentina 0*, Clifford Chance Briefing Note, June 2014; *The pari passu clause and the Argentine case*, Global Law Intelligence Unit, Allen & Overy, December 2012; Gelpert, Anna, *Sovereign Damage Control*, Peterson Institute for International Economics, May 2013; Weidemaier, Mark C., *Sovereign Debt After NML v. Argentina*, 8 Cap. Mkts. L.J. 123, 125 (2013); Brief of Joseph Stiglitz as *Amicus Curiae* in Support of Petitioner, Republic of Argentina v. NML Capital, Ltd., 189 L. Ed. 2d 234 (2014) (No. 13-990); United Nations Conference on Trade and Development, *Argentina's 'vulture fund' crisis threatens profound consequences for international financial system* (June 25, 2014); Organization for American States, *Declaration in Support for the Position of Argentina on its Sovereign Debt Restructuring* (July 3, 2014).

considerable uncertainty as to the approach that will be taken by courts, what is relatively certain is that these decisions will inspire future “copycat” litigation—indeed, such litigation has already commenced. In March 2013, the Export-Import Bank of Taiwan Province of China (“Ex-Im Bank”) commenced an action in New York against Grenada, seeking (i) specific performance of the *pari passu* clause contained in defaulted loans made to Grenada and (ii) an order preventing payment on outstanding bond debt unless Grenada were to simultaneously make payments on the defaulted loans. While the case is still in its early stages, the New York District Court declined to grant a motion for summary judgment in favor of Ex-Im Bank, indicating that, even if the *pari passu* clause in the relevant loan agreement is identical to those in the defaulted bonds of Argentina, the liability of Grenada could only be established on the basis of an assessment of its “course of conduct”.¹⁷ Since the case has not gone to trial, it is still unclear how the court will apply this standard.

18. While there is not yet certainty on the question, the prevailing view is that the expansive interpretation of the *pari passu* clause made by the New York courts is unlikely to be followed by the English courts. The position of the English courts is significant given that international sovereign bonds governed by English law represent approximately 40 percent of the outstanding stock in notional value. There is no clear English judicial precedent on the interpretation of the *pari passu* clause. In the case of *Kensington Int'l Ltd. v. Republic of Congo*,¹⁸ the claimant sought an injunction on the basis of (*inter alia*) a “ratable payments” interpretation of the *pari passu* clause; however, the court did not in the end analyze the meaning of the clause as it dismissed the application on other grounds. The Financial Markets Law Committee (FMLC),¹⁹ in a 2005 report that reflects its current views on the *pari passu* clause, noted that analysis of English case law provides persuasive authority against the payment interpretation. It concluded that as a matter of English law the “ranking” interpretation is the proper interpretation of the *pari passu* clause in sovereign debt obligations and that the “ratable payment” interpretation is unsupported except where the clause is very clearly drafted to achieve this effect.²⁰ The FMLC recently updated its earlier report, stating that the neither the New York Court Decisions nor the decision of the U.S. Supreme Court to decline

¹⁷ *Exp-imp. Bank of the Republic of China v. Grenada*, No. 13 Civ 1450, 2013 U.S. Dist. LEXIS 117740, at 11-13 (S.D.N.Y. Aug 19, 2013). As the court ordered a full trial, it did not consider Ex-Im Bank’s request for an injunction.

¹⁸ [2003] EWHC 2331 (English High Court decision, upheld on appeal). The *pari passu* clause in that case differs from that in Argentina’s defaulted bonds. While it did not follow the two-sentence construction, it included a reference to “priority of payment”, which the claimant sought to rely on, as follows: “...the claims of all other parties under this agreement will rank as general obligations of the People’s Republic of Congo, at least *pari passu* in right and priority of payment with the claims of all other creditors of the People’s Republic of the Congo”.

¹⁹ The FMLC is an independent body of legal experts that was established by the Bank of England to examine issues of legal uncertainty in financial markets.

²⁰ See *Issue 79 – Pari Passu Clauses: Analysis of the role, use and meaning of the pari passu clauses in sovereign debt obligations as a matter of English law*, Financial Markets Law Committee, March 2005.

hearing the case had changed the FMLC view that the standard *pari passu* clause would not be interpreted by English courts to require ratable payment.²¹

19. Sovereign issuers have already begun to take action to address the potential problems raised by the New York Court Decisions. In some cases, sovereign issuers have modified the standard *pari passu* clause in new issuances in a manner that explicitly excludes the ratable payment interpretation (e.g., Ecuador and Greece²²). In other cases, while the text of the clause has not been modified, the issuer has clarified in the offering memorandum that the clause should not be interpreted to require ratable payment (e.g., Honduras and Belize²³). A number of sovereign issuers (e.g., Colombia, Mexico and Paraguay) have identified as a risk factor in the prospectus the possibility that the New York Court Decisions could potentially reduce or hinder the ability of sovereign issuers to restructure their debt. Importantly, there is no evidence to date that these modifications and clarifications have affected the price of the issuances. During the consultation process, other sovereign issuers indicated their intention to include in future issuances modified *pari passu* clauses that specifically disavow the ratable payment interpretation.

20. Consistent with the above, ICMA has proposed a new standard form of *pari passu* clause for sovereign bonds in its Model Clauses.²⁴ This *pari passu* clause is designed to make clear that it is only an “equal ranking” clause that prohibits the sovereign from legally subordinating

²¹ See *Role, Use and Meaning of Pari Passu Clauses in Sovereign Debt Obligations as a Matter of English Law* – Memorandum, August 2014
http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_memorandum_on_pari_passu_clauses.pdf.

²² Greece’s euro denominated notes issued in April 2014 include the following *pari passu* clause: “The Notes rank, and will rank, equally among themselves and with all other unsubordinated and unsecured borrowed money of the Republic; *provided, however, that*, consistent with similar provisions in the Republic’s other indebtedness, this provision shall not be construed so as to require the Republic to pay all items of its indebtedness ratably as they fall due”. Ecuador’s US dollar notes issued in June 2014 include the following *pari passu* clause: “The Notes will rank equally in terms of priority with Ecuador’s External Indebtedness (other than Excluded Indebtedness), provided, that, such ranking is in terms of priority only and does not require that Ecuador make ratable payments on the Notes with payments made on its other External Indebtedness.”

²³ Belize’s offering memorandum dated February 2013 includes the following language: “Paragraph 1 (c) of the Terms and Conditions of the New Bonds confirms that the New Bonds shall rank *pari passu* (equally) among themselves and with all other present and future unsecured and unsubordinated Public Debt (as defined) of Belize. A contractual provision similar, but not identical, to Paragraph 1(c) has been the subject of on-going litigation in U.S. federal courts in a case captioned NML Capital, Ltd. v Republic of Argentina. The plaintiffs in that case have argued that the *pari passu* provision in the defaulted Argentine bonds they are holding required Argentina, if and when it makes a payment under certain of its other debt instruments, to make a pro rata payment on the bonds held by the plaintiffs. This interpretation of the provision is being contested by the defendant, the Republic of Argentina, and by various other interested parties including the United States Government. To ensure clarity on the point, Belize does not understand Paragraph 1 (c) of the Terms and Conditions of the New Bonds, or any comparable provision in any other debt instrument of Belize, to require Belize to pay all items of its Public Debt on a ratable basis”. The language in Honduras’ March 2013 notes is nearly identical, with the exception of the last paragraph, which reads as follows: “To ensure clarity on the point, Honduras intends to take the position that the *pari passu* clause in the terms and conditions of the Notes does not obligate it to pay Public External Indebtedness on a ratable basis.” Belize also included a provision in the domestic legislation authorizing its new bonds that expressly confirmed that the *pari passu* provision did not promise ratable payment of equally-ranked debt.

²⁴ See footnote 9, above.

the indebtedness to other relevant debt.²⁵ More specifically, following the approach used by Ecuador and Greece, the ICMA Model Clauses make explicit that, while it requires equal ranking of all unsubordinated external indebtedness, it does not require that such indebtedness be paid on an equal or rateable basis.²⁶

21. Market participants are generally supportive of the proposed modifications to the *pari passu* clause. Some investors saw merit in removing the *pari passu* clause in its entirety from future sovereign bond contracts as a way to mitigate the impact of the New York Court Decisions. Most market participants, however, generally preferred to keep the clause, but with modifications in line with the ICMA Model Clauses which, in their view, clarify the meaning of the clause while providing adequate protection for creditor rights. Market participants have indicated that they anticipate that modifications to the *pari passu* clause will not affect the price of issuances.

22. In light of the uncertainty concerning the interpretation of the *pari passu* clause, staff is of the view that *pari passu* clauses should be drafted in a manner that, consistent with the ICMA Model Clauses, explicitly excludes the obligation to effect rateable payments. Staff's outreach with market participants and sovereign issuers suggests that modification of the *pari passu* clause would, on balance, be beneficial to all parties involved and the system in general. As noted above, there is no evidence to date to suggest that the pricing of issuances that include modified *pari passu* clauses have been adversely affected. Perhaps more importantly, as evidenced by the ICMA initiative, creditors and sovereign issuers recognize that it is in their own interest to support inclusion of clauses that limit the leverage of holdout creditors during the restructuring process. Indeed, a number of sovereign issuers indicated to staff that they intend to include modified *pari passu* clauses along the lines of the ICMA Model Clauses in future international sovereign bond issuances.

STRENGTHENING COLLECTIVE ACTION CLAUSES

A. Overview of Collective Action Clauses

23. In light of the evolution of the sovereign debt market over the past 30 years, there has been a growing awareness that "collective action" problems may undermine the sovereign debt restructuring process. Specifically, even if creditors as a group recognize that it is in their best interests to agree to a restructuring as soon as possible, individual creditors may be incentivized not

²⁵ *Id.*

²⁶ The ICMA model *pari passu* clause reads as follows: "The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank *pari passu*, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, *provided, however*, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa."

to participate (“hold out”) in the hope of recovering payment on the full contractual claim. If the perceived holdout risk is significant, creditors who would otherwise have agreed to participate in a restructuring may be unwilling to do so for inter-creditor equity and liability reasons. Full payment of these holdout creditors would also reduce the sovereign’s available resources to pay the restructured creditors, thus undermining a negotiated settlement by further increasing the incentive to hold out. This coordination failure can, therefore, lead to a disorderly restructuring despite it being in the creditors’ collective best interest to reach a smooth and negotiated agreement. As has been discussed extensively in previous papers, it was generally recognized that these risks became more significant with the emergence of bonded debt as the primary source of sovereign financing during the 1990s.²⁷ After considerable discussion during the early 2000s as to what type of mechanism should be relied upon to address these collective action problems, it was decided to rely upon a contractual approach; namely, the promotion of CACs.

