Collective Action Clauses in International Sovereign Bonds

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In his presentation on the history of the sovereign debt restructuring, Mr. Fisher focused on the collective action problems under the existing framework. I would like to discuss briefly the legal features of collective action clauses found in outstanding international sovereign bonds that enable a qualified majority of bondholders to restrain the ability of a minority of bondholders to undermine the restructuring process so as to provide a degree of order and predictability to the restructuring process. I will also discuss recent proposals to introduce new bond provisions that are designed to address inter-creditor equity concerns and to help facilitate communications and negotiations between the sovereign debtor and its creditors.

International Sovereign Bonds

Sovereign bonds are bonds issued or guaranteed by the state or the central bank. A bond is considered international if it is governed by a law other than the law of the issuer and gives a foreign court jurisdiction over any claims that may arise under the bond. Most international sovereign bonds issued by emerging market economies are governed by the laws of either New York or England. A large number of international sovereign bonds are governed by Japanese law and by German law.

International sovereign bonds are typically issued under fiscal agency agreements or trust structures.[2] The legal effect of the fiscal agency and trust structures is quite

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different. Under a fiscal agency agreement, the fiscal agent is appointed by, and is an agent of, the issuer. The agreement typically specifies that the fiscal agent has no relationship of agency or trust for or with the bondholders and does not owe the bondholders any duty of care. The main function of the fiscal agent is to make principal and interest payments to the bondholders. He may also perform, on the issuer's behalf, certain administrative functions including the publication of notices to the bondholders and acting as a depositary for the issuer's accounts.

A trust deed or trust indenture is a contract between an issuer of the bonds and a trustee made for the benefit of the bondholders. The trustee represents the interests of bondholders and owes fiduciary obligations to the bondholders as a group. The trust deed vests in the trustee certain powers and duties to enforce the issuer's obligations and bondholders' rights. For example, in the event of default, the trustee has primary responsibility for enforcing the remedial provisions of the contract. As a matter of practice, trustees are often used when the transaction is more complicated or involves the use of collateral. In addition, if the bond is to be listed, the stock exchange may require a trustee to be appointed.[3] Because the trust structure tends to be more expensive than the fiscal agency arrangement, Most international sovereign bonds governed by New York and English law are issued under fiscal agency agreements. There is, however, no legal bar in the United States and United Kingdom to the use of trustees by sovereign debtors.

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[2] Trust deeds are used in connection with bonds governed by English law while trust indentures are used in connection with bonds governed by New York law.

[3] For example, the London Stock Exchange generally requires the appointment of a trustee to represent the holders of the listed debt securities. See Yellow Book, paragraph 13.12.

Trust arrangements are a concept peculiar to common law jurisdiction and are not usually recognized by civil law jurisdictions.[4] Many civil jurisdictions have developed devices other than the trust to represent the bondholders as a group. For example, the Japanese Commercial Code provides for the establishment of a commissioned company for bondholders to represent bondholders as a group.

Collective Action Clauses

Collective action clauses found in existing international sovereign bonds are designed to help address the free rider problems that arise when a minority of creditors seek to take advantage of the forbearance of others that are more willing to reach a restructuring agreement with the debtor. The majority may be unwilling to agree to a restructuring if they fear that the minority bondholders who hold out will derail the restructuring process or press for repayment on the original terms following restructuring. Even if the risk of holdouts does not prohibit the debtor and other creditors from reaching a deal, holdouts can also seek to litigate to stop payments on the new bond that emerges from the restructuring.[5]

Collective action clauses can be classified into two general categories. The first type consists of "majority restructuring provisions", which enable a qualified majority of an issuance to bind all bondholders of that issuance to a modification of key financial terms either before or after a default. The second type can be described as "majority enforcement provisions", which enable a qualified majority of bondholders to limit the

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[4] See, e.g., Albert S. Pergam, *Eurobonds: Trustees, Fiscal Agents and the Treatment of Default,* in Adapt ion and Renegotiation of Contracts in International Trade and Finance (N. Horn ed. 1985), p. 338.

