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Collective action clauses – the way forward

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Collective action clauses (CACs) are a new element in the international financial architecture which is to ensure orderly and timely resolution of sovereign default. It was only in the summer of 2002 that a Working Group of the G10[2] was set up with the explicit aim of providing guidelines or a framework for the formulation of these clauses.[3] The proposal by the Working Group gained wide currency with its endorsement by the G10 Finance Ministers and Governors in September 2002.[4] At the same time, US private sector trade associations ("Gang of Seven"[5]) also developed their own proposals for such clauses and there was IMF support throughout the whole period.

In February 2003 such clauses were for the first time[6] included in a sovereign bond issue under New York (NY) law by a large major borrower, Mexico, and several other sovereign borrowers followed suit during 2003-04. By the beginning of 2004 it had become clear that key elements of CACs, in particular majority action clauses, had been included in this new bond documentation. This feature is expected to contribute to the more orderly resolution of sovereign debt crises by preventing unwarranted creditor holdouts.

This note reviews developments in 2003, provides a preliminary legal assessment of these newly adopted CACs and finally reviews some key open issues.

The broader background

CACs are an integral part of the bond contract between a sovereign borrower and a private sector lender. These clauses become effective when and if a default of a sovereign borrower occurs.[7] The vast economic literature coping with assessing the debt sustainability of a sovereign borrower is thus relevant. In the international context, a sovereign borrower may default on its bonded debt for a variety of reasons which reflect the ability and willingness to honour its debt obligations. From a legal perspective it is easy to claim pacta sunt servanda (contracts have to be honoured), but from a humanitarian/economic or political perspective a sovereign state may assess any debt payments quite differently. However, the CACs discussion usually assumes that the underlying sovereign debt at stake is deemed to be unsustainable.[8]

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[2] Group of Ten (2003a).

[3] The Group of Ten (1996) had reached the following broad conclusion at that time: "Sixth, a market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation between debtors and their private creditors, as well as within the creditor community, in the event of crisis would be desirable. Market initiatives would deserve official support as appropriate."

[4] Group of Ten (2002).

[5] Gang of Seven (2003).

[6] There had been several earlier cases of including CACs in NY sovereign bond issues, but these had gone unnoticed by the market. Also, the introduction of majority amendments in note programmes in the UK and Canada in 2000 had no impact on price or liquidity (see IMF Survey 2003b).

[7] The definition of default varies on legal, economic, supervisory and rating agency grounds. Also, some clauses may take effect before default.

[8] The relevant economic literature on ability and willingness to pay and the notion of (non)-sustainability of such debt is vast.

From an international perspective it is desirable to aim at a resolution mechanism in debt restructuring that has the attributes of fairness (equity) to all parties and is orderly and timely. It should be noted that CACs are not concerned with the substance of the debt negotiation process itself but are primarily concerned with the process of the settlement of litigation within the legal system.[9] Thus any agreement or settlement procedure (negotiation, mediation or arbitration that parties conclude outside the courts) may also be satisfactory and will not necessarily be covered by CACs.[10] The contractual CACs were aimed at two emerging issues: the distribution of a large number of retail bondholders worldwide on the heels of a large credit appetite by some sovereigns, starting with the 1991-92 boom period, and the associated issue that some creditors will attempt to manipulate the process for their own benefit. More recently the emergence of in-fighting between creditors themselves in order to take a stab at assets of sovereign states first has emerged as a serious threat in upsetting orderly and timely restructuring.

Traditionally, CACs were typically included in sovereign bonds governed by English, Japanese and Luxembourg law. Historically, such bonds issued under US, German, Italian or Swiss law did not include such clauses. The largest market for sovereign bonds is in the US, the State of New York. The adoption of CACs on the NY market was thus the key to providing an internationally acceptable level playing field (see Box 1). While Italy adopted CACs in 2003 under NY law, sovereign bonds issued under German and Swiss legislation last year were without CACs.

The role of the official sector in this scenario is essentially justified as establishing a more transparent and level playing field for debtors and creditors in all the major domestic legal systems. The legal thrust was thus to contribute to legal clarity or reduce legal uncertainty and introduce legal efficiency as an element of the international financial architecture.[11] There was also the implicit aim to reduce the time lag between the start of default and final settlement.[12] The official sector's role may thus be interpreted as a facilitator of a change which would benefit debtors/creditors and perhaps also the financial intermediaries as none of the private sector participants would be able to easily provide unbiased input to this process.

Markets have, for the most part, paid little attention to the inclusion of CACs in 2003. One is thus inclined to conclude – at least at this point in time – that business concerns about CACs are about to vanish and that, for example, consideration of CACs is very subsidiary in sovereign bond pricing. However, we do not have any evidence yet how CACs might perform in a case where a major sovereign bondholder defaults on bonds which include CACs. There may also be a realisation by markets that sovereign bonds without CACs should have markup costs[13] as litigation in default may be longer, more drawn out, and subject to higher legal risks than for bonds without such clauses. There have also been no further comments on CACs by the Gang of Seven after an initial public recognition by the EMCA (Emerging Market Credit Association) of Mexico's first bond issue with CACs in February 2003, the Gang of Seven having remained silent on the type of CACs that countries have chosen to employ.

