Sovereign Debt Management Forum 2014

Background Note for Breakout Session 8

Legal aspects of sovereign issuance in international capital markets

Introduction

Sovereign issuers in international capital markets face the important choice of legal terms of a new bond, which can act as a tool to mitigate risks in the event of a crisis. In this session, legal trends in international capital markets and key issuer choices will be discussed. For example, issuers need to choose the law that will govern the bond, the use and design of collective action clauses (CACs), pari passu clauses, and whether to use a trust structure or fiscal agent to intermediate between issuer and investors. Furthermore, the selection of legal advisers will be discussed.

Legal Aspects of International Bond Issuances

International bond issuances are subject to a foreign law and a number of legal choices have to be made by the issuer. By definition, international sovereign bonds are bonds offered under a foreign jurisdiction, in most of the cases under New York or English law (around 90% of outstanding international bonds). For first-time or infrequent issuers in the international capital markets, this can be particularly challenging as they may not have enough knowledge and practical experience to take informed decisions. Because of that, issuers should get proper and specialized advice from international law firms to complement their in-house counsel.

Debt managers should ensure that they have received appropriate legal advice and that the transactions they undertake incorporate sound legal features (IMF and World Bank, 2014). The relevant jurisdiction should be clearly identified. It is important for debt managers to receive appropriate legal advice and to ensure that the transactions they undertake are backed by sound legal documentation. In doing so, debt managers can clarify the government's rights and obligations in the relevant jurisdictions. Several issues deserve particular attention, including: the design of provisions of debt instruments, such as clearly defining events of default, especially if such events extend beyond payment defaults on the relevant obligations (e.g., cross-default and cross-acceleration); the breadth of a negative pledge clause; the implications of including *pari passu* clauses; and the scope of the waiver of sovereign immunity. Disclosure obligations in the relevant markets must be analyzed in detail because they can vary from one market to another.

Giving all the legal features that should be considered, legal advice should be timely and comprehensive. In fact, sound practice, as stated in the Debt Management