[5] For example, the recent success of the litigation strategy employed by Elliott Associates against Peru illustrates the considerable leverage that a creditor can exercise on a sovereign debtor. Elliott Associates who had held out when the debt was restructured into Brady bonds was able to pressure Peru into satisfying its claim in full by taking legal measures that forced Peru to settle in order to avoid default on the Brady bond payments.

ability of a minority of bondholders within the same issue to enforce their rights once a default has occurred, thereby providing a useful brake on disorderly behavior of a minority while the sovereign debtor is negotiating in good faith with its creditors. As will be discussed later, majority enforcement provisions can be enhanced by using a trust structure where the rights of individual bondholders to initiate legal proceedings upon an event of default are, subject to certain conditions, conferred upon the trustee and any litigation proceeds recovered by the trustee are distributed *pro rata* among all bondholders.

Majority Restructuring Provisions

In the late 1870s, majority restructuring provisions were introduced to corporate bonds and related trust deeds governed by English law when it became apparent that a minority of holdout creditors could take disruptive action in the hope of obtaining more favorable terms at the expense of the issuer and the other creditors.[6] Due to the lack of a bankruptcy process comparable to Chapter 11 in the United States, unanimity requirements for modifying payment terms contained in those bonds enabled an uncooperative minority to force a financially-distressed debtor to liquidate even when a majority of bondholders preferred a debt restructuring. To reduce such a minority's leverage, contractual provisions were introduced in the London market to allow a qualified majority to modify payment terms and to bind all bondholders within the same issue to the new terms. Such majority restructuring provisions became the market standard for sovereign bonds governed by English law.[7]

[6] Lee C. Buchheit and G. Mitu Gulati, *Sovereign Bonds and the Collective Will,* Working Paper No. 34, March 2002, Georgetown University Law Center, Washington, DC 2001, p.5.
[7] Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses,* Fin. Stability Rev. (June 2000) 142, 145.

Main Features. Although the design of majority restructuring provisions vary among bonds governed by different laws, they generally share a number of features. The issuer generally has the right to call a bondholders' meeting during which it may propose a restructuring of the bond terms. Bondholders with a specified percentage of outstanding principal (typically around 10 percent) may request the trustee or fiscal agent to call a meeting. If the bonds are issued under trust deeds, the trustee also has the discretion to call a meeting.

Bonds generally require that adequate notice (typically between 20 and 90 days) be given to bondholders about the date, time and location of the meeting and the details of the modification proposal. If the bonds are registered with the trustee or fiscal agent, notices should be mailed to individual bondholders. If the bonds are in bearer form, notice is typically given by publication in the specified financial press twice within a specific number of days before the date of the meeting. Most Eurobonds are now issued in the form of global notes held by custodians so as to eliminate the need for physical delivery of securities on each occasion when the securities are traded. In that case, notice is normally given through the clearing systems such as Euroclear and Clearstream Banking in Europe and The Depositary Trust Company in the United States.

Key bond terms may be modified by a bondholders' meeting only if the quorum requirements are met. Most sovereign bonds require a quorum of two or more persons holding 75 percent of outstanding principal for the first meeting. If the quorum is not achieved, the meeting will be adjourned for a specified period of time. The quorum typically is reduced to bondholders holding 25 percent of outstanding principal for an adjourned meeting. The low quorum requirement for adjourned meetings is, in part, designed to provide an incentive for bondholders to participate in the first meeting where the modification proposal will be considered. In practice, adjourned meetings rarely happen.

If the quorum requirement is met, the meeting will be convened and bondholders would need to vote on the modification proposal. The voting thresholds for modification of key financial terms generally range from two-thirds to three-fourths of the value of the bond issue that is represented at the meeting, not the total value of the outstanding principal. Such a modification decision, once accepted by the required qualified majority of bondholders, is binding on all bondholders within the same issue regardless of whether an individual bondholder was present at the meeting or voted for the change. In order to protect the rights of individual bondholders, some sovereign bonds specifically exclude the bonds held by or for the benefit of the issuer for quorum and voting purposes. This is designed to prevent the issuer from engineering a restructuring that is prejudicial to the interest of individual creditors.

Market Practice. Market practice for international sovereign bond documentation regarding the majority restructuring provisions is not uniform. As noted above, majority restructuring provisions are the market standard for Eurobonds governed by English law. They are also typically found in bonds governed by Japanese law ("Samurai bonds"). Bonds governed by New York and German law generally do not contain these provisions. This considerable variation in the use of majority restructuring provisions in outstanding international sovereign bonds is largely due to market practice rather than the requirements of national laws.