[9] Procedure may, of course, influence substance. Also, we are concerned here with the national legal systems.

[10] Assume a world where all outstanding sovereign bonds contained "standard" CACs. How would this influence actual behaviour of participants in negotiation, mediation or arbitration?

[11] In a nutshell, there were major differences in governing laws between two major legislations in which substantial sovereign bond issues were released: the US (New York) and the UK (London).

[12] These lags had been reduced historically during the 1990s but the current case of Argentina will tip the balance in the other direction.

[13] The economic literature seems to demonstrate that the probability of default is independent of CACs. However, the probability of loss-given-default may be influenced by including CACs and perhaps render bonds with CACs cheaper (see Koch (2003)). The recent papers by Eichengreen, Kletzer and Mody (2003) and Kletzer (2004) include a review of some empirical findings.

Box 1: Developments in sovereign bond markets

For emerging markets, foreign direct investment is the most important financing source. The international debt securities market has overtaken bank loans and official sector flows over the last 10 years to become the second largest source of capital for emerging market borrowers. By end-2002, bank loans and debt securities (US$ 485 billion) had roughly equal shares in total external debt.[14]

Table 1 illustrates recent magnitudes. Bonds issued under foreign jurisdictions were a source of finance to sovereign states (mainly emerging market economies) of the order of US$ 76 billion in 2003. This is back in line with the issuing activity of the 1993-98 period. By 2003, issuance under New York law had become the most important for such bonds. The English market remains important while most other markets have been fading away more recently, except for Italy.

Table 2 indicates the major shift towards including CACs in the sovereign bond documentation under New York law. Nearly half the issuance value in New York included CACs in 2003. The "Other" group in this table is above all influenced by the shift towards CACs on the Italian market during mid-2003. Since the early 1990s, a range of markets have been relatively small or only had an occasional issue (Austria, Colombia, Denmark, Greece, Netherlands, Portugal, Sweden and Other US) while others have dried up during the last few years (France and Luxembourg, after 1999; Spain, after 1998; and Canada after 2001) or have declined (Germany and to some extent Switzerland, since 1999).

Table 3 shows the breakdown by individual country for 2002 and 2003 under all governing jurisdictions. In 2003, several sovereign states issued bonds with and without CACs. In most cases this reflects issuing under different governing laws throughout the year; in other cases this may be due to a shift during the year on the NY market itself.

The adoption of CACs in sovereign bond issues in 2003-04

The year 2003 may be dubbed the watershed year for CACs. They became, for the first time, widely adopted by a range of key sovereign issuers in New York.[15] The official sector continued to play an active role. The EU officially recommended including CACs in sovereign bond issues by European borrowers. The IMF/World Bank included their recommendation on the addition of CACs in their revised Amendments to the Guidelines for Public Debt in November 2003[16] and the G10 continued its leading role by setting up an informal review mechanism to assess the adoption of CACs towards the end of 2003.

The breakthrough in terms of actually introducing CACs in sovereign bond issues on the NY market occurred with the Mexican bond issue of February 2003. Other countries followed suit, inter alia Uruguay and Brazil (April), Korea and South Africa (May), Belize (June), Italy (July) and Turkey (September). In 2004, Chile, Hungary, Panama, Colombia, Costa Rica, the Philippines and Venezuela have successfully completed bond issues including CACs for the first time, while Brazil, Turkey and Mexico's 2004 issues again included CACs.[17] Some sovereigns have not included CACs in their 2003 NY issues, including China and the Philippines.[18] While there were no sovereign bonds with CACs on the NY market in 2002, in 2003 nearly 50% (by value) of all new sovereign bonds under NY law included CACs (see Table 2).

[14] McGuire and Schrijvers (2003), p 67.

[15] However, CACs had been introduced in individual issues in New York earlier. CACs are a standard feature under UK law.

[16] IMF/World Bank (2003).

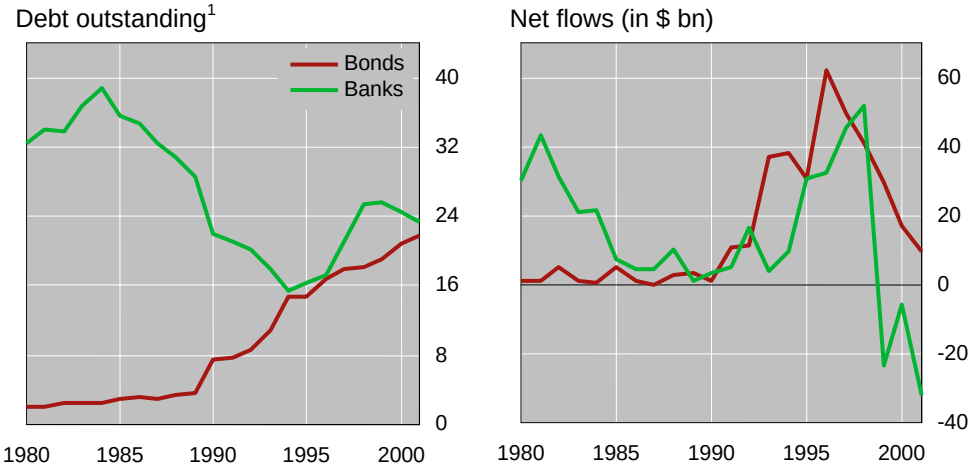
[17] Taylor (2004).