24. Although CACs have a number of different features, the most important feature is one that enables a qualified majority of bondholders of a specific bond issuance to bind the minority of the same issuance to the terms of a restructuring, making it more difficult to block a restructuring.²⁸ More specifically, a CAC will allow the key financial terms of a bond to be modified upon receipt of support of a qualified majority of bondholders holding a requisite percentage (typically 75 percent) of the outstanding principal of a given series. Under certain international sovereign bonds (e.g., English law governed bonds), the modification of key terms requires the support of a qualified majority of bondholders represented at a meeting at which a quorum of bondholders is present.²⁹ Inclusion of CACs in international sovereign bonds has become the standard market practice and CACs have played a useful role in achieving high creditor participation in a number of past sovereign debt restructurings (see Box 2).

²⁷ Bonded debt is typically issued to – or purchased on the secondary market by – a large and diverse group of creditors.

²⁸ An additional feature of CACs in existing international sovereign bonds is the “majority enforcement” provision, which limits the ability of a minority of creditors to enforce their claims following a default. These provisions typically (i) require the support of at least 25 percent of the outstanding principal of a given series to accelerate their claims after a default (i.e., declaring all principal and accrued interest due and payable immediately) and (ii) enable a simple or qualified majority to “de-accelerate” (i.e., to reverse an acceleration that has already occurred).

²⁹ For a detailed discussion of collective action clauses, see [The Design and Effectiveness of Collective Action Clauses: Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use](#) and [Collective Action Clauses – Recent Developments and Issues](#).

Box 2. History and Experience of Collective Action Clauses (CACs)

In the early 2000s, the Fund contributed to the development of CACs as part of a concerted international effort to strengthen the contractual approach to facilitate orderly debt restructuring.¹ In 2002, the G-10 Working Group issued recommendations² to strengthen clauses in sovereign bonds, including a set of model CACs for use under New York law governed sovereign bonds.³ In 2003, when the Executive Board discussed recent developments in relation to CACs and the G-10 recommendations, Directors encouraged staff to hold an active dialogue with emerging market issuers with a view to encouraging the use of CACs in the New York and other markets in line with those recommended by the G-10 Working Group.⁴ In response to the Board and the IMFC's call for the Fund to encourage voluntary inclusion of CACs through multilateral and bilateral surveillance,⁵ a staff guidance note was developed to guide staff's efforts to engage in a more active dialogue with members on this issue. Since 2003, the IMF-World Bank Guidelines for Public Debt Management have suggested that debt managers should consider including CACs in new international sovereign bond issuances, in consultation with their financial and legal advisors.⁶

Since then, the inclusion of CACs has become the standard market practice for issuances of international sovereign bonds. While CACs allowing for collectively-binding restructuring decisions have traditionally been included in sovereign bonds governed by English and Japanese law, prior to 2003 sovereign debt issuances under New York law generally did not include such clauses. Since Mexico's issuance in February 2003, which resolved the first mover problem, inclusion of CACs has been the market practice for New York law governed bonds. As of June 2014, it is estimated that of the approximately US\$900 billion foreign law bonds outstanding, about 80 percent include CACs. Of a total outstanding stock of New York law governed bonds of about US\$420 billion, about 75 percent include CACs.⁷

The introduction of CACs in the early 2000s was well received by market participants. Theoretically, CACs improve the efficiency of restructuring through coordination gains, while reducing the cost of restructuring to the debtor, thus making recourse to restructuring more appealing. Evidence concerning the impact of the introduction of CACs on sovereign yields suggests that the efficiency gains dominated for countries with good ratings, leading to lower yields, while the result was more mixed for countries with weak ratings.⁸

1/ See [Collective Action Clauses – Recent Developments and Issues](#).

2/ See: <http://www.bis.org/publ/gten08.htm#pgtop>.

3/ In February 2003, the Institute of International Finance and six other financial industry trade associations put forward for discussion a draft set of model CACs developed for bonds governed by New York and English law. *Inter alia*, the proposed voting thresholds under these model CACs are generally higher than those under the G-10 recommendations.

4/ See [The Acting Chair's Summing Up—Collective Action Clauses—Recent Developments and Issues](#).

5/ See [Communiqué of the International Monetary and Financial Committee of April 12, 2003](#).

6/ See [Revised Guidelines for Public Debt Management](#), paragraph 46.

7/ To obtain this data, staff has relied on the Bloomberg and Dealogic databases, which may be subject to inaccuracies, and the assumptions that English and Japanese law-governed bonds all include CACs. These estimates were revised from those reported in the May 2014 Board Paper to reflect a new cut-off date (July 2014) and the removal of instruments with multiple listings, GDP-warrants, holdout bonds, Sukuks, and China's domestic issuances under Hong Kong governing law. See also footnote 8 of the main text above.

8/ See Eichengreen, Barry, Kletzer, Kenneth, Mody, Ashoka, *Crisis Resolution: Next Steps*, National Bureau of Economic Research Working Paper No. 10095, November 2003; Bardozzetti, Alfredo, Dottori, Davide, *Collective action clauses: how do they weigh on sovereigns?* Banca d'Italia, Working Paper No. 897, January 2013. Bradley, Michael, Gulati, Mitu, *Collective Action Clauses for the Eurozone*, Review of Finance, 2013, pp. 1-58.

Box 2. History and Experience of Collective Action Clauses (concluded)

CACs have played a useful role in achieving high creditor participation in a number of past debt restructurings.⁹ In the recent cases of Belize (2007, 2013), Seychelles (2010) and St. Kitts and Nevis (2012), the use of these series-by-series CACs enabled high creditor participation and facilitated the debt restructuring process.¹⁰ Another example of the successful use of CACs was in Ukraine (2000), where the authorities used the CACs in the three Eurobonds governed by Luxembourg law, with minimal holdout problems. Also, in the case of Moldova (2002) and Uruguay (2003), the use of CACs contributed to a smooth restructuring.

9/ Other market-based instruments used in recent debt restructurings to attract broad creditor participation include “exit consents”, which allow a majority of bondholders to modify the nonpayment terms of old bonds in an exchange when accepting and exiting from the exchange offer.

10/ See [A Survey of Experiences with Emerging Market Sovereign Debt Restructurings](#). While its bonds included CACs, Pakistan decided not to use these clauses in its 1999 debt exchange.

25. Although existing CACs have helped mitigate the collective action problem in sovereign debt restructuring, they do not eliminate the holdout problem. Since most existing CACs operate on a series-by-series basis, they allow the possibility that a creditor, or a group of creditors, can obtain a “blocking position” in a particular series and effectively nullify the operation of CACs in that series. Thus, while these CACs have functioned well in many restructurings, their vulnerability to “holdout” creditors has limited their effectiveness in other cases. As discussed above, the 2012 Greek debt restructuring, although conducted relatively smoothly, revealed the limitations of existing CACs in addressing holdout creditor issues. In that case, holdouts were able to obtain a blocking position in about half of the foreign law-governed bond series, thereby preventing the operation of CACs in those series. In addition, CACs embedded in some of the instruments exchanged by Dominica (2004) did not prevent the holdout problem that the country faced in the restructuring due to the relatively high concentration of bonds in the hands of certain creditors. The possibility that holdout creditors may obtain a blocking position in a particular bond series may, for inter-creditor equity reasons, undermine the incentive of holders of other series to agree to the terms of the restructuring.

26. As noted earlier, the New York Court Decisions have increased this risk. To the extent that these decisions give holdouts a more powerful enforcement tool, it will increase the incentive for them to obtain blocking positions and litigate for full recovery. Moreover, potentially more cooperative creditors may be nervous about the possibility of holdouts using this tool in a manner that interrupts payments on the restructured bonds, which may make them more reluctant to participate in a restructuring.

27. It was recognized as early as 2003 that contractual clauses allowing for the “aggregation” of claims across bond series for voting purposes can significantly mitigate the limitations of series-by-series CACs.³⁰ If claims are aggregated across bond issuances for voting purposes, the ability of holdout creditors to block the participation of a particular series becomes far

³⁰ See [The Restructuring of Sovereign Debt—Assessing the Benefits, Risks, and Feasibility of Aggregating Claims](#).

more difficult. Aggregation can also provide certainty to holders of other series that holders of all series will be bound by the restructuring, thereby giving them the additional incentive to participate. The benefits of aggregating claims across issuances were demonstrated in the 2012 restructuring of Greece's domestic law governed debt. To facilitate the restructuring of its domestic law governed bonds, Greek authorities enacted legislation that aggregated claims across all of the affected domestic law issuances, thereby eliminating the power of creditors to obtain a blocking position in an individual issuance. In contrast to Greece's international sovereign bonds, all of the affected domestic law governed debt was restructured.³¹ It is unlikely that the restructuring would have proceeded as smoothly had the claims not been aggregated in such a manner. Without such aggregation, holdout creditors may have been in a position to obtain a blocking position in particular bond issuances that would have prevented a series-by-series CACs from operating in those issuances.³²

28. A few international sovereign bond issues already provide for a limited form of aggregation. Thus far, only four countries (Argentina, the Dominican Republic, Greece, and Uruguay) have included aggregation clauses in their international sovereign bonds, and the ESM treaty requires the inclusion of standardized aggregation clauses ("Euro CACs") in all new euro area government bonds (domestic and foreign law-governed bonds) with a maturity above one year starting from January 1, 2013.³³ Aggregation is limited in all these instances inasmuch as the clauses rely on a "two limb" voting structure, which requires that a minimum threshold of support be achieved *both* (a) in each series *and* (b) across all series being restructured. The key advantage of this approach, relative to the traditional series-by-series CAC, is that the minimum level of support needed from each series is lowered from (the typical) 75 percent of outstanding principle to 66 2/3 percent of outstanding principal, thereby making it more difficult and costly for holdout creditors to obtain a blocking position in a particular issue. To compensate for this lowering of the individual series threshold, no individual series can be restructured in the absence of a minimum level of support across all bonds series (75 percent in the case of Greece and Euro CACs, and 85 percent in the case of Argentina, Uruguay, and the Dominican Republic).

29. While two limb aggregation clauses in sovereign bonds are a welcome development, they still allow holdouts to control an issue, albeit with greater effort and cost. In particular, while the required 66 2/3 percent threshold for each individual series under the aggregation clauses is easier to achieve than the typical 75 percent threshold under series-by-series CACs, creditors may still be able to obtain a blocking position with respect to a particular series. In such cases, the

³¹ The aggregation mechanism was coupled with a low voting threshold of two-thirds of aggregated outstanding principal of all affected domestic law bonds based on a quorum of 50 percent.

³² For example, one series of domestic law-governed debt in the amount of EUR 14.5 billion (EUR 9.76 billion of which was tendered in the exchange) was set to mature on March 20, 2012, immediately after the Executive Board approved an arrangement for Greece. It has been reported that a number of investors moved into this issuance, anticipating that these bonds would not be restructured, or would receive a smaller haircut.