For instance, absence of majority restructuring provisions in bonds governed by New York law has arisen out of practice which owes much to the U.S. corporate bond convention. The U.S. Trust Indenture Act of 1939 ("TIA"), which applies to U.S. publicly issued bonds of corporate borrowers, explicitly precludes any reduction in the amounts due to a bondholder without his consent or any impairment of his right to sue to recover the missed payments.[8] The legislative history of the TIA suggests that Congress and the Securities and Exchange Commission ("SEC") were concerned that majority restructuring provisions would enable corporate insiders to gain control of a bond issue and then reach a deal with the issuer to the detriment of the minority bondholders.[9] The drafters of the TIA preferred any modification of payment terms to occur under the supervision of a bankruptcy judge in order to safeguard the interests of bondholders.

Although the TIA does not apply to foreign sovereign bonds issued in the United States, sovereign bond documentation has, as a matter of practice, generally followed the lead of the TIA by requiring unanimous consent for modifying payment terms. Because U.S. law does not prohibit the use of majority restructuring provisions in any sovereign bond issues, there is no legal or regulatory reason why these bonds could not make use of these provisions. Indeed, there has been at least one case where an international sovereign bond governed by New York law has included majority restructuring provisions.[10]

It is not clear whether international sovereign bonds governed by German law could include majority restructuring provisions without legislative changes. In Germany,

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[8] Section 316(b) of the TIA. Prior to the public issuance of corporate bonds, the governing bond indenture must be qualified under the TIA.
[9] Mark J. Roe, *The Voting Prohibition in Bond Workouts,* 97 Yale L.J. 232, 250-252 (1987).
[10] Electricity Generating Authority of Thailand, U.S.$300,000,000, 7 Percent Guaranteed Bonds Due 2008.

the Act on the Joint Rights of Bondholders of 1899 ("Bondholders Act") provides for a statutory regime for modification of bond terms. The Bondholders Act permits a three-quarter majority of bondholders to reduce or postpone interest payments for up to three years, but does not allow waiver of the bondholder's right to receive principal which is reserved to insolvency proceedings. Because the terms of the Bondholder Act apply by law to all domestic nonsovereign bond issues, they are not restated in the bond documentation.

Like the TIA, the Bondholders Act does not apply to international sovereign bonds governed by German law. It is generally acknowledged that the terms of these bonds may be subject to provisions contained in German Civil Code regarding standard business conditions which are intended to provide for consumer protection. Many German practitioners and market participants point to the risk that a German court may be reluctant to enforce a majority restructuring provision contained in an international sovereign bond because its impairment of the rights of individual bondholders does not meet the standard established in the Civil Code. As there is no court decision directly on point to address this uncertainty, they believe that the validity of majority restructuring provisions can only be assured through the enactment of a new statute.[11] As a result, German law firms have generally been reluctant to issue legal opinions confirming the validity of majority restructuring provisions. This may explain why international sovereign bonds governed by German law do not contain these provisions.

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[11] See, e.g., Michael Gruson and Herbert Harrer, *DM-Denominated Bond Issues by Foreign Issuers in Germany,* 10 Emory Int'l L. Rev. 195, 223-226 (1996).

In February 2000, the German government issued a statement on the validity of collective action clauses in foreign sovereign bonds governed by German law.[12] The statement notes no legal impediments to incorporate collective action clauses into the foreign sovereign bonds issued under German law, provided that the debt restructuring serves to safeguard the joint interests of all creditors. According to the statement, as the Bondholders Act does not apply to foreign sovereign bonds, these bonds are subject to the general principle of freedom of contract and limitations established in the Civil Code. A clause will be void under the Civil Code if it places a bondholder at an undue disadvantage to such an extent as to be incompatible with the principle of good faith. The statement indicates that it is generally acknowledged in legal writing that no undue disadvantage would exist if collective action clauses were modeled on the principles of the Bondholders Act. It further explains that although the Bondholders Act does not permit majority decisions on waiver of principal, which is subject to insolvency proceedings, such decision should be permissible in foreign sovereign bonds because foreign issuers are not subject to German insolvency laws. To date, the statement of the German government has not affected market practice because many practitioners have expressed the view that the statement has no legal force and thus does not resolve the legal uncertainty that currently exists.