[18] Bonds without CACs were issued in 2003 under NY law after March 2003, by inter alia, China, Colombia, Israel, the Philippines, Taiwan (China) and Venezuela.

In 2003, there were no CACs included in the sovereign bond issues on the German and Swiss markets: the basic documentation of the only sovereign bond issue by Turkey on the German market and also the only sovereign bond issue by Greece on the Swiss market remained basically unchanged.[19]

The Japanese and UK sovereign bonds all include CACs.[20] More than half of the sovereign bonds issued worldwide in 2003 (on a value basis) contained CACs.[21]

Structure of emerging market debt



[1] As a percentage of total emerging market external debt outstanding.

Source: World Bank. Graph 1

Continued international support for the inclusion of CACs in 2003-04

One of the key elements in promoting CACs was the supportive stance of the Finance Ministers of the EU countries. The speech by the ECOFIN President in April 2003 announced that "the EU will use contractual provisions based on the framework developed by the G10, and where necessary in accordance with applicable law and adjusted to local practice, in their central government bonds issued under a foreign jurisdiction and/or governed by a foreign law by the end of this year."[22] Italy introduced collective action clauses in the documentation of all New York-governed bonds issued after 16 June 2003.[23]

The IMF continued its supportive role in 2003, as reflected in the April 2003 Communiqué of the International Monetary and Financial Committee, and the Guidelines for Public Debt now state explicitly: "When issuing sovereign bonds governed by foreign laws, debt managers should consider including these clauses in new borrowings, in consultation with their financial and legal advisors" (p 6). There have also been other publications,

[19] In both countries some further legal clarification is required and the official sector is in dialogue with the key underwriters.

[20] There was only one sovereign bond issue (by Poland) under Japanese law in 2003 (July). Differences between Japanese and UK bonds continue to exist. One key difference is the permanent bondholders' representative: while the UK follows a trustee arrangement, there is a fiscal agent in Japan. The Polish sovereign bond issue in Japan follows in the main the newly adopted standards evolving in the US (NY) market.

[21] An estimate for the worldwide issue of sovereign bonds in 2003 is about US$ 76.3 billion (based on Dealogic Bondware).

[22] Economic and Financial Committee (2003). While this quote does not explicitly use the word of collective action clauses, "contractual provisions" are an indirect reference to CACs.

[23] Ministero dell'Economia e delle Finanze (2003).

like the IMF Survey, continuing to support the adoption of CACs[24] while the Fund has started to encourage the use of such clauses in the context of its annual country and multilateral surveillance efforts.

Towards the end of 2003, the G10 recommended taking stock of developments and continued to monitor changes and emerging problems carefully. The G10 plans to examine the CACs included in sovereign bonds in their recent bond issues and to assess the differences vis-à-vis the G10 template.[25] The follow-up process will take place during 2004.

Early 2004 have seen a renewed commitment and encouragement in a press release by the US Treasury to include collective action clauses in sovereign bonds under New York law.[26] The G7 continued to voice support for CACs in their Florida communiqué in February 2004.[27]

Selected key issues in the introduction of CACs

A. Two immediate questions appear to be: (1) why have some countries not adopted CACs? and (2) should differences in the nature of detailed CAC provisions be of concern?

1. Adoption/Non-adoption of CACs by some major sovereign bond issuers

One may only speculate why *some countries did not include CACs* in their NY issues last year. The argument that countries or their legal advisers may not be aware of these clauses is now less cogent than perhaps at the beginning of 2003. Sovereign bond issues including CACs are on the increase and the official sector was supportive in promoting CACs throughout the year.

There has also been no evidence of a market impact due to the inclusion or exclusion of CACs. During the phase of the inclusion of CACs empirical evidence before and after the introduction of CACs has not shown any costs or liquidity constraints associated with the addition of such clauses in bond documentation.[28]

The outlook for the inclusion of CACs in future sovereign bond issues for countries which have thus far not included CACs seems generally positive. This should equally include those countries which plan to tap the market in the near future. Efforts should thus continue to sensitise sovereign borrowers as well as financial intermediaries to the inclusion of CACs.

2. Differences in CACs across various national legislations

a) Is the current variety in CACs a matter of concern and should there be a further role in standardising/harmonising the currently evolving market standards?

There seems to be some agreement that there is no value added in pursuing the introduction of exactly the same clauses in the same format under all relevant governing laws. Elderson and Perassi (2003)[29] side with the IMF Executive Board's meeting of 7 April 2003: "while it might be desirable for CACs to possess the feature described above [ie a set of common features, in the authors own words] differences in legal systems, market features, or country circumstances may necessitate some variation."[30]

The first question is thus: What are the variations? (That is, what are the facts?) A second question subsequently touches upon the significance of the differences.

[24] IMF (2003b).

[25] Group of Ten (2003b).

[26] Taylor (2004).

[27] Group of Seven (2004).

[28] It also appears that rating agencies have begun to pay some attention to CACs; but even notching by individual rating agencies due to CACs is not very likely. Admittedly this is a preliminary conclusion based on consultations with S&P.

[29] Elderson and Perassi (2003). pp. 18-19.

[30] IMF (2003a).

What are the facts?