³³ Economic and Financial Sub-Committee on EU Sovereign Debt Markets Model Collective Action Clause, November 2011 as supplemented (http://europa.eu/efc/sub_committee/cac/cac_2012/index_en.htm).

particular holdout series would be excluded from the restructuring, while the restructuring would still be carried out for other series so long as the two limb voting thresholds are met. Under this scenario, bondholders would not be protected against the risk that the restructuring would go forward without including all bond series, thereby reducing their incentive to participate.

B. Introducing the Option of a “Single Limb” Voting Procedure

30. In light of the above considerations, there have been significant discussions over the past eighteen months regarding the feasibility of introducing a “single limb” voting procedure. This procedure requires only a single vote calculated on an aggregated basis across all affected bond series i.e., a series-by-series vote would no longer be necessary. As a result of these discussions, there is broad agreement that designing a CAC that includes a single limb voting procedure would provide a very effective tool to address collective action problems. In the context of a multi-series restructuring, a creditor could no longer hold out simply by purchasing a controlling position in a particular issuance. By eliminating the requirement of a series-by-series vote (i.e., the second limb), a single limb voting procedure effectively removes the possibility of obtaining a controlling position within a particular issuance to block the restructuring of that issuance.

31. Notwithstanding these benefits, it was generally recognized during the consultation process that a single limb voting procedure would only be feasible and desirable if it contained adequate safeguards to address potential abuse. Accordingly, much of the discussion that has taken place in various fora over the past eighteen months has focused on the feasibility of designing a single limb voting procedure that is both acceptable to the market and legally enforceable in the relevant jurisdictions. The remainder of this section provides an overview of the key issues that have been discussed and the basis for the general agreement regarding the availability of a single limb voting procedure, one which is broadly reflected in the recently published ICMA Model Clauses.³⁴

32. In discussions with market participants, a key issue that arose regarding the design of a single limb voting procedure was the need to ensure that there were adequate safeguards to ensure inter-creditor equity. These safeguards would ensure that holders of a particularly large bond issuances could not use their voting power to agree upon terms that discriminate against the holders of smaller issuances. For example, in circumstances where there are several issuances (issues A, B and C) and the size of issues A and B is much larger than that of issue C, there is a risk that—in the absence of a series-by-series voting requirement—the holders of the A and B issuances could “gerrymander” or dominate the vote by virtue of their larger combined voting power, resulting in a restructuring where the holders of the A and B issuances receive instruments that are of greater value than the holders of issuance C.

³⁴ See footnote 9 above.

33. To address this concern, there was broad support during the consultation process that, in circumstances where the sovereign issuer wishes to utilize a single limb voting procedure, it could only do so if it offered all affected bondholders the same instrument or an identical menu of instruments. Accordingly, the CAC contained in the ICMA Model Clauses requires that, in circumstances where a single limb voting procedure is utilized, all holders of bonds that are affected by the vote must receive bonds whose terms are “uniformly applicable.” The “uniformly applicable” test is met if: (i) bondholders are offered the same new instrument or other consideration, or the identical menu of instruments or consideration; or (ii) the issuer proposes amendments to the terms and conditions of each series that would result in the amended instruments having identical provisions (other than provisions which are necessarily different, such as currency of payment). Where the single limb voting procedure is utilized, the ICMA Model Clauses provide that the restructuring would become binding upon the support of 75 percent of total outstanding principal of the aggregated claims, which is in line with the voting threshold currently applicable to traditional series-by-series CACs included in bonds governed by New York law.

34. It should be emphasized that, while the “uniformly applicable” safeguard ensures that all affected bondholders will receive the same instrument or an identical menu of instruments, it does not guarantee that the economic effect of the modification will be the same for each series affected. Since the terms of the bond series to be affected by the restructuring will differ, offering bond series the same instrument or identical menu of instruments may deliver different economic outcomes when measured on a net present value basis. For instance, if a qualified majority of bondholders voted to accept the same long-term instrument in a restructuring, the impact on those bondholders with relatively short residual maturities when compared with original contractual terms would be greater than that on those holding claims with relatively long residual maturities. Similarly, an identical reduction in the interest rate to 4% p.a. in two series of bonds originally with interest rates of 5% and 7% p.a., respectively, would also result in different net present value outcomes for each series.

35. Notwithstanding the above, it was recognized during the consultation process that creditors have traditionally not had a general expectation that the terms of the restructuring would seek to ensure net present value uniformity across all bond series. Indeed, a review of past international sovereign debt restructurings indicates that bondholders have willingly participated in restructurings, conducted in both pre- and post-default contexts, that offered the same instrument or an identical menu of instruments, even if this may result in different economic outcomes across issuances.³⁵ In a post-default context, this reflects the fact that differences in original bond maturities cease to exist upon default, as all claims may be accelerated and become due and payable. In a pre-default context, to the extent that the restructuring takes place during a period of debt distress and there is a significant risk that a default will occur in the absence of a restructuring, creditors will also take into account the likelihood that the various claims could be

³⁵ In Russia’s 2000 post-default restructuring, the offer involved two old bonds (maturing in 2015 and 2020, respectively) that were exchanged for the same new instrument (comprised of two Eurobonds representing principal and past due interests respectively); the participation rate was 99 percent.

accelerated and become due and payable. In this regard, a staff review of the price convergence of sovereign bonds in the period immediately before default also suggests that bond prices converge to the expected net present value of future payments of post-restructuring bonds.³⁶

C. Designing a Single CAC with a Menu of Voting Procedures

36. Notwithstanding the benefits of a single limb voting procedure, the consultation also revealed that there may be circumstances where flexibility is needed to offer bondholders different restructuring terms. More specifically, there may be cases where the sovereign debtor may wish to offer instruments of different value to different groups of bondholders and where these groups accept that this differentiation is a necessary feature of the restructuring. In these circumstances, the “uniformly applicable” safeguard would not allow for the entire stock of debt to be restructured through the use of a single limb voting procedure since the requirement that all bondholders participating in the vote receive the same instrument or identical menu of instruments would not be met.

37. To address this possibility, the ICMA Model Clauses provide for flexibility in two different respects.

- First, to the extent that the issuer wishes to offer different terms to *different groups of bond issuances*, the CAC set forth in the ICMA Model Clauses enables the issuer to use the single limb voting procedure to conduct separate votes for different groups of bond issuances. This “sub-aggregation” feature has the benefit of both allowing for differentiation among different groups of bondholders while, at the same time, reducing the leverage of a holdout creditor who could undermine a restructuring by obtaining a significant position in a single bond issuance in one of the groups. Sub-aggregation under the ICMA approach must also satisfy the “uniformly applicable” condition discussed above; i.e., all holders within the same group must receive the same instrument, identical menu of instruments, or amendments resulting in instruments with identical provisions (as described above).
- Second, to the extent that the issuer wishes to offer different terms to *different bond issuances*, the CAC set forth in the ICMA Model Clauses enables the issuer to select either a traditional series-by-series voting procedure or a two limb aggregation voting procedure (See Figure 1).³⁷

³⁶ By analogy, this concept is recognized in bankruptcy law. For example, under U.S. Chapter 11, unsecured creditors are generally considered to be equally ranked and, accordingly, may be offered the same restructuring terms - notwithstanding the fact that they held different instruments before the bankruptcy. This is because all debts are considered due and payable by operation of law as a result of the bankruptcy filing.

³⁷ Under the ICMA Model Clauses, the voting threshold for the series-by-series procedure is at least 75 percent of the outstanding principal of that series, and the voting thresholds for the two limb procedures are (i) at least 66⅔ percent of the aggregated principal amount of all series affected, and (ii) more than 50 percent of the principal amount of each affected series. See footnote 9.

Figure 1. CAC with Menu of Voting Procedures

Key Features	Menu of voting procedures		
	Single series	Aggregated	
		Two limb	Single limb
Uniform applicability requirement	No	No	Yes
Voting threshold	75% (per series)	66⅔% (aggregate), 50% (per series)	75% (aggregate)
Sub-aggregation	No	Yes	Yes

38. In the context of the consultation process, a number of observations were made about how a “menu-based CAC” would operate.

- First, while the inclusion of a menu of voting procedures within a single CAC will make the text of the CAC more complicated, this complexity is considered, on balance, necessary given the benefits of the flexibility that it provides.** In that context, it was recognized, that, as the menu-based CAC is used in a restructuring process, the preferences of the issuer and the creditors regarding the choice of voting procedures would reveal themselves over time. Thus, while the CAC under the ICMA Model Clauses has the full range of voting procedures and, therefore, is somewhat complicated, there may be a desire to reduce the menu—and thereby simplify the CAC—at some point in the future.
- Second, while the issuer would take the initiative in selecting a particular voting procedure in the context of a restructuring, this choice would be informed by the preferences of creditors.** For example, it was understood that, in circumstances where separate votes were conducted because of the desire of the sovereign to differentiate the terms offered to different bondholders, creditors would not vote in favor of this approach unless they concluded that differentiation was necessary. Moreover, in such cases, it would be very likely that a group of bondholders would make its own approval conditional upon other groups approving the terms that had been offered to them.
- Third, the very existence of a menu of voting procedures under the CAC may create incentives for participation.** For example, to the extent that a creditor receiving a differentiated offer under a two limb aggregation CAC was considering using its controlling position to block the participation of its bond issuance in the restructuring, it would be aware that, in the event of a failure to receive a sufficiently high participation rate in the restructuring, the sovereign could utilize the option of a single limb aggregation CAC (provided that it can offer terms that are “uniformly applicable”, as described above).

D. Other Design Issues

Scope of Debt

39. During the consultation process, there was considerable focus on the scope of debt that should be covered by an aggregated CAC framework, particularly with respect to governing law. On the one hand, some investors expressed concern that limiting aggregated CACs to debt governed by foreign law would send a signal that it would be acceptable for sovereigns to amend their domestic law-governed debt through domestic legislation. For these investors, relying on the contractual approach for the restructuring of all forms of debt would help better protect creditors' rights and support the attractiveness of sovereign debt as an asset class. On the other hand, some investors worried that aggregating foreign and domestic law bonds could give the issuer the ability to use its influence over local investors to force an undesirable outcome on the holders of the foreign law bonds.³⁸ In the end, the approach taken by the ICMA Model Clauses is to include such clauses in "syndicated issues of sovereign debt securities lead managed by one or more ICMA members with cross-border distribution,"³⁹ which consists primarily of bonds governed by foreign law.

40. As noted earlier, this approach is generally consistent with the approach that has been taken by the Fund in the past. It is recognized that there may be merits in including CACs in all forms of debt—whether governed by domestic law or foreign law. Indeed, the inclusion of CACs in domestic law-governed debt may, depending on the circumstances, obviate the need to rely on the type of legislation that was relied upon in the case of Greece. Nevertheless, it is recognized that holdouts possess greater legal leverage in the context of foreign law-governed bonds. It is for this reason that the Fund has focused on the promotion of CACs in bonds governed by foreign law.