Similar to the German legal framework, Japanese Commercial Code also provides for a mandatory regime for the restructuring of corporate bonds governed by Japanese law. The Code allows the inclusion of majority restructuring provisions in the corporate bonds, but any modification of payment terms has to be approved by a court in order to

[12] Bundesministerium der Finanzen, Statement by the Federal Government on the Validity of Collective Action Clauses in Foreign Sovereign Bonds Subject to German Law, Berlin, February 14, 2000.

ensure that the rights of individual creditors have not been abused by any collusion among the issuer and the majority creditors.

The Commercial Code does not apply to Samurai bonds. As a matter of practice, however, Samurai bonds have included majority restructuring provisions contained in the Commercial Code, with the exception that there is no specific reference to the need for judicial approval for modification of payment terms. A minority of bondholders could invoke the "abuse of rights" provision in the Civil Code to challenge a majority decision. So far the majority restructuring provisions have never been used in Samurai bond restructurings and there have been no court rulings on this issue.

Majority Enforcement Provisions

Majority enforcement provisions are designed to limit the ability of an individual bondholder to enforce its rights against the sovereign debtor following a default, thus providing a brake on aggressive litigation by dissident creditors during the period when the debtor and most creditors are negotiating a restructuring agreement. The relevant provisions include acceleration, reversal of acceleration, initiation of legal proceedings and sharing. The rights of bondholders to accelerate the bond and take enforcement actions are different depending on whether the bond is issued under a fiscal agency agreement or a trust deed.

Acceleration. Acceleration is a contractual remedy that allows a creditor to declare the full outstanding amount of the bond due and payable upon occurrence of an event of default. Most of international sovereign bonds normally require a vote of 25 percent of the value of bond issue to accelerate. Allowing a qualified majority to restrain the ability of a small group of bondholders to accelerate is important particularly when an event of default is triggered by the cross-default provision. This provision will help a sovereign that has a number of different outstanding issues to avoid the collapse of its debt structure because of its failure to make payments with respect to a single bond issue.

There are, however, exceptions. Certain sovereign bond issues registered with the SEC (Schedule B issues) that use fiscal agency agreements give each individual bondholder the right to accelerate its own bond, not the entire issue, without limitations. Some sovereign bonds governed by New York law contain both an individual right of acceleration of its own bond and a requirement for a vote of 25 percent of outstanding principal to accelerate the entire issue. Finally, in the case of bond issues using a trust deed or trust indenture, the trustee has the considerable discretion to accelerate the entire issue on behalf of the bondholders in addition to being required to accelerate upon a collective vote.

Reversal of Acceleration. In many international sovereign bonds governed by New York law, bondholders holding a requisite percentage of outstanding principal, typically 50 percent but in some cases 75 percent, may reverse an acceleration of a bond issue if all the events of default have been cured or waived (except payment of amounts due solely by virtue of acceleration). Allowing a majority of bondholders to rescind an acceleration can act as a deterrent against litigation during the negotiation period. In the event that the bondholders who requested the acceleration do not represent the wills of the majority, dissident bondholders may be discouraged from initiating litigation if they are aware that a debtor could gather the support of a majority to reverse the acceleration before a judgment could be obtained.

This mechanism played an important role in discouraging litigation against Ecuador during the recent restructuring of its debt.[13] Following Ecuador's default on its Brady bonds and Eurobonds in 1999, the Discount Bonds were accelerated by bondholders with 25 percent of the outstanding principal of that series. Eleven months later, Ecuador made an offer to exchange its outstanding sovereign bonds for new instruments on the condition that the acceleration of the Discount Bonds would be rescinded. Such a rescission, which required the support of bondholders holding at least 50 percent of that issue, was accomplished at the closing of the exchange offer.

International sovereign bonds governed by English law, German law and Japanese law do not contain a de-acceleration provision. With respect to bonds governed by English law, reversal of acceleration could be achieved through the activation of the majority restructuring provision by changing the maturity date of the bond from the accelerated date back to the original date. Such an amendment would require a special quorum and support of a qualified majority of bondholders.