Broadly speaking, some key provisions/terms of the CACs have moved towards an accepted market standard. These include:

- Majority action clauses[31] in amending key terms (thus binding in minorities and holdout creditors).
- Disenfranchisement provision (excludes from voting those bonds held directly of indirectly by the issuer).
- Accepted hurdles for acceleration and deacceleration (these are the conditions in terms of bondholder shares for pursuit when default occurs and the conditions for reinstatement of the debtor that is rescission of acceleration).[32]
- Voting on non-reserved matters has been consistently fixed at 66 2/3% as recommended by the G10 and the Gang of Seven.[33]

Admittedly, there are the noted outliers for these provisions. However, a consensus is emerging in bond documentation on these key clauses which leans on the G10 recommendations.[34]

b) Some other provisions continue to differ between the G10 and the Gang of Seven recommendations and what the markets are willing to adopt.

The G10 Working Group recommended a set of provisions designed to restrict the ability to initiate disruptive litigation. The idea of providing the trustee with more power by, for example, having him initiate the proceedings has essentially not been introduced in NY law. This appears to be due to the generally prevailing fiscal structure in current US sovereign bond documentation. While this may reflect the likely preference of sovereign borrowers for adopting a fiscal structure on which they can easily draw and perhaps rely (in negotiation), there may also be market resistance to such a major change. The Gang of Seven had supported the fiscal agent, who represents the issuers. The fiscal agent setup has been adopted in all recent NY issues (only Uruguay has included a trust indenture) and is part of the Japanese bond documentation.

Neither the G10 recommendation of an engagement provision nor the proposal for a similar "Engagement clause" by the Gang of Seven has been adopted in NY sovereign bond issues.

Nor is it perhaps also not a major surprise that the "information provision" (a milder G10 and a stronger Gang of Seven version) has not been adopted throughout. The EFC (Economic and Financial Committee) of the EU already noted in September 2003 with regard to the G10 proposals: "With the exception of the G10's proposed information provisions which are dealt with by other internationally-agreed means, they closely follow the prescription of the G10 CACs designed for use under New York law." Such an information provision is difficult to formulate, may be an advantage/disadvantage in negotiation and also seems difficult to implement in practice (eg as confidentiality arrangements are involved). [35]

[31] Most issuers have chosen a threshold of 75% of principal outstanding for votes on "reserved matters" (such as payment terms). This is consistent with G10 recommendations. A few issuers like Brazil, Belize and Guatemala have opted for a higher threshold of 85%, echoing the Gang of Seven proposal. Some commentators have suggested that these sub-investment grade issuers may have chosen a higher threshold to signal greater commitment to avoiding future restructurings. But the inclusion of CACs with a 75% threshold by Turkey, a sub-investment grade issuer, suggests that there is no clear market split according to ratings (see Hovaguimian (2003)).

[32] The inclusion of a 25% threshold for acceleration in the event of default has been consistently applied. Rescission of acceleration in NY sovereign bonds requires a threshold of 50% or 66 2/3%. The Gang of Seven (G10) had recommended 75% (66 2/3%) as a threshold.

[33] Chile is the only exception with 50% of the vote required for non-reserved matters.

[34] See the comparative grid in the Annex: Collective Action Clauses in some recent sovereign bonds – comparisons with G10 recommendations.

[35] Most debtors would consider this to be imposing undue constraints (eg as an obligation to supply certain documents, data, etc).

c) Not adopting some G10 recommendations may be interpreted as a preliminary judgment on the recommendations of the G10 but may also be interpreted as leading to certain standards by which the markets are willing to live. In other cases the Gang of Seven recommendations have been followed. Market practice is now a mix of both, and some proposals by the G10 and the Gang of Seven have not been taken on board by the market at all.[36]

It is not immediately obvious how this status quo is to be evaluated. Do we need to narrow the gap further between the two main legal centres (NY and the UK)? Should some G10 recommendations be pursued further? One starting point for such an evaluation is the original aims of the G10 Working Group on Contractual Clauses.[37]

The G10 Working Group noted the following three objectives when promoting contractual clauses:

"Critical to the effort is the desire to create a structure that will build on existing market practices, promote a consistent framework across jurisdictions and benefit the interests of both debtors and creditors. The following three key objectives have been identified:

(i) to foster early dialogue, coordination, and communication among creditors and sovereigns caught up in a sovereign debt problem;

(ii) to ensure that there are effective means for creditors and debtors to re-contract, without a minority of debt-holders obstructing the process; and

(iii) to ensure that disruptive legal action by individual creditors does not hamper a workout that is underway, while protecting the interests of the creditor group. "

A preliminary assessment of these objectives elicits the following remarks:

(i) The currently emerging version of CACs in NY bonds has not included clauses dealing with information exchange.

(ii) Will the CACs be able to deliver on the question of rogue/holdout creditors? Majority action will bind in dissenting creditors. However, how confident are we that the minority dissenting creditor should not find means and ways to effectively claim payment of outstanding debt later?[38]

[36] See Appendix (taken with minor editorial changes from Hovaguimian (2003)).

[37] Group of Ten (2003a).

[38] This is admittedly an advocatus diaboli question (see p 10).