41. The scope of foreign law-governed bonds that could be aggregated under the CAC set forth in the ICMA Model Clauses is appropriately broad. Consistent with the two limb aggregation voting procedure that has already been accepted in the market, a single limb voting procedure could accommodate bonds denominated in different currencies or governed by different foreign laws. The CAC under the ICMA Model Clauses recognizes that, in the context of any form of aggregation, the issuer would need to establish a methodology (as approved by the appointed "aggregation agent", who must be independent of the issuer) to value different types of bonds for voting purposes (e.g., to calculate the principal amount of zero-coupon bonds or total value of bonds denominated in different currencies). The Euro CACs include in the terms of the CAC an

³⁸ They also noted that disclosure for bonds governed by domestic law has traditionally been very scant, and that changes to this regime would be needed in order to ensure adequate disclosure and transparency of aggregated CACs.

³⁹ See ICMA's August 29, 2014 press release on revised collective action clauses and a new standard *pari passu* clause to facilitate future sovereign debt restructuring at <http://www.icmagroup.org/assets/documents/Media/Press-releases-2014/ICMA1406---ICMA-publishes-revised-collective-action-clauses.pdf>. In this press release, ICMA also noted that the revised standard CACs will not apply to syndicated issues of sovereign debt securities that are subject to the mandatory euro area model CAC introduced in January 2013.

example of such a methodology.⁴⁰ This methodology could also be relied upon to determine the value of a holder's bonds for the purposes of calculating the amount they are eligible to receive under the restructuring.

42. The ICMA Model Clauses also provide for considerable flexibility with respect to the design of the contractual basis for aggregation. For example, the CAC could be contained in a master agreement pursuant to which all of the individual issuances that are subject to aggregation are issued. In practice, such master agreements may take the form of a trust indenture (New York law) or a trust deed (English law). Alternatively, the clauses could be contained in a specific bond issuance and the terms of the clauses could be incorporated by reference into other bond issuances.⁴¹

Disclosure

43. During the consultation process, it was recognized that, in order for any aggregation clause to be both acceptable to the market and legally enforceable, it is critical that all of its features be clearly and adequately disclosed. Potential investors must be made fully aware that: (i) in the event of a restructuring, the outcome of a vote on a restructuring could be affected by the votes cast by the holders of other bond series; and (ii) that the issuer has broad discretion to select from a menu of voting procedures, as either set forth in the relevant master agreement or under the terms of a specific bond issuance (including where incorporated by reference). Moreover, it would be important that the relevant prospectus highlight the features of the single limb voting procedure and indicate that the terms are set forth either in the master governing agreement or in a previous bond issuance.

Information Covenant

44. Under the ICMA Model Clauses, information covenants are included as part of the CAC. During the consultation, a number of creditors supported the inclusion in the model CAC of an explicit requirement that, prior to making a restructuring offer, the sovereign debtor provide information to the bondholders regarding: (i) a description of the issuer's economic and financial circumstances which are in the issuer's opinion relevant to the request for modification, existing

⁴⁰ The methodology set out under the Euro CACs provides that the principal amount of a zero-coupon obligation for voting purposes is equal to its present value on the record date for a proposed modification (or its nominal amount if post-default). The present value is calculated using one of the following three discount rates: (i) if the bond was originally issued as a zero-coupon obligation, the applicable discount rate is its yield to maturity at issuance, (ii) if such obligation was stripped from a couponed debt security, the applicable discount rate is the coupon on the underlying debt security, and (iii) if such obligation was stripped from a couponed debt security that cannot be identified due to the fungibility of all of the issuer's zero coupon obligations maturing on the same date, the applicable discount rate is the weighted average of the coupons on the issuer's debt securities having the same stated maturity date as the one in question, or if there are no such securities, the coupon interpolated on a linear basis using the weighted average of the coupons on the issuer's debt securities having the two closest maturity dates to that of the obligation in question.

⁴¹ See definition of "Debt Securities Capable of Aggregation" under the ICMA Model Clauses (see footnote 9 above).

debts, broad policy reform program and provisional macroeconomic outlook; (ii) details of any financial assistance or debt relief that has been agreed with multilateral or other major creditors, subject to any applicable information disclosure policies of the Fund and such other creditors; (iii) a description of the issuer's proposed treatment of securities falling outside the scope of multi-series aggregation under the CAC and its intentions with respect to any other securities and its other major creditors; and (iv) where securities will be sub-aggregated, a description of the proposed treatment of each sub-group.

45. As stated in the May 2014 Board Paper, a restructuring proposal is only likely to achieve a high participation rate if the debtor provides adequate information to creditors to enable them to make an informed decision. During the consultation process, staff emphasized that, if the CAC is to include an information covenant that reflects this principle, it should be drafted in manner that (a) ensures consistency with Fund policy and (b) has legal clarity so as to minimize the risk of unintended litigation. To the extent that creditors request the inclusion of an appropriately designed information covenant as part of the CAC, it would be appropriate to include such covenants if they meet these conditions. In staff's view, ICMA's information covenant meets these conditions.

Potential for sovereign manipulation

46. During the discussions, creditors expressed some concern that a single limb voting structure may increase the risk that a sovereign manipulates the voting process by influencing the votes of entities it controls. There was a recognition that these concerns can be addressed through an appropriately drafted "disenfranchisement" provision. Following the G-10 approach⁴², many international sovereign bonds include relatively broad disenfranchisement provisions, which exclude for voting and quorum purposes all bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities (see Box 3). The disenfranchisement provisions set forth in the ICMA Model Clauses take a similar approach. It should be noted that these disenfranchisement provisions have been incorporated into existing international sovereign bond issuances.

⁴² See [The Design and Effectiveness of Collective Action Clauses](#).

Box 3. Disenfranchisement Provisions

Many international sovereign bonds include disenfranchisement provisions to address the risk that a sovereign could manipulate the voting process by influencing the votes of entities it controls. These provisions first appeared in sovereign bonds in the early 1990s but became more prevalent in the early 2000s in tandem with the shift to the wider use of CACs in New York law-governed bonds and in response to the report of the G-10 Working Group on the design of CACs.¹ Most disenfranchisement provisions, including under the ICMA Model Clauses, follow the G-10 approach; the disenfranchisement provision under the Euro CACs is narrower than the G-10 approach, which may reflect the specific constitutional arrangements of the euro area.

G-10. The disenfranchisement provision recommended by the G-10 report excludes from the calculation of “outstanding amount” for voting purposes all bonds “owned or controlled directly or indirectly by the issuer or any of its public sector instrumentalities”. The definitions of “control” and “public sector instrumentalities” are left to be negotiated on a case-by-case basis. In practice, “public sector instrumentalities” have been defined to include the central bank and any other government-owned or controlled entity.

Euro area. The Euro CACs² exclude for quorum and voting purposes all bonds that have been cancelled, redeemed, or that are held by the issuer, any department, ministry or agency of the issuer, or any corporation, trust or other legal entity that is controlled by the issuer, department, ministry or agency of the issuer, unless such corporation, trust or other legal entity has “autonomy of decision” in how it votes. “Control” is defined as the power to direct the management or appoint a majority of the board of directors or other persons performing similar functions, either directly or indirectly through the ownership of voting or other ownership interests. A bondholder will be deemed to have “autonomy of decision” if under applicable law it may not take instruction from the issuer or is required to act in accordance with an objective prudential standard in deciding how to vote, or owes a duty to vote in the interest of a person other than the issuer or entities under its control. Accordingly, unlike the G-10 and ICMA provisions, bonds held by euro area central banks would not be disenfranchised under the Euro CACs.

ICMA. The disenfranchisement provision under the ICMA Model Clauses is broadly in line with the G-10 approach, excluding all bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities. In addition, it includes a specific definition of “control” (which is in line with the definition under the Euro CACs) and “public sector instrumentality” as the central bank and any other department, ministry or agency of the government or any other entity owned or controlled by the government or any of the foregoing. It also specifically excludes bonds that have been cancelled or redeemed, which is consistent with the approach under the Euro CACs.³

1/ See Report of the G-10 Working Group on Contractual Clauses, September 26, 2002.

2/ See http://europa.eu/efc/sub_committee/cac/cac_2012/index_en.htm

3/ See *ICMA Sovereign Bond Consultation Paper*, December 2013, *ICMA Sovereign Bond Consultation Paper Supplement*, June 2014 and *ICMA Standard CACs - August 2014* (available at <http://www.icmagroup.org/resources/Sovereign-Debt-Information/>).

E. Legal Enforceability

47. During the consultation process, it was recognized that the single limb aggregation voting procedure would need to be both designed and applied in a manner that safeguards its legal enforceability. For example, when bonds with different governing laws are aggregated for voting purposes, it is important that the voting procedure required for each bond issuance be adhered to before the aggregation calculation is made. Moreover, as indicated above, adequate disclosure of the terms of the CAC will be a condition for their enforceability. In addition to these general requirements, all voting procedures in the CAC under the ICMA Model Clauses—whether a series-by-series, two limb, or single limb procedure—must not be applied in a manner that gives rise to claims of “bad faith” or “abuse of power” against the majority of creditors.

48. The consultation concluded that, while there is no inherent legal vulnerability in the single limb voting procedure, legal issues could arise if it was misused—as is the case with any type of CAC. During the consultation process, a considerable amount of attention was devoted to the question of whether a single limb voting procedure was particularly prone to legal challenge on the grounds of abuse of power by the majority. The overall conclusion was that there was nothing intrinsic in the design of the single limb option that made it more vulnerable from a legal perspective, at least under the laws of England and New York, than CACs with a series-by-series vote. Rather, as with all voting procedures under CACs, it could be challenged if used in bad faith or in a way that otherwise unfairly benefits the majority at the expense of the minority. Indeed, the general view was that the existence of a legal vulnerability in the event of abuse of any type of voting procedure under the CAC in the ICMA Model Clauses (series-by-series, two limb, or single limb) was a helpful safeguard because it would provide an important constraint on the behavior of the sovereign and its creditors during the restructuring process. In ICMA's view, a number of the safeguards that have been included in the single limb voting procedure – in particular, the 75 percent voting threshold – would provide added protection for creditor rights and address the key legal vulnerability. As a means of obtaining a greater understanding regarding issues of legal enforceability that may arise in the context of a single limb voting procedure, Fund staff sought legal advice from New York and English counsel. Their views are summarized in Box 4.⁴³

⁴³ While a comprehensive assessment of the legal enforceability under other major jurisdictions in which international sovereign bonds are issued has not been carried out, in Germany, for example, it is generally acknowledged that an amendment to existing domestic legislation would be required to implement a single limb aggregation voting procedure.

Box 4. Legal Enforceability of Single-limb Aggregation under New York and English Laws

English Law

A single limb voting procedure is likely to be enforceable under English law provided there is no bad faith or abuse of power. As a general principle, English courts will seek to give effect to contractual provisions—including the type of single limb voting procedure described above—in accordance with their terms. Where a majority of a class of creditors has the power to bind a minority, a majority vote is only likely to be successfully challenged in the English courts where the majority appears, in exercising its voting rights, to be acting in bad faith or abusing its power.