Initiation of Legal Proceedings. The extent to which the ability of individual bondholders to enforce their rights against the sovereign is limited depends on whether the bond is issued under a fiscal agency agreement or a trustee. For international sovereign bonds issued under a fiscal agency agreement, each bondholder normally has the right to bring enforcement proceedings against the debtor following an event of default to recover the amount that is due and payable. When a trust structure is used, the individual bondholders' rights to institute actions is, subject to certain conditions, effectively delegated to the trustee. Under the English-style trust deeds, the trustee has the power to enforce the instrument. Individual bondholders cannot commence a lawsuit

[13] Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap,* Int'l Fin. L. Rev., Dec. 2000 at 17, 18.

to enforce their rights to principal and interest unless a trustee fails to initiate a proceeding after (i) it is requested to do so by the requisite percentage of bondholders (typically between 20 percent and 25 percent) and (ii) it has received adequate indemnification. Though the trustee has the discretion to initiate proceedings, it rarely does so because of the risks and costs involved.

Unlike an English-style trust deed, the US-style trust indenture gives each bondholder an unqualified right to bring an individual enforcement action against the debtor to recover any principal or interest payments that are not paid to him when due. Only the right of individual bondholders to initiate litigation with respect to the accelerated amounts is delegated to the trustee. This requirement follows the provisions of the TIA though the TIA does not apply to sovereign bonds. Similar to an English-style trust deed, individual bondholders cannot pursue legal remedies unless the trustee, after being instructed by the requisite percentage of bondholders and offered satisfactory indemnification, fails to initiate legal proceedings after a specified period (typically 60 days).

The trust structure effectively enables a qualified majority of bondholders to limit the ability of individual bondholders to pursue litigation either before or after acceleration while they are negotiating a restructuring agreement with the sovereign. In addition to providing temporary protection for the sovereign's assets, such a limitation could enhance the prospects of a successful negotiation. Majority bondholders would be less willing to exercise forbearance and negotiate with the sovereign in an orderly manner if they believe that other bondholders are taking advantage of their forbearance by seizing the limited supply of assets held in foreign jurisdictions by the sovereign.

Sharing. The terms of the trust deed ensure that any amounts recovered by the trustee through legal proceedings are distributed pro rata among all bondholders. As the trustee initiates lawsuits to enforce the instrument on behalf of all bondholders, the proceeds of litigation are for the benefit of the bondholders as a group. This sharing feature helps discourage disruptive litigation by dissident bondholders: even if a bondholder wishing to pursue litigation managed to acquire enough bonds to require the trustee to initiate litigation, the sharing requirement will reduce such bondholder's incentive to do so.

Market Practice. Majority enforcement provisions are commonly found in international sovereign bonds governed by New York and English law. As discussed above, only a small portion of the existing bonds are issued under trust deeds or trust indentures. There is no legal bar in the United States or U.K. to the use of the trust structure by the sovereign issuers. Samurai bonds generally provide that the commissioned company for bondholders accelerates the bond at the request of bondholders holding at least 50 percent of the outstanding principal. This requirement is modeled on the Commercial Code which does not apply to Samurai bonds. Moreover, under the terms of Samurai bonds, the commissioned company for bondholders may initiate legal proceedings to recover payments for bondholders. It is not clear, however, whether a clause limiting individual bondholders' rights to institute lawsuits would be valid under Japanese law. International sovereign bonds governed by German law do not contain majority enforcement provisions. Under the terms of these bonds, each bondholder has the right to accelerate the bond and initiate legal proceedings. There is legal uncertainty as to whether provisions that limit the ability of individual bondholders to enforce their rights could be included in international sovereign bonds governed by German law.

Recent Proposals for New Bond Provisions

In April 2002, John Taylor, Under Secretary of the U.S. Treasury called for a market-oriented approach to making sovereign debt restructuring process more orderly and predictable.[14] Under this approach, sovereign borrowers and their creditors were encouraged to introduce to their debt contracts two new provisions that have not yet been included in existing international sovereign bonds, namely the "engagement clause" and the "initiation clause". These clauses are designed to establish the workout procedures for the sovereign debtor and its creditors to follow in the event of a restructuring. In addition, in an attempt to address collective action problems, there has been some discussion of developing a new clause that would aggregate creditor claims across debt instruments for voting purposes. Feedback from the market regarding these proposals has been limited.