In a few recent cases, pari passu clauses have prevented sovereign debtors from making payments to later/newer debtors. This has either resulted in default on the more recent debt or "forced" a new settlement of the older debt. The related cases are Elliott vs Peru,[39] Leucadia vs Nicaragua (see Box 2) and Dart vs Argentina. The case Italian bondholders vs Republic of Argentina[40] shows a scale of litigation that is different from past experience, insofar as it includes retail investors and opens significant debate over the issue of immunity protection for sovereign states.

(iii) The currently adopted CACs will also not be able to deliver on the G10 Working Groups third objective. All foreign bond issuers in NY (except Uruguay) have used fiscal agency agreements, where the fiscal agent is the agent of the issuer – not the bondholder – and there are no restrictions on individual action. While trust deeds are common under English law, the EMCA and EMTA have not endorsed such documentation as it would "unduly restrict the right of individual bondholder action".[41]

Box 2: Recent litigations

Leucadia vs Nicaragua:[42] Leucadia National Corp (LUK) won a US court judgment in 1999 against the government of Nicaragua for US$ 87 million as compensation for commercial loans on which Nicaragua defaulted during the 1980s. The creditor opted out of the government buyback of the debt in 1995, in which investors only recouped 8 cents on the dollar. In September 2003, a Brussels court issued an injunction on funds the government's paying agent Deutsche Bank AG was scheduled to transfer to settlement house Euroclear, headquartered in Brussels. Euroclear would have disbursed the money to the holders of Nicaragua's indemnification bonds.

As a result of the ruling, Nicaragua's government has been forced into another default, missing a US$ 1.8 million payment to bondholders that was due on 1 August 2003. Nicaragua had been servicing new bonds since the loan restructuring.

[39] As there was no official ruling in this case, it is not taken up here in more detail.

[40] For this case, see Elderson and Perassi (2003).

[41] Gang of Seven (2003), footnote 2: "EMCA and EMTA are unable to endorse the English-style documents included in this Package because, while they represent an improvement in the Bond documentation currently in use in the Euromarkets, such documents typically contains a sharing mechanism and *unduly restrict the right of individual bondholder action."*

[42] Pruitt (2003) and Commercial Court of Brussels, 8 September 2003, "Nicaragua vs. LNC Investments and Euroclear".

Box 3: The current pari passu clause and litigation issues

Regardless of whether or not one agrees with this interpretation of the pari passu clause, the fact remains that holdout creditors could stall payments/force sharing of payments, induce further defaults on the part of the sovereign state or trigger a legal battle between creditors themselves. The time lags in all these processes have always been several years. This does not augur well for any debt restructuring as any unsatisfied creditor may be able to affect the settlement of debt.[43]

The current legal playing field is thus full of mines:

1. The current uncertainty with regard to the legally "correct" interpretation of the pari passu clause prevails.

   Buchheit and Pam (2003) take pains to trace the meaning of the pari passu clause down trough US legal history and conclude: "At no time…did the pari passu clause ever require a borrower to make rateable payments to all of its equally-ranking creditors *[as implied by the rulings above[44]]*. Nor did it ever provide a legal basis for one unsecured creditor to enjoin or intercept non-rateable payments to another creditor, notwithstanding the equal legal ranking of their respective claims against the borrower. The rateable payment theory of the pari passu clause is, under the light of history, just a fallacy" (p 35).

2. The seizure of assets in the payment stream may be subject to special legal attention/rules in bankruptcy. Carving-out rules may apply which aim at protecting the payment and settlement mechanism. However, it is not obvious how such rules may be upheld when a legal claim to such assets has already been established.

3. While payment orders may not be executed, it is not so obvious whether and when a holdout creditor may actually be able to collect on such assets in the settlement process. If the payment is being executed by a foreign government, the assets may be subject to some immunity protection. But even such immunity protection may not be watertight, even assuming that for the US it falls under the Foreign Sovereign Immunities Act (but what about such rules in other countries, eg Belgium[45]). More generally, there are also no internationally accepted rules that would effectively guarantee "carve-outs" in payment and settlement processes.

The unresolved question is how we can ensure the priority of new liabilities going forward. The finality to such a question is lodged in the majority clauses of the CACs; however, doubts will continue to exist as this is essentially a private sector process.[46]

[43] This may not bode well for debt restructuring in Argentina as payments on any old and new debt could be blocked in future (that is, also payments to international organisations).

[44] Italicised text added by the author.

[45] Belgium/Brussels has been relevant, as Euroclear's legal seat is there. Also consider the recent case in Italy as reported by Elderson and Perassi (2003) in the case of the Italian bondholders vs the Republic of Argentina (p 6): "The judge had preliminarily considered the Italian Courts as competent, because both the government bond issue and the consequent legal relationship and obligations are rules of a private law nature. As a result, the jurisdiction has to be assessed on the basis of the rules of the private international law and none can invoke the customary principle that guarantees the immunity in favour of foreign States for their activities in Italy, as such principle only applies to activities coming under public law."

[46] The SDRM was to resolve this uncertainty through tighter legal international agreements.