Abuse of power could arise if the decisions are taken for the exclusive purpose of benefitting the majority rather than the entire creditor group affected. Bad faith or abuse of power generally arises when the authority conferred upon the decision maker (i.e., the majority of creditors) has been exercised in a manner that is clearly unrelated to the purpose for which it is granted. A review of the case law indicates that, in the context of majority voting clauses, abuse of power may exist in circumstances where the decisions were taken for the exclusive purpose of benefitting the majority rather than the entire creditor group. For this reason, the Privy Council struck down a restructuring of debentures where the only reason that the majority voted for the restructuring was because the majority (but not the minority) had been promised common stock in the company.¹

However, the principle of abuse of power does not require the minority to receive the same economic benefits as the majority. Nor does the good faith requirement oblige the majority to act in the best interests of the minority. Rather, what is relevant is whether there is adequate evidence that the majority is acting in the interest of the class in general. In one case, the majority creditors had economic interests that were not identical to the minority, and the terms of the restructuring resulted in them receiving claims of a greater economic value. The High Court upheld the restructuring because the agreement was “the result of a proper two-sided negotiation that had, as its object, a restructuring of the borrower’s debts that gave it the best chance of survival. This was not abusive, but a proper exercise of power”.²

It follows that the inclusion of a provision that ensures that all creditors receive the same economic outcome, while helpful from a market acceptability perspective, is neither necessary nor dispositive as a legal matter. Of greater relevance is whether the overall objective of the restructuring is to improve the situation of all of the creditors who are eligible to vote. Where, from an NPV perspective, the outcome of the restructuring for creditors may differ relative to their original claims, the restructuring will be legally enforceable if there is a basis to conclude that, in the absence of a restructuring, there was a risk that the sovereign debtor would not have been able to service its claims to all creditors within the group. In these circumstances, the minority will have benefitted relative to what could have happened if the restructuring had not taken place.

The Financial Markets Law Committee has concluded that an appropriately designed single limb voting procedure is likely to be enforceable under English law. The FMLC expects to publish a comprehensive report on this subject in fall 2014.

1/ *British America Nickel Corporation, Limited and Others v. J. O'Brien, Limited* [1927] AC 369.

2/ *Redwood Master Fund, Ltd and Others v TD Bank Europe Limited and Others* [2002] EWHC 2703 (Ch), as affirmed in *Sergio Barrios Azevedo v Imcopa Importacao, Exportacao e Industria de Oleos Limitada*, [2012] EWHC 1849 (Comm), [2013] EWCA Civ 364 (in relation to consent fees) and *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation Limited* [2012] EWHC 2090 (Ch) (in the context of exit consents).

Box 4. Legal Enforceability of Single limb Aggregation under New York and English Laws (concluded)

New York Law

A single limb voting procedure is likely to be enforceable under New York law provided that it is exercised in the best interests of bondholders as a class and the voting is free from any collusion or corruption. Unlike under English law, there is little recent case law to draw on for guidance as to the legal enforceability of CACs under New York law. The reason for this is historical – CACs disappeared from U.S. law corporate bonds after the passage of the U.S. Trust Indenture Act of 1939, which effectively forbade their use.³ Older case law, however, indicates that the legal enforceability of CACs has generally not been questioned by U.S. courts provided that there is no collusion or corruption by the majority. As long as there is evidence that the restructuring is designed to avoid a default that may take place or to cure a default that has already taken place, the objective will be presumed to be in the best interests of all holders affected and, therefore, will be legally enforceable. This includes where, as result of the restructuring, the outcomes among creditors may differ when assessed on a net present value basis.⁴

3/ Although the Trust Indenture Act prohibition against CACs did not apply to sovereign bond issues, the drafters of U.S. law-governed sovereign bonds similarly avoided the incorporation of CACs after 1939. This drafting convention lasted until 2003 when CACs began to be introduced in New York law-governed sovereign bonds. Since 2003, there have been only two cases in which a CAC was used to restructure a New York law-governed sovereign bond (Belize in 2007 and again in 2013), neither of which resulted in a legal challenge.

4/ CACs have been viewed as legitimate tools “to minimize the power of a fractious minority to thwart the general good” *Hackettstown Nat’l Bank v. D.G. Yuengling Brewing Co.*, 74 F. 110, 113 (2d Cir. 1896) and to prevent “a small minority of the bondholders from forcing unreasonable and inequitable concessions from the majority.” *Sage v. Cent. R. R. Co.*, 99 U.S. 334, 341 (1879). The power conferred on the majority, these decisions say, must be exercised “in good faith” and “honestly” (*Hackettstown*, 74 F. at 112-13); courts condemned “corrupt” or “collusive” majorities acting “to crush out the rights of the minority or to put them at a disadvantage” (*Sage*, 99 U.S. at 341).

F. Staff Assessment

Design Issues

49. Consistent with the approach followed by the ICMA Model Clauses, staff is of the view that CACs in international sovereign bonds (i.e., bonds governed by foreign law) should include a “single limb” voting procedure – a single vote calculated on an aggregated basis across all affected bond series - that provides adequate safeguards to protect the interests of creditors. Where the single limb voting procedure is utilized, the CAC should require that all affected bondholders are offered the same instrument, an identical menu of instruments, or amendments resulting in instruments with identical provisions (as described above). The relevant voting threshold for a single limb voting procedure should be 75 percent of the aggregated outstanding principal of all affected series.

50. To provide additional flexibility, CACs should be designed to allow for differentiation among creditors, where this is considered appropriate by both the issuer and its creditors. Consistent with the CAC under the ICMA Model Clauses, this can be achieved by providing a menu that includes: (a) a single limb voting procedure with the possibility for “sub-aggregation”, (b) a two limb aggregation voting procedure, and (c) a traditional series-by-series voting procedure. It is

recognized that the range of alternative voting procedures that are included in such CAC may evolve over time, taking into account experience with their use and market preferences.

51. The aggregation features of the CAC should accommodate a broad range of debt instruments, including bonds denominated in different currencies and governed by different laws. Consistent with the approach under existing bonds that include two limb aggregation features, the CAC should include an appropriate methodology (or provide for such methodology to be determined by an independent entity prior to the proposed modification) that can value different types of bonds for voting purposes. While there may be benefits in including CACs in bonds governed by domestic law, the priority of the Fund should be to continue to promote the inclusion of aggregated CACs in bonds governed by foreign law, given that these bonds give potential holdouts the greatest amount of legal leverage.

52. To address concerns regarding potential manipulation of the voting process, the CAC should include robust disenfranchisement provisions. These provisions can be designed along the lines of those adopted by the G-10 or ICMA, which have already been included in international sovereign bonds.

53. With respect to disclosure, the relevant bond documentation should be fully transparent regarding both the design of the CAC and the scope of debt that it will cover. The relevant prospectus should highlight the voting procedures included in the CAC.

54. To ensure high participation, it is important that the sovereign provide creditors with adequate information prior to making a restructuring offer. Accordingly, to the extent that creditors require the CAC to include specific information covenants, it is appropriate that the CAC include such covenants, provided that they are consistent with Fund policy and are drafted so as to minimize the risk of unintended litigation. The information covenant set forth in the CAC under the ICMA Model Clauses is, in the staff's view, appropriately designed.

Potential Benefits

55. In the staff's view, the above-described features of CACs provide sufficient flexibility to support all forms of debt restructuring, including upfront debt reductions and reprofiling. Specifically, in circumstances where there is an upfront debt reduction, a single limb voting procedure could be utilized to restructure the entire stock of debt, as long as all affected bondholders are offered the same instrument or an identical menu of instruments. However, in cases where it is considered appropriate to offer a different menu of instruments to different creditors, an alternative approach can be used. For instance, in the context of a reprofiling, if an issuer offers to extend the maturities of all affected instruments for a given period of time, this will likely result in bondholders of different series being offered different instruments. By way of illustration, if the issuer offers to extend the maturities of all affected bondholders for three years, a holder of a one-year instrument (remaining maturity) would be offered a four-year instrument, while a holder of a three-year instrument would be offered a six-year instrument. In such cases, a single limb voting procedure cannot be used since the "uniformly applicable" requirement would not be

met. However, an issuer could still use the single limb voting procedure on a sub-aggregated basis by “pooling” different series of bonds and then aggregating the vote within these pooled series. Thus, for example, a group of bondholders holding maturities of 1-2 years could be placed in the same voting pool and offered an instrument of 5 years, while holders of instruments with maturities of 2-4 years could be placed in a voting pool and offered an instrument of 7 years. In such cases, within each pool, the uniformly applicable requirement would be met. Issuers could also choose to use a two limb voting procedure, or the traditional series-by-series voting procedure, in the case where it is considered desirable to differentiate not only among different pools of issuances but also among different bond issuances.