Collective Representation/Engagement Clause

While collective action clauses can facilitate an orderly restructuring by limiting the ability of individual bondholders to disrupt negotiations, they do not establish procedures for negotiation. A debtor seeking to achieve a rapid restructuring with bondholders confronts an immediate obstacle when it sets out to negotiate the restructuring terms: with whom should it negotiate. The presence of a widely dispersed and anonymous community of bondholders makes consultations among the sovereign, bondholders and other creditors practically difficult to achieve. While a sovereign debtor

[14] "Sovereign Debt Restructuring: A U.S. Perspective" remarks by John B. Taylor, Under Secretary of Treasury for International Affairs at the conference "Sovereign Debt Workouts: Hopes and Hazards?", Institute for International Economics, Washington, D.C. April 2, 2002.

can convene a meeting of bondholders for the purposes of requesting them to select a representative that is permitted to negotiate on their behalves, such a move could be time consuming and, from the debtor's perspective, hazardous: once the bondholders meet, they may choose, instead, to take this opportunity to enforce their rights under the bonds. For example, if the debtor has defaulted on one bond issue but wishes to restructure all of its debt, the holders of the bonds that have not yet become due may feel the need to use the opportunity of a bondholders' meeting to vote to accelerate the issue and initiate legal proceedings

The current legal framework does not provide for an adequate procedure for negotiation between the debtor and bondholders. In the case of bonds issued under fiscal agency agreements, the fiscal agent is the agent of the issuer and cannot represent bondholders to negotiate with the debtor. Even if the bond is issued under a trust deed or trust indenture, the trustee is not a useful negotiating counterpart under the terms of the existing bonds. Because of its fiduciary relationship with bondholders, the trustee will be reluctant to discuss a modification of terms that would impair the rights of bondholders without prior authorization from the bondholders, which raises the problems of delay and uncertainty noted above.

Thus, it is important to establish a procedure for bondholders to participate in the discussions with the debtor and other creditors as early as possible in the restructuring negotiations. Such a procedure should benefit both the debtor and bondholders. From the debtor's perspective, it would shortcut the long process of consultation with all bondholders and help achieve a rapid restructuring. From the bondholders' perspective, they would want their voices to be heard at the negotiation table early in the restructuring process. To address this problem, proposals have been made recently to introduce provisions in future bonds that would facilitate the appointment of a party to represent all bondholders in the negotiations. One of the proposals would expressly give the trustee the authority to act as a channel of communication between the debtor and bondholders prior to a bondholders' meeting.[15] The trustee could delegate this function to a third party, but neither the trustee nor its delegate would have any authority to legally bind the bondholders to any proposal. The authority of the trustee would be automatically terminated (unless extended by the bondholders) when a bondholders meeting is called. The government of Canada has recently included such a collective representation clause in its foreign currency bond and note issues.[16]

The "engagement clause" proposed by John Taylor, Under Secretary of the U.S. Treasury, contemplates a more robust role for the collective representative. Under the proposed engagement clause, the representative would be empowered to negotiate with the debtor on behalf of all bondholders. The clause would detail how bondholders would be represented and what data the debtor would need to provide to the creditors' representative and within what period of time. Although not explicit in the proposal, it may be assumed that the clause would not give the representative the authority to bind bondholders to the terms of a restructuring.

While acknowledging the role of a creditors' representative in facilitating communication between the debtor and the bondholders in the initial period of the crisis, many market participants believe that there is no need for introducing collective representation provisions in future bonds. They are of the view that any provision that

[15] See Lee C. Buchheit, *The Collective Representation Clause",* Int'l Fin. L. Rev., September 1998.
[16] Finance Canada News Release, 13 April 2000.

would empower a designated representative to negotiate with the debtor would delay the commencement of negotiations between the debtor and the creditors. [17] They pointed out that the bondholders prefer to sit at the negotiation table themselves instead of through an intermediary. If bondholders choose to appoint a representative, they could do so under the terms of existing international sovereign bonds by convening a bondholders' meeting. Moreover, they argued that trustees are, as a practical matter, ill-suited to act as negotiators. Trustees normally perform mechanical duties specified in the bond documentation. Because the trustees owe fiduciary obligations to the bondholders, they would be very reluctant to accept the level of responsibility provided in the proposal.

What they perceive as the main obstacle to an orderly and rapid debt restructuring is the lack of a transparent and collaborative restructuring process. They emphasized the need for clearer rules regarding the development of sovereign debt restructuring proposals. In that regard, they suggested that when approaching a creditor group, the sovereign debtor advises them of the treatment afforded to other creditor groups so as to enable them to make an informed decision.[18] However, as it may take time for a representative committee to form, it may be in the interests of bondholders to have their legally designated representative meet with the debtor in the interim. Once the committee has been formed, the role of the representative would diminish.