While there is good reason to believe that the inclusion of CACs will effectively bind in holdout creditors, the sanguine conclusion appears to be that there still may be some residual legal risk as these are private civil law processes. The recent case of Italian bondholders vs Argentina may be relevant here. In one case the court granted the motion of private bondholders and, moving from the assumption that the issue and the placement of a loan are commercial activities under international private law, denied Argentina immunity from attachment and execution. In other cases the court recently denied petition of attachment on the basis of the Argentine default, because the insolvency of a sovereign state is covered by immunity (see Box 3).[47]

B. While the adoption of some elements of CACs in NY has narrowed the gap between the issues of bonds in terms of governing laws between the two key countries, there may still be cause for concern.

Assume a country has bonds under both governing laws and assume a sovereign debt default. Judges may come to different conclusions as to who might litigate, who might represent bondholders and who might accelerate. A level playing field has not been achieved and legal arbitrage may come into play.

C. There are also some issues which were explicitly not tackled by the G-10 Working Group on Contractual Clauses. Two of them are aggregation clauses and sovereign loans.

Currently Argentina is a case in point where such aggregation clauses may have been of help in coordinating the negotiating position of the creditors. Not only is such coordination difficult due to the wide retail holdings of Argentine securities, but also due to non-existing procedures for aggregating potential claims. Only Uruguay has tackled these questions in its recent bond documentation in NY. Do we conclude that Uruguay sets a good standard for such clauses to be included in future sovereign bond documentation?

The *Report of the G-10 Working Group on Contractual Clauses* also did not include syndicated loan agreements in its deliberations on CACs in sovereign bonds. These loans have become more of a liquid asset and are more widely traded, priced and also held. They have become like securities as they have become capital market assets in their own right.[48] These developments may call for CACs in such syndicated loans to be looked at more carefully. Already during the Russian crisis in 1998-99 it had become evident that it was no longer as easy as in the past to bind in all creditors into the London process. This was primarily due to the diverse holdings of these syndicated loans by banks and a range of different institutional holders.

D. What risk does the key provision of majority action (CACs) face?

These are some initial thoughts on what might happen, even in a world of CACs.

The wide interpretation of the pari passu clause in terms of pro rata sharing in settlement of the debt has the potential to unhinge CACs. No state will be able to make safe payments when these payments are transferred through another entity. Sequestration of such payments is possible.

Due to the above risks, markets have already been exploring new/other mechanisms to circumvent such risks by collateralising future flow receivables.[49] The evaluation and effectiveness of such new instruments are beginning to be evaluated.

Sovereign bonds in the US do not include effective deterrents to bringing individual holder suits. These are included in UK-style trustee bonds but are not part of the fiscal structure. This appears to unhinge majority action clauses to some extent.

The immunity protection of sovereign states may be seen as a deterrent against individual legal proceedings. Yet, immunity protection itself may be at stake, as evidenced by the case of Italian bondholders vs Republic of Argentina. In these cases, CACs appear to be the unique suitable tool at the disposal of unpaid individual creditors.

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[47] In Italy, the bilateral agreement between the governments of Italy and Argentina prevails over the (private) contractual agreements in sovereign bonds. This may strengthens the case for a revival of the SDRM process.

[48] Thomas and Wang (2004).

[49] IMF (2003c).

Summary and some key open issues

There has been substantial progress in including CACs in sovereign bond documentation on the NY market. The emerging split between sovereign bonds with and without CACs does not appear to be affecting market behaviour. CACs have also not been tested in courts, so that a more in-depth evaluation of their merits will have to await the test of time. However, the emerging and "unresolved" old issues may in due course merit a more thorough evaluation. This summary lists some areas in which further work could be envisaged and where agreement to move ahead by the G10 may help.

Efforts to include CACs in all major legislations (NY, Germany and Switzerland) should continue. It appears that some sovereign borrowers/intermediaries/creditors are still resisting or are indifferent to or unaware of CACs. International efforts to generally promote the inclusion of CACs should continue.

This note has explored deviations between the G10 recommendations and the actual adoption of CACs in NY. With the divergence in the legal clauses adopted, there is good reason to revisit individual clauses and assess in perhaps more detail why some G10 recommendations have been taken on board and others not (a case in point is fiscal vs trustee agreements). This review of the legal clauses has shown to some extent what the market is willing to adopt and what the market will not adopt. Only a part of the overall G10 objectives as set out by its Working Group has been achieved. Is there a need to review the individual G10 clauses on the basis of the emerging market practice in New York? Following the evidence in this note, two major related legal questions arise. Does the market evolution in 2003 undermine the basic thrust of the CAC policy in such a way that this raises a major concern as recommendations were not adopted? Is the remaining difference in clauses between the two key governing law centres, NY and the UK, cause for concern?

The G10 may also want to explore in some more detail the importance of the aggregation clauses, especially as countries have a whole series of different bonds outstanding. The G10 Working Group was unable to reach a consensus on this issue in 2002-03 but perhaps it is time to reconsider.

The G10 may also want to review the question of including CACs in syndicated loan agreements. Syndicated loans have become more like securities as they are more widely traded and held by more and more diversified financial agents. Collective action under the traditional London approach will thus be at stake.

At this point in time it is not possible to assess the effective contribution of CACs as there is little experience on them and their role of is untested in complex cases. Why and when will CACs not be able to deliver what they are supposed to deliver? What are these risks, and do we have to wait for a crisis to see what could happen?