PROMOTING CONTRACT REFORM AND NAVIGATING THE TRANSITION

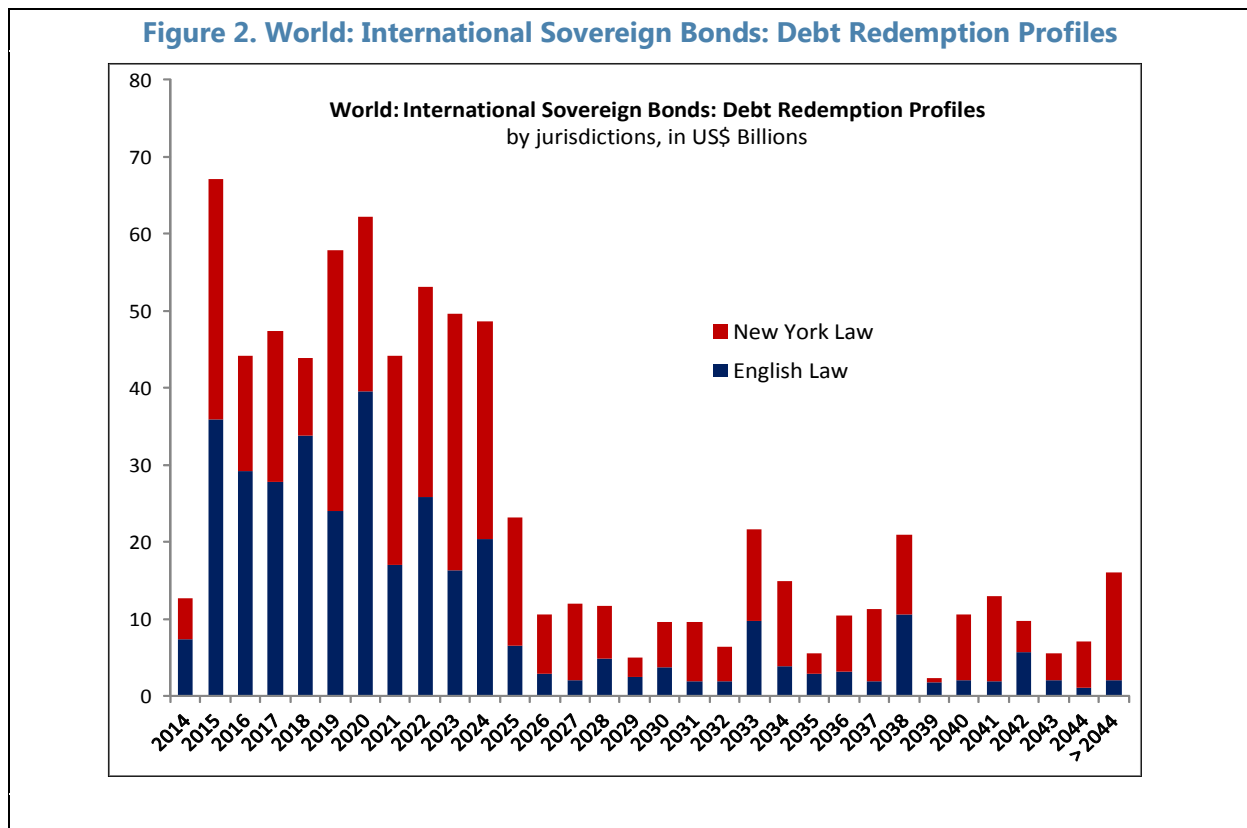
56. What role can the Fund play in promoting the inclusion of the proposed contractual provisions described in the previous sections of the paper in new international sovereign bond issuances? With respect to an amended *pari passu* clause, the fact that issuers have already begun to issue bonds with such clauses—with no apparent adverse effects on pricing—suggests that promoting the widespread adoption of these modified clauses may be relatively straightforward. However, with respect to the adoption of CACs that include a single limb voting procedure, since such clauses have not yet been used in any existing bonds, the process may be more complex—notwithstanding the fact that the consultation process to date suggests strong support for such a voting procedure among issuers and creditors.

57. It is proposed that the Fund would encourage the introduction of the modified *pari passu* clause and proposed CAC, using a three-pronged approach:

- *Collect information.* Staff would continue to gather detailed information on the stock of existing international sovereign bonds, including CACs and *pari passu* clauses, residual maturities (as this determines the lifespan of the existing debt stock that does not contain modified *pari passu* clauses and proposed CACs), and the authorities’ intentions regarding future issuances. Such information gathering would raise awareness among the membership and could take the form of periodic surveys of public debt managers.
- *Engage with the membership.* Staff would promote—and participate in—dialogue with member countries on the merits of the proposed contractual provisions in various fora, including the Fund’s annual Public Debt Management Forum—which gathers together public debt management experts, including senior government debt managers, public debt policymakers, central bank officials, academics and the private sector. Meetings of the IMFC and the G-20 would also be an opportunity to encourage active consideration of the reforms in the contractual framework to address collective action problems.

- *Inform the Board and the public.* Staff would provide periodic progress reports to the Board, based on updated surveys, with respect to the status of sovereign issuers' inclusion of the proposed contractual provisions in international sovereign bonds, with the expectation that such reports would be published. The first progress report could be issued within six months after the Board's consideration of this paper.

58. Even if the Fund is successful in promoting the inclusion of the proposed contractual provisions in new international sovereign bond issuances, this will not affect the existing stock. The value of the current stock of international sovereign bonds currently outstanding is approximately \$900 billion.⁴⁴ Approximately 71 percent of this total stock will mature within ten years, while 29 percent matures beyond this ten year period (see Figures 2 and 3).⁴⁵ For those bonds governed by New York law—where the risks are more acute given the New York Court Decisions—approximately 39 percent will mature after ten years.



⁴⁴There is no single or complete source for data on outstanding international sovereign bonds and their breakdown as to jurisdiction of issuance. To estimate the total amount of international sovereign bonds outstanding and the amounts outstanding in key jurisdictions, staff has relied on the Bloomberg and Dealogic databases, which may be subject to inaccuracies.

⁴⁵ Staff surveyed 21 emerging market economies with international bond outstanding in the amount of approximately \$500 billion. Of these bonds, approximately two-thirds are issued under New York law and approximately a third under English law, with those issued under other jurisdictions only a very small percentage. For purposes of the survey, staff relied on data from national sources, as well as Bloomberg and Dealogic databases.

Figure 3. Maturities of Outstanding International Sovereign Bonds

Share of outstanding international bonds that will mature in:
(Cumulative; in percent)

	<i>New York Law</i>	<i>English Law</i>	<i>Total</i>
3 years	17.1%	28.5%	24.0%
5 years	27.7%	45.0%	39.3%
7 years	39.7%	61.0%	53.0%
10 years	61.0%	78.8%	71.3%
>10 years	39.0%	21.2%	28.7%

Sources: National authorities, Bloomberg, Dealogic and IMF staff calculations.

59. As discussed in the second section of this paper, the extent to which the existing stock of debt will undermine the debt restructuring process will depend, in large part, on how courts interpret *pari passu* clauses in future litigation. In particular, if the New York Court Decisions are interpreted broadly, there is a significant risk that the restructuring process will be undermined by these clauses. If, however, the New York Court Decisions are interpreted more narrowly, the risks will be mitigated. As discussed, much will depend on (a) the weight that is given to the contractual analysis set forth in the Second Circuit decision and (b) how the “course of conduct” standard is applied.

60. While it is unlikely that the existing uncertainty regarding the existing stock can be addressed in the immediate future by promoting the accelerated turn-over of this debt, such an approach may become more feasible over time. In light of the significant amount of time during which much of the current stock will be outstanding, one approach would be to encourage issuers to accelerate the turn-over through liability management operations, including bond buybacks and bond swaps (exchanges) whereby sovereign issuers would exchange their existing stock of international sovereign bonds for newly issued bonds with the proposed contractual provisions. However, the consultation with issuers and the market indicates that such an approach is likely not feasible, at least in the near term. Bond holdings are widely dispersed, making a voluntary exchange impractical and potentially costly for the issuer, who would need to bear the administrative cost and provide an upside to investors to induce them to participate. Achieving high participation, even if the current stock includes series-by-series voting CACs, would likely be a challenge. Moreover, sovereign issuers expressed concern about the signal that such an operation would send regarding their own vulnerabilities. At the same time, consultations reveal that the appetite for this approach may increase over time if: (a) the modified *pari passu* and proposed CACs have been successfully introduced into the market without any adverse pricing impact and (b) it becomes clear that the New York Court Decisions are being interpreted broadly and, accordingly, the outstanding stock creates a serious risk for the restructuring process. In that event, a concerted liability management exercise could be considered, provided that it is managed in a way to address

the first mover problem and is accepted as an exercise designed to benefit both issuers and creditors.

61. In the event that future courts interpret the New York Court Decisions broadly and in a manner that seriously undermines the restructuring process, consideration could also be given to addressing the outstanding stock problem through legislative action – which has already been proposed by some observers.⁴⁶ The remedy fashioned by the New York Court Decisions, which requires Argentina to make ratable payments to holdout creditors, has been considered by the U.S. authorities and others as contrary to the FSIA. The FSIA protects sovereign assets from attachment, arrest and execution, except to the extent specifically provided for by the statute.⁴⁷ Under the FSIA, sovereign property located outside the U.S. falls outside a U.S. court’s enforcement authority. The U.S. authorities have expressed concern that, since Argentina uses funds located outside the U.S. to make payments on its restructured bonds, any injunction that restrains the use of such funds to pay the restructured bonds contravenes the FSIA, as it restrains a sovereign’s use of property that the FSIA expressly provides is immune from attachment, arrest and execution. As stated in the U.S. brief, “the courts are not permitted to achieve by injunction what they are prohibited from doing in the exercise of their limited execution authority under the FSIA.”⁴⁸

62. Accordingly, if the New York Court Decisions are interpreted broadly, one way of addressing these issues would be to clarify the FSIA in a manner that makes it explicit that an injunctive remedy requiring ratable payments could not limit a sovereign’s use of assets that are otherwise beyond the scope of the execution authority permitted by the FSIA. Such a clarification would limit the impact of a broad interpretation of the *pari passu* clauses contained in the existing stock of bonds governed by New York law, since it would mean that the injunction could only apply to the use of assets not otherwise immune under the FSIA (i.e., assets within the U.S. used for commercial activity).

63. In the immediate future, while there is still some uncertainty regarding the magnitude of risk presented by the existing stock, it will be necessary to design restructurings in a manner that minimizes the concerns raised by the New York Court Decisions. In particular, creditors may not be willing to participate in a future restructuring unless they have assurances that the stream of payments owed to them under the restructured debt is not vulnerable to interruption by actions taken by holdout creditors that are similar to those used by the holdout creditors in the case of Argentina. While it would not be appropriate for the Fund to prescribe how this should be achieved, the Fund will, itself, want some assurances that this can be achieved so as to ensure that there is a sufficiently high participation rate in future debt restructuring.

⁴⁶ See for example letter from the Centre for Economic and Policy Research (CEPR) calling on the U.S. Congress to mitigate the fallout from the New York Court Decisions debt (July 31, 2014) (<http://www.cepr.net/index.php/press-releases/press-releases/economists-call-on-congress-to-mitigate-fallout-from-ruling-on-argentine-debt>).

⁴⁷ See 28 U.S.C. §§ 1609-1611.

⁴⁸ Brief for the United States as *Amicus Curiae* in Support of Reversal, *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012) (No. 12-105-cv(L)), 2012 WL 1150791.

ISSUES FOR DISCUSSION

- Do Directors support staff's proposal to support the widespread use of modified *pari passu* clauses in line with the ICMA Model Clauses in international sovereign bonds to enhance legal certainty and consistency across jurisdictions?
- Do Directors agree that the key design features of the CAC framework described in paragraphs 49-54 could address collective action problems more effectively while affording adequate safeguards for creditors' rights?
- Do Directors support the role proposed for the Fund in encouraging the inclusion of the proposed contractual clauses in international sovereign bonds?

Annex I. Recent History of *Pari Passu* Clauses in New York Law-Governed Sovereign Debt¹

ORIGINS OF THE *PARI PASSU* CLAUSE

1. ***Pari passu* clauses are commonly included in unsecured cross-border corporate and international sovereign debt agreements.** Originating in the corporate context, *pari passu* clauses have been used in international sovereign debt agreements (loans and bond issuances) at least since the early 1900s, and are now ubiquitous in both. Literally translated, "*pari passu*" is a Latin phrase meaning "in equal step" or "equally". As a contract clause, its meaning depends both on the specific language agreed upon between the contracting parties, and the governing law under which it is interpreted.
2. **In the corporate context, the meaning of the typical *pari passu* clause is well-settled.** Where a statutory insolvency regime is available – for example, for corporate entities – the *pari passu* clause ensures that in the event of liquidation the debt in question will have the same priority in the hierarchy of claims as the debtor's other unsecured and unsubordinated debt to which it applies. Thus, all claims subject to a *pari passu* clause will receive a similar ratable share of the insolvent entity's assets upon distribution.² In this context, the *pari passu* clause is not generally believed to affect the payment of unsecured indebtedness prior to the debtor's insolvency (which is determined by contractual maturities).