Initiation Clause

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[17] See, *e.g.*, "A Casual Observer's Commentary on the Taylor Proposal and EMCA's Model Covenants for New Sovereign Debt Issues (5/03/02)" at www.emta.org ("Commentary"). In addition, in their letter dated June 3, 2002 to the Secretary of Treasury, Paul O'Neill , EMTA, IIP, IPMA, the Bond Market Organization, SIA and EMCA indicated their support for the use of collective action clauses in sovereign debt contracts (the "Private Sector Letter").

[18] *Id.*

As borne out by experience, after a default, it normally takes a period of time for creditors to get relevant information from the sovereign, choose a representative or form a creditors' committee, and negotiate the terms of a restructuring with a debtor. During this period, there is a risk of maverick litigation that could inhibit progress in the negotiations between the debtor and the majority bondholders. To prevent a rush to the court house and a grab race, Under Secretary Taylor has proposed to introduce an "initiation clause" in future bonds that would provide for a "cooling off" period between the date when the sovereign announces its intention to restructure and the date that a creditor representative is chosen.[19] During the cooling off period, payments would be temporarily suspended or deferred and the bondholders would be prevented from initiating litigation. In the former case, the initiation clause could provide for a grace period that would defer the occurrence of event of default until a specified period has elapsed. Under this approach, bondholders would not have the right to accelerate until the occurrence of an event of default. In the latter case, the clause could defer creditor enforcement following occurrence of a default and therefore, bondholders would have the right to accelerate their claims, but would not be able to enforce their claims.

It is not entirely clear whether the initiation clause would make an important contribution to the restructuring process because majority enforcement provisions contained in existing bonds can provide a brake on aggressive litigation by dissident creditors so as to provide a breathing space for the sovereign to negotiate with majority bondholders. Some market participants have expressed their concern that the initiation clause would unduly restrain creditors' contractual rights to enforce their claims after a

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[19] See Taylor Remarks, supra note 14.

default.[20] In their view, there is no evidence to suggest that a sovereign default will be followed by a rush to the courthouse. Moreover, they indicated that the initiation clause would transfer leverage from the creditors to the debtor, which would only serve to weaken emerging market debt as an asset class.

Aggregation of Claims

It is generally recognized that collective action clauses can facilitate an orderly and rapid debt restructuring. However, these provisions can only bind bondholders within the same issue because they operate within the four corners of the bond instrument. They neither affect bondholders of other bond issuances nor apply to other types of indebtedness such as bank debt and trade credit. As a result, given the multitude of instruments and diverse creditor community that currently exist, the sovereign debtor faces a formidable task of convincing each syndicate to accept the restructuring proposal.

In light of this limitation, there has been some discussion of the possibility of developing a contractual provision that would effectively aggregate creditor claims across all bonds and other debt instruments for voting purposes. Although aggregation of claims is not a standard feature in existing corporate bonds and loan agreements that could serve as a model for international sovereign bonds, some features of the medium-term note programs that are registered under Rule 415 of the U.S. Securities Act of 1933 (the “1933 Act”) may provide some guidance as to the design of the aggregation provision.[21] Medium-term note programs typically established in a trust indenture allow debt securities with varying maturities and interest rates to be issued in different tranches. The

[20] See, *e.g.,* the Commentary and the Private Sector Letter, supra note 17.
[21] Medium-term note programs, which was first developed in the early 1970s, are programs where debt securities with varying maturities and interest rates are offered on a continuous basis using marketing and settlement procedures developed in the commercial paper market. See Charles J. Johnson, Jr., *Corporate Finance and the Securities Laws,* 6th Printing, September 1994, p. 428.

trust indenture normally contains certain provisions that are applicable to all notes covered by the program such as events of default, governing law and bondholders' meetings, although it generally requires that voting be conducted on a series by series basis for acceleration and amendment purposes. The trust indenture allows maturities and interest rates of individual notes to be determined when they are sold.