Table 1	Sovereign bond issues, 1991-2003 announced issuance by governing law in billions of US dollars, annual averages
Table 2	Adoption of collective action clauses in sovereign bond issues, 2002-03 in billions of US dollars
Table 3	Sovereign bond issues by country without (no) and with (yes) CACs in billions of US dollars
Comparative grid	Collective action clauses in some recent sovereign bonds – comparison with G10 recommendations
Appendix	Comparison of the G10 and Gang of Seven CAC proposals

Please note that this factual information was collated around mid-January 2004.

Table 1

Sovereign bond issues, 1991-2003
announced issuance by governing law
in billions of US dollars, annual averages

	1991-92	1993-98	1999	2000-01	2002	2003
New York	2.4	15.6	22.1	36.2	36.9	46.6
English	22.3	27.6	19.0	13.7	15.6	22.5
Italian	3.2	7.4	5.0	6.8	1.5	4.9
German	4.7	9.6	8.6	2.9	0.0	0.5
Japanese	3.2	5.6	0.7	5.2	0.2	0.4
Swiss	1.1	1.4	0.3	0.6	0.1	0.5
Other	2.7	7.6	4.1	0.2	1.0	0.6
Total	39.6	74.8	59.8	65.6	55.4	76.1

Note: Other includes Austria, Canada, Colombia, Denmark, France, Greece, Luxembourg, Netherlands, Portugal, Spain, Sweden and Other US.

Source: Dealogic Bondware.

Table 2

Adoption of collective action clauses in sovereign bond issues, 2002-03
in billions of US dollars

	2002		2003	
	No	Yes	No	Yes
New York	36.9	.	23.9	22.7
English	.	15.6	.	22.5
Other	2.6	0.2	4.6	2.4
Total	39.5	15.8	28.5	47.6
Memo item: *Number of countries*	*24*	*18*	*20*	*28*

Source: Dealogic Bondware.

Table 3

Sovereign bond issues by country without (no) and with (yes) CACs in billions of US dollars

	2002		2003	
Issuer	**No**	**Yes**	**No**	**Yes**
Bahrain Monetary Agency			0.3	
Bangko Sentral ng Pilipinas (Central Bank of the Philippines)		0.3		
Bank Markazi Jomhouri Islami Iran (The Central Bank of the Islamic Republic of Iran)		1.0		
Banque Centrale de Tunisie	0.7			0.4
Commonwealth of The Bahamas			0.2	
Dominican Republic			0.6	
Federation of Malaysia	0.8			
Federative Republic of Brazil	3.5	0.4		5.8
Government of Grenada	0.1			
Government of Jamaica	0.3			
Government of Romania		0.6		0.8
Hellenic Republic		0.5	0.7	0.4
Kingdom of Bahrain				0.5
Kingdom of Morocco				0.5
Kingdom of Sweden		3.3		1.3
Kingdom of Thailand				0.3
LGT Finance Ltd	0.1		0.2	
New Zealand		0.4		0.3
Norges Statsbaner BS – NSB				0.1
People's Republic of China			1.5	
Qatar Global Sukuk QSC				0.7
Republic of Austria	0.1	4.4		4.4
Republic of Belize	0.1			0.1
Republic of Bulgaria	1.2			
Republic of Chile	1.0		1.0	
Republic of China (Taiwan)			0.1	
Republic of Colombia	1.0		1.0	
Republic of Costa Rica	0.3		0.3	0.2
Republic of Croatia		0.6		0.8
Republic of Cyprus		0.5		
Republic of El Salvador	1.3		0.3	
Republic of Estonia		0.1		
Republic of Finland	1.5			
Republic of Guatemala				0.3
Republic of Hungary				2.2
Republic of Iceland		0.4		0.2
Republic of Italy	12.3		9.9	7.0
Republic of Korea				1.0
Republic of Lebanon	0.8			
Republic of Lithuania		0.4		0.4
Republic of Panama	0.6		0.3	
Republic of Peru	1.9		0.8	0.5
Republic of the Philippines	2.6	0.3	2.6	0.7
Republic of Poland	1.4	1.3		4.3
Republic of South Africa	1.3			1.4
Republic of Turkey	2.6	0.7	3.1	2.1
Republic of Ukraine		0.4		1.0
Republic of Uruguay	0.4			
Republic of Venezuela			3.0	0.7
Slovak Republic				0.9
State of Israel		0.3	0.8	
United Kingdom				3.0
United Mexican States	4.0		2.0	5.4
Total	39.5	15.8	28.5	47.6
Source: Dialogic Bondware.				

Collective action clauses in some recent sovereign bonds – comparison with G10 recommendations

G10 recommendation (*Other relevant features in italics)*	**UK**	**Italy**	**Mexico**	**Uruguay**	**Brazil**	**Belize**	**South Africa**	**Turkey**	**Poland**	**Korea**
Governing law	English	NY	NY	NY	NY	NY	NY	NY	NY	NY
Permanent bondholders' representative										
Bondholders' negotiating representative elected by 2/3 of bondholders										
Bondholders' meeting on request of 10% of bondholders										
Majority action provisions for amendments to reserved matters with 75% vote										
List of reserved matters	*	*	*	*	*	*	*	*	*	*
Majority action on non-reserved matters with 66 2/3% vote				*						
Non-material amendments may be made without the bondholders' consent										
Acceleration requires support of 25% of bondholders	*			*						
Rescission of acceleration by 66 2/3 % of bondholders	*		*				*		*	*
Litigation to be instituted solely by the permanent representative										
Majority action on continuation and outcome of litigation	*									
Pro rata distribution of proceeds										
Disenfranchisement provision		*		*						
Information provision – to be included on a case by case basis				*						
Events of default										

	Same as G10 in substance		Different from G10		Mixed	*	Some minor variation	

APPENDIX: Comparison of the G10 and Gang of Seven CAC proposals

Both the G10 and the Gang of Seven trade associations proposed model features for CACs in sovereign bonds issued under New York law.[50] The key features and how they compare with evolving market practice are summarised below.