PARI PASSU CLAUSES IN SOVEREIGN DEBT AGREEMENTS

3. **The meaning of *pari passu* clauses in sovereign debt is less clear than in corporate debt.** As there is no equivalent statutory insolvency regime for sovereigns - indeed, a sovereign cannot be "liquidated" and its assets distributed to its creditors in the same way as a corporate entity - the meaning of *pari passu* clauses in sovereign debt agreements is less clear.

¹ This Annex focuses on the interpretation of *pari passu* clauses in sovereign debt agreements governed by New York law. *Pari passu* clauses are also found in sovereign debt agreements governed by other laws, including English law, which is discussed in more detail in the main paper.

² This mainly protects the creditor against involuntary legal subordination, which can occur under the laws of some countries (for example, in Spain and the Philippines, the act of notarizing a debt in a public instrument will render it legally senior to any other debts which have not been so notarized). Legal subordination under U.S. law would not be possible without the lender's consent.

A. The “Ranking” Interpretation

4. **Until the late 1990s, the prevailing view was that the typical *pari passu* clause in sovereign debt agreements protected only the legal ranking of a sovereign’s creditors.** Under the narrower, “ranking” interpretation, the typical *pari passu* clause was thought to protect only the legal ranking of a sovereign’s unsecured and unsubordinated external debt.³ A sovereign could affect the legal ranking of such creditor claims, for example, by (i) earmarking government revenues or by allocating foreign currency reserves to a single creditor, (ii) adopting legal measures that would have the effect of preferring one set of creditors over others,⁴ or (iii) allowing creditors to obtain priority without the consent of other creditors. Under the “ranking” interpretation, the *pari passu* clause is understood to protect against acts of legal subordination of one creditor’s claims in favor of other equally ranked creditors, but not to have a bearing on the timing of payments or to require “ratable” payments.

B. The “Ratable Payment” Interpretation

5. **Beginning in the late 1990s, an alternative interpretation of the *pari passu* clause as requiring “ratable payment” to creditors surfaced in litigation against sovereign debtors.** Under this broader, “ratable payment” interpretation, the clause not only protected legal rank but also included a payment obligation that required the sovereign to pay its creditors on a ratable basis. While this interpretation would not preclude a sovereign from contracting debts with different repayment profiles, the implication was that if the sovereign were unable to pay all of its debts in full as they became due and payable, it would need to pay such debts on a ratable basis. However, the absence of a formal “point of insolvency” for sovereigns, and the lack of any objectively identifiable limit on a sovereign’s ability to pay, has made it more difficult to interpret what “ratable payment” means in the sovereign context.

6. **The “ratable payment” interpretation first gained ground in the litigation brought by Elliott Associates against Peru.** In June 2000, Elliott Associates, an investor in distressed debt, obtained a judgment from the New York courts in respect of certain defaulted bank loans guaranteed by Peru.⁵ Following several unsuccessful attempts to enforce its judgment against Peru, Elliott attempted, in September 2000, to target an interest payment due on Peru’s restructured

³ “External Debt” will be defined in the relevant agreement and generally includes all foreign-currency denominated debt with limited exceptions (e.g. for debt placed locally and certain short term debts such as T-bills).

⁴ See footnote 2, above.

⁵ *Elliott Associates L.P. v Banco de la Nacion*, 2000 WL 1449862 (SDNY Sept 29 2000) (amending judgment).

Brady Bonds by seeking injunctions against Peru and third parties involved in the payment chain. Elliott, which had not participated in Peru's Brady Bond restructuring, sought an order from the Belgian courts to prevent Morgan Guaranty Trust Company of New York, as operator of the Euroclear System (which held bondholder accounts to which the payments would be credited), from processing payments from Peru to the restructured Brady Bondholders.⁶

7. **In the litigation against Peru, Elliott's interpretation of the *pari passu* clause⁷ as requiring "ratable payments" to similarly-situated, unsecured creditors was adopted *ex parte* by a Belgian court.** While a lower court in Belgium denied Elliott's application for relief, the Brussels Court of Appeal —on an *ex parte* basis⁸ — granted the temporary restraining order against Euroclear, for purposes of the application accepting the argument advanced by Elliott that the *pari passu* clause in its bank debt not only prevented Peru from legally subordinating its claims, but also prohibited it from paying other creditors without making a ratable payment to Elliott. Notably, the court had before it a declaration by Professor Andreas Lowenfeld of New York University Law School that supported the "ratable payment" remedy sought by Elliott.⁹ While a hearing on Peru's motion to vacate the order granted by the Brussels court was scheduled, Peru decided to settle with Elliott before the hearing, presumably to avoid risking a default on its Brady bonds.

8. **The *ex parte* Brussels court decision and the Lowenfeld Declaration opened a debate over the proper scope of the *pari passu* clause.** Notwithstanding that these decisions were granted *ex parte* and were limited to enforcement (and not determination of liability) for a debt

⁶ Elliott also sought and obtained *ex parte* orders freezing any funds held or received in relation to payment on Peru's Brady bonds by Chase Manhattan Bank (as fiscal agent for the Brady Bonds), the Bank of New York (as cash correspondent for Euroclear), Morgan Guaranty Trust Co (as operator of Euroclear), and the Depository Trust Company. However, these restraining notices were subsequently vacated.

⁷ The *pari passu* clause, which was included in Peru's guarantee of the commercial bank loans at issue read as follows: "The obligations of [Peru] hereunder do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of [Peru], and interest thereon".

⁸ In an *ex parte* procedure, the defendant is not notified of the claim against it or heard by the court before the decision is reached.

⁹ Declaration in *Elliott Associates., L.P. v Banco de la Nacion*, 194 F.R.D. 116 (S.D.N.Y. 2000) (No. 96 Civ. 7916 (RWS)). In his Declaration, Lowenfeld stated: "I have no difficulty in understanding what the *pari passu* clause means: it means what it says – a given debt will rank equally with other debt of the borrower, whether that borrower is an individual, a company, or a sovereign state. A borrower from Tom, Dick and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If there is not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis...if the borrower proposed to pay Tom \$20,000 in full satisfaction, Dick \$10,000 and Harry nothing, a court could and should issue an injunction at the behest of Harry. The injunction would run in the first instance against the borrower, but I believe (putting jurisdictional considerations aside) to Tom and Dick as well".

governed by New York law¹⁰, by granting a remedy on the basis of the “ratable payment” interpretation of the *pari passu* clause, the Brussels court decision generated interest in the use of the *pari passu* clause as a mechanism for the enforcement of claims against sovereign debtors. This prompted a debate over the correct scope of the *pari passu* clause in sovereign debt agreements.

9. **The litigation against Peru also spawned “copycat” claims by distressed debt funds seeking to rely on the “ratable payment” interpretation.** In *LNC Investments v Nicaragua and Euroclear* (1999), LNC Investments alleged that the *pari passu* clause in Nicaragua’s defaulted debt entitled it to a proportionate share of any payments made by Nicaragua through Euroclear on its restructured debt. While a lower court in Brussels accepted LNC’s argument, this decision was overturned on appeal on the grounds that Euroclear was not a party to the contract that contained the relevant *pari passu* clause. Belgium subsequently amended its legislation to eliminate similar interference with principal and interest payments paid through Euroclear and other cash intermediaries.¹¹ In *Red Mountain Finance v Democratic Republic of Congo* (2001), the California courts denied Red Mountain’s motion for a ratable payment based on the DRC’s *pari passu* clause, but relying on its inherent equitable powers to aid enforcement of its judgments, entered an injunction against the DRC which had a similar effect.¹²

10. **Argentina attempted to obtain a ruling in 2003 on the proper interpretation to be given to its *pari passu* clause.** In December 2001, Argentina defaulted on approximately \$92 billion in principal amount of its external debt. In order to lay the groundwork for its anticipated exchange offer, Argentina filed a motion in late 2003 seeking an order precluding certain plaintiff judgment creditors from interfering with payments to other creditors on the ground that its payments to such creditors would violate the *pari passu* clause in its defaulted debt. One such

¹⁰ The Brussels court relied on the *pari passu* clause to award temporary relief until the parties could be heard on the merits of Elliott’s application to enforce a money judgment that had been awarded on separate grounds (i.e. non-payment under the New York law-governed bonds). Neither the New York courts nor Lowenfeld had been called upon to interpret the *pari passu* clause in the New York litigation, nor to determine whether it had been breached.

¹¹ *LNC Invs. LLC v Republic of Nicaragua & Euroclear S.A*, No. 2003/KR/334 (Court of Appeals of Brussels, 9th Chamber, Mar. 19 2004). In Belgium, the settlement finality law was amended in 2004 to expressly protect Euroclear and other Belgian or foreign credit institutions acting as cash correspondents from any injunction that could attach or otherwise block a cash settlement account or any cash transfer to be credited to such an account (Article 9 of the Belgian Act of April 28, 1999 implementing the EU Settlement Finality Directive, as amended by Article 15 of the Law of November 19, 2004 and subsequent legislation). Likewise, Luxembourgian law prohibits the enforcement of an injunction against funds passing through Clearstream. Article 15 of the Luxembourg Securities Act states that “neither an attachment of, nor an enforcement against, nor a conservatory measure with respect to accounts to which securities accounts in the securities settlement system are booked are permitted.”

¹² *Red Mountain Finance v Democratic Republic of Congo*, Case No. CV 00-0164, United States District Court – Central District of California, Los Angeles Division. 2001.

creditor, EM Limited, took the position that it had not yet formed a view, and that there was therefore no justiciable controversy. NML submitted a letter to the court agreeing there was not yet a justiciable *pari passu* issue, but requesting an opportunity to participate in any litigation on the question that might be forthcoming. NML explained that its interpretation of the clause was different from that offered by Argentina, and that in its view the clause prohibited Argentina from voluntarily paying one creditor holding its external debt unless it made ratable payments to similarly situated creditors.

11. The United States supported both Argentina’s effort to obtain a ruling, and its interpretation of the *pari passu* provision. In a Statement of Interest filed with the court, the United States supported Argentina’s position on the merits:

“Creditors, debtors, and international financial institutions alike share a common understanding that sovereign payment crises will be resolved through the consensual, good-faith process leading to a restructuring of debt, in conjunction with the adoption by the debtor country of economic reform, often under the auspices of, and with financial support from, multilateral lenders such as the IMF. These parties also recognize that creditors remain free to enforce their contracts in court. A novel reading of the *pari passu* clause, however, that would prohibit sovereign debtors from making payments to third-party creditors or require sovereign debtors to make simultaneous, ratable payments to all creditors would undermine this well-understood established framework as well as do damage to settled market expectations.”¹³

The district court ultimately determined that the issue was not yet ready for adjudication.