Pursuant to Rule 415 under the 1933 Act, a qualified issuer may register the entire projected amount of the medium-term notes to be issued under the program on a delayed or continuous basis by filing a shelf registration statement with the SEC. The shelf registration statement only needs to specify the total amount of debt securities that the issuer reasonably expects to put on the market within two years. Once the securities are registered, they will be put "on the shelf". When market conditions appear favorable, the issuer may take some securities off the shelf by filing a prospectus supplement with the SEC which contains the definitive maturity, interest rate and pricing information of such securities. A few months later when another market window opens, the issuer may repeat the process. Additional securities may be issued from time to time until all of the registered securities have been sold, at which time the issuer may file a new shelf registration statement. Therefore, shelf registration permits variation in the structure and terms of securities on short notice, enabling the issuers to tailor the securities to the demands of investors and thereby reducing the cost of raising capital.

It could be envisaged that a master debt program like the medium-term note program would be established by a sovereign borrower under which different kinds of debt instruments (such as bonds and bank debts) with varying maturities and interest rates could be issued or entered into. The master program would provide the votes of creditors that hold debt instruments issued pursuant to the master program (whether presently or in the future) would be aggregated when determining whether there is adequate support by a qualified majority of creditors to make the restructuring binding all creditors. Aggregation, however, would not result in the equalization of all claims for debt restructuring purposes. Safeguards would need to be in place to ensure that the seniority of certain claims is protected. In addition, as the financial interests of creditors vary greatly depending on the debt instruments they hold, creditors would need, for voting purposes, to be divided into classes based on the similarities of their claims.

While aggregating bonds across issues for voting purposes through contract is legally feasible under New York and English law, bonds with such a feature may be commercially unpopular. First, it would be difficult to achieve equity among issues because the financial interests of bondholders vary depending on the maturities of the bonds they hold. For example, even if all instruments, regardless of their maturity dates, could be accelerated following a default, the financial interests of the creditors holding long-term bonds would be quite different from those of creditors holding short-term bonds. Secondly, early market reaction to this provision indicates that investors are concerned that an aggregation of claims of foreign creditors with those of regulated financial institutions of the sovereign may provide an opportunity for the government to use its moral suasion to engineer a restructuring that is unfair to foreign creditors.[22] They pointed to the risk that the authorities could pressure domestic banks and pension funds with substantial claims on the sovereign to accept considerable debt reduction that would be binding on all creditors. Finally, the effectiveness of any dispute resolution process

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[22] See, *e.g.,* the Commentary, supra note 17.

would be severely undermined by the fact that the relevant instruments would be governed by different laws and subject to the jurisdiction of different courts.

Conclusion

Although there is a broad consensus that collective action clauses can facilitate an orderly and rapid debt restructuring by addressing the free-rider problems, only a small portion of international sovereign bonds issued by emerging market economies contain these clauses. As discussed above, the considerable variation among outstanding international sovereign bonds regarding the inclusion or exclusion of these provisions is largely due to practice rather than different requirements of national laws. In particular, there is no legal bar in the United States to the incorporation of collective action clauses in international sovereign bonds governed by New York law.

The official sector has, since 1996, encouraged the emerging market sovereign borrowers to include collective action clauses in their international bonds as a way of improving crisis resolution mechanism.[23] However, the official calls for the broader use of collective action clauses have not affected the market practice to date. Sovereigns' fear of breaking the established market practice (the "first mover" problem) and incurring potential additional costs, as well as creditors' concerns about a higher likelihood of a default on the bonds that contain collective action clauses contribute to unwillingness of both issuers and creditors to include these clauses in new bond issues. Nonetheless, the recent communications from major private sector organizations suggest growing support

[23] See, e.g., the G10 report on "The Resolution of Sovereign Liquidity Crises" (1996), the G22 "Report of the Working Group on International Financial Crises" (1998), and communiqués by the G7 in June 1999 and April 2000.

for the use of collective action clauses with high voting thresholds in international sovereign bonds.[24]

The most promising of the new provisions that were recently proposed is a type of collective representation clause (or engagement clause). This clause would authorize the trustee of a bondholder syndicate or a representative to act as a channel of communication between the debtor and bondholders as early as possible during the restructuring. While incorporation of the initiation clause and aggregation clause could play a helpful role in the debt restructuring process, early market reaction to these proposals has been rather negative. However, as a number of design features of these clauses are to be resolved and feedback from the market has been very limited, it is too early to draw any firm conclusions.

[24] The Emerging Markets Creditors Association recently proposed a number of model provisions for sovereign debt issues governed by New York law. See www.emta.org. See also the Private Sector Letter, supra note 17.

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