The main differences are that:

- the G10 recommend the use of a trustee (or alternative) as a representative of bondholders and the accompanying restrictions on litigation, while the Gang of 7 prefer use of a fiscal agent who is the agent of the issuer (rather than bondholders) without any restrictions on individual litigation;
- the G10 recommend lower voting thresholds for amendments than the Gang of Seven;
- the Gang of Seven recommend a wider set of reserved matters than those proposed by the G10; and
- the Gang of Seven propose more demanding information requirements than the G10.

Market practice is a mix of both. Many of the G10 recommendations have been taken on board – most importantly the majority action provisions. But issuers have chosen a fiscal agent structure rather than a trustee, consistent with the Gang of Seven proposals.

G10 recommendations for New York law bonds	**Gang of Seven recommendations for New York law bonds**	**Market practice – in bonds issued by Mexico (and others)**
Permanent bondholders' representative (trustee or other)	No – fiscal agent, who represents the issuer	Gang of Seven. Fiscal agent (in all recent NY law issues except Uruguay's).
Bondholders' negotiating representative elected by 2/3 of bondholders	The "Engagement clause" provides, in the event of default or restructuring, for bondholders to elect a representative *committee* (or individual) with votes from 50% of bondholders, unless more than 25% object. The representative(s) could engage legal counsel and financial advisors and the issuer would cover the costs.	Neither. No provision for representation (as far as aware).
Bondholders' meeting to be convened at any time upon request of the issuer, permanent representative, or 10% of bondholders	Adds lower 5% threshold for bondholders to request the fiscal agent to call a meeting in the event of default, or if a restructuring is announced	Consistent with both. Slightly closer to G10.
Majority action provisions for amendments to reserved matters with 75% vote	Higher threshold of 85% and adds that changes to reserved matters are prohibited if more than 10% object. Also includes some matters which require 100% consent to change.	Closer to G10 (only Brazil and Belize chose 85%)

[50] The *Report of the G-10 Working Group on Contractual Clauses* was published in March 2003 and is available at: http://www.bis.org/publ/gten08.htm. The Gang of Seven proposals were attached to the letter of 31 January 2003 from Chamberlin, Dallara et al to the Governor and are also available at http://www.emta.org/ndevelop/Final_merged.pdf.

G10 recommendations for New York law bonds	Gang of Seven recommendations for New York law bonds	Market practice – in bonds issued by Mexico (and others)
List of reserved matters: (i) change the payment date; (ii) reduce the principal amount; (iii) reduce the portion of the principal amount due in the event of an acceleration; (iv) reduce the interest rate; (v) change the currency or place of payment; (vi) change the obligation of the issuer to pay additional amounts; (vii) change the definition of "outstanding" or reduce the voting requirements; (viii) to (xi) regarding permanent representative and enforcement.	Covers (i) to (vii). Also adds changes to the pari passu clause (or other specified substantive covenants) as appropriate; and any detrimental changes to the events of default or negative pledge provisions. Also adds that changes to the following require 100% consent: governing law, jurisdiction, and waiver of sovereign immunity.	Elements of both. Most cover G10 reserved matters (i) to (vii) but also add pari passu, events of default, governing law and jurisdiction (with 75% threshold).
Majority action provisions for amendments to non-reserved matters with 66 2/3% vote	Higher threshold of 75%	G10
Amendments can be agreed in writing or at a meeting	Yes	Consistent with both
Acceleration instruction by bondholders representing 25% of principal	Yes	Consistent with both
Rescission of acceleration decision by 66 2/3 % of bondholders	Rescission by 75% vote	Closer to G10 – mix of thresholds of 66 2/3% and 50% (neither as high as Gang of Seven 75%).
Litigation to be instituted solely by the permanent representative	No	Gang of Seven
Continuation and outcome of litigation – directed by majority of bondholders	No	Gang of Seven
Pro rata distribution of proceeds	No	Gang of Seven
Disenfranchisement provision	Yes	Consistent with both.
Information provision – to be included on a case by case basis	Requires: SDDS subscription and compliance; publication of 12-month forecasts of central government budget and inflation; Paris Club minutes and terms of agreement; terms of any other restructuring agreements; terms of IMF arrangements; and other information that the fiscal agent, on instruction of 5% of bondholders, may "from time to time reasonably request". Notices and other information provided to bondholders must also be given to the IPMA, EMTA, EMCA and IIF for publication on their websites.	Neither. Only Uruguay has included information requirements, and they would apply only in the event that it seeks amendments.

Table prepared by Catherine Hovaguimian (2003).

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