12. The meaning of the typical boilerplate *pari passu* clause in sovereign debt, and the proper remedy to be awarded for its breach, has been the subject of considerable commentary. Contemporaneously with and following Argentina’s effort to resolve the *pari passu* issue, academic and market commentators have addressed the issue frequently and at length. Eventually, as a review of the annexed list of references will confirm, a substantial body of literature addressing the meaning of the typical *pari passu* clauses, and the remedy to be awarded for its breach, was developed. While a handful of commentators have supported the interpretation offered by NML, the majority have supported the view that the typical *pari passu* clause does not require ratable payments, noting that this is consistent with the market understanding of the clause.

¹³ Statement of Interest of the United States at 11, *Macrotecnic Int’l Corp. v. Republic of Argentina*, No. 2002 Civ. 5932 (TPG). (S.D.N.Y. Jan. 12, 2004), 2004 WL 5475206.

NML V ARGENTINA – THE NEW YORK COURT DECISIONS

13. **The New York courts recently adopted the “ratable payment” theory of the *pari passu* clause in the litigation between NML Capital and the Republic of Argentina.** As discussed in Section II of the main paper, the New York courts have recently applied the ratable payment theory to the *pari passu* clause in Argentina’s defaulted bonds. As indicated in that case, the New York courts determined that Argentina had breached the *pari passu* clause in the debt held by the holdout plaintiffs, and fashioned a remedy that prohibited Argentina from making payments to its restructured bondholders without making a “ratable” payment to the plaintiffs.

A. Liability under the *Pari Passu* Clause

14. **The District Court interpreted Argentina’s *pari passu* clause as requiring equal ranking of payment obligations under the relevant debts.** The District Court, the court of first instance in that case, interpreted the particular *pari passu* clause in Argentina’s bonds as requiring it “*at all times to rank its payment obligations pursuant to NML’s Bonds at least equally with all the Republic’s other present and future unsecured and unsubordinated External Indebtedness*”. The court held that Argentina violates this clause whenever it lowers the rank of its payment obligations under NML’s Bonds, “*including (and without limitation) by relegating NML’s bonds to a non-paying class*” by either: (1) failing to make the payments currently due to the holdout creditors while at the same time making payments currently due to its restructured bondholders or (2) legislative enactment.¹⁴

15. **The District Court found that Argentina had lowered the rank of its defaulted debt, and thereby breached the *pari passu* clause, through each of two courses of conduct.** In the first place, the District Court found that Argentina violated the clause by making payments currently due under the restructured bonds, while “*persisting in its refusal to satisfy its payment obligations currently due under NML’s Bonds*”. Secondly, and consistent with the court’s interpretation of the clause discussed above, it held that Argentina violated the clause by enacting laws (the so-called “Lock Law” and “Lock Suspension Law”) that prohibited it from reaching a settlement with the holdout creditors or offering them better terms than those offered to the restructured bondholders.¹⁵

¹⁴ See *NML Capital, Ltd. v Republic of Argentina* (S.D.N.Y. Dec. 7 2011), at paragraph 4.

¹⁵ See *NML Capital, Ltd. v Republic of Argentina* (S.D.N.Y. Dec. 7 2011), at paragraphs 5 and 6.

16. **On appeal from the District Court’s ruling, the Second Circuit concluded that the *pari passu* clause in Argentina’s defaulted bonds included two distinct obligations.** Specifically, the Court identified two distinct obligations based on the two sentences of the clause:

“The first sentence....prohibits Argentina, as bond *issuer*, from formally subordinating the bonds by issuing superior debt. The second sentence... prohibits Argentina, as bond *payor*, from paying on other bonds without paying on the [defaulted] Bonds. Thus the two sentences of the *Pari Passu* Clause protect against different forms of discrimination: the issuance of other superior debt (first sentence) and the giving of priority to other payment obligations (second sentence)”.

17. **Affirming the District Court’s decision, the Second Circuit stated that Argentina’s “course of conduct” breached the *pari passu* clause.** The Second Circuit specifically declined to decide whether the clause was breached through “*any* non-payment” by Argentina on its defaulted bonds whilst continuing to make payment on its other unsecured and unsubordinated external debt. Rather, it simply affirmed the District Court’s decision that Argentina’s “course of conduct” had breached the *pari passu* clause.¹⁶

B. Remedy for Breach of the *Pari Passu* Clause

18. **Instead of providing for the contract remedy of acceleration or a monetary reward for the breach, the District Court granted injunctive relief, preventing Argentina from making payments to the restructured bondholders without first making a “ratable payment” to the holdout creditors.** The breach of a *pari passu* clause constitutes an event of default under the relevant debt agreement, giving the bondholders the right to “accelerate” all payments of interest and principal due thereunder. However, rather than seeking monetary damages from the court for Argentina’s breach of contract, NML sought an order for specific performance and/or injunctive relief to remedy the harm.¹⁷ The District Court, finding in favor of NML, exercised its equitable powers to: (1) require Argentina to perform its obligations to make a “ratable payment” to the plaintiff holdout creditors prior to or at the same time as it makes its next payment on the restructured bonds and (2) prohibit Argentina from paying the restructured bondholders without first or at the same time making a “ratable payment” to the plaintiff holdout creditors. As a means of enforcing its order, the New York courts effectively barred the bond trustee and other parties in the

¹⁶ See *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246, 264 n. 16 (2d Cir. 2012).

¹⁷ In the common law tradition (for example, in the U.S. and England), courts may grant “equitable remedies” where legal remedies are not adequate to address the harm suffered by the plaintiff. Injunctive relief is an equitable remedy that requires a party to take or refrain from taking a specified action. Specific performance is a form of injunctive relief that requires the party to take the specific action required under the relevant contractual provision that has been breached.

payment chain from facilitating any payment on the restructured bonds unless payment was also made to the holdout creditors.¹⁸

19. **The District Court defined “ratable” payment to require payment in full to the holdout creditors when Argentina made its next coupon payment on the exchange bonds.** The District Court defined “ratable” payment to mean that if Argentina pays 100% of the amount *currently due* to the restructured bondholders (i.e., the periodic coupon payment), it must also pay 100% of the amount *currently due* to the litigating holdout creditors (i.e., all past due principal and interest). The court thus dismissed an alternative calculation of “ratable payment”, contemplated by the Second Circuit, whereby the payment ratio would reflect the amount currently due to restructured bondholders as a share of the total amount due to them (i.e. if the periodic coupon payment represents 1% of the total value of the restructured bonds, Argentina would only need to pay 1% of the amount currently due to the holdout creditors).

20. **On appeal, the Second Circuit affirmed the orders, holding that the District Court had not abused its discretion in exercising its equitable powers.** In particular, the court referred to Argentina’s “*continual disregard*” for the rights of its creditors under the defaulted bonds in its determination that monetary damages would not be an adequate remedy. In several other respects, the court placed reliance on the particular “*manner*” in which Argentina had breached the clause to uphold the lower courts’ injunction.

SOVEREIGN *PARI PASSU* CLAUSES AFTER NML V ARGENTINA

21. **The breadth of the legal precedent created by the New York Court Decisions remains to be determined.** As discussed in the main paper, while certain elements of the New York Court Decisions are potentially far reaching in terms of the impact they may have on the overall sovereign debt restructuring process, other elements are potentially more limiting. On the one hand, the Second Circuit construed the text of a commonly used *pari passu* clause in a way that will make it difficult to limit the precedential meaning of the clause to Argentina. On the other hand, the basis for the Second Circuit’s conclusion that Argentina had actually breached this clause – that is,

¹⁸ In justifying the exercise of its equitable powers to grant injunctive relief, the District Court relied upon Argentina’s persistent failure to make payments to the defaulted bonds, noting for example its “unprecedented, systematic scheme of making payments on other external indebtedness, after repudiating its payment obligations to the Plaintiffs”. More generally, the District Court reasoned that the injunctions served the public interest of enforcing contracts and upholding the rule of law where sovereign creditors have “no recourse to bankruptcy regimes to protect their interest and must rely upon courts to enforce contractual promises”. See *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 06978, Dkt. No. 371 (Feb. 23, 2012) (order granting injunctions).

Argentina’s “course of conduct” - was arguably narrower and more readily limited to the facts of the Argentine case. The ramifications of the New York Court Decisions thus depend on how future courts interpret the Argentine precedent.

22. **What is apparent, however, is that there has been an increase in the use of *pari passu* clauses that may be susceptible to the “ratable payment” interpretation.** The risk that a future court might interpret a *pari passu* clause in the same way as Argentina’s may be influenced by its specific formulation. According to many commentators, the risk is greater where the clause expressly references payment, such as the clause employed by Argentina and Peru. Academic research indicates that since the 1990s, *pari passu* clauses referencing “payment” have become more common, representing the majority of the *pari passu* clauses in international sovereign bonds issued between 2000 and 2013 (See Box). It is also relatively certain that the New York Court Decisions will inspire future copycat litigation – as the recent action filed against Grenada, discussed in the main paper, makes clear.

Box. Taxonomy of Sovereign *Pari Passu* Clauses

According to legal commentators, the *pari passu* clauses that are currently found in international sovereign bonds can be divided into two main categories – those that reference “payment” and those that do not.¹

- Reference to ranking only – The first main category of *pari passu* clauses refer only to the ranking of the issuer’s unsecured and unsubordinated external debt. A typical “ranking” clause might read as follows: “the debt instrument ranks *pari passu* with all of the issuer’s other unsecured and unsubordinated external indebtedness”. (This was the formulation in some of Grenada’s defaulted loans). A modified version of this clause might exempt certain legislative acts by the borrower from the general requirement that unsecured debts be ranked equally (“mandatory exemption” clauses).
- Reference to ranking and payment – The second main category of *pari passu* clauses includes a reference to the ranking of payments. There are two principal formulations:
 - Single sentence – “The Bonds rank, and will rank, *pari passu* in right of payment with all of the Issuer’s present and future unsubordinated External Indebtedness”. (This was the formulation in Peru’s defaulted debt contracts, as well as some of Grenada’s defaulted loans).
 - Two sentences – “The Bonds will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Issuer and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Issuer under the Bonds shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.” (This was the formulation in Argentina’s defaulted bonds).
- A less frequent formulation of a “payment” *pari passu* clause includes an explicit promise of equal payment e.g. that the bonds “rank *pari passu* in right of payment and shall be paid as such.”

1/ A typical *pari passu* clause in a loan agreement might provide that “The [payment] obligations of the borrower under this Agreement rank at least *pari passu* with all its other present and future unsecured obligations”.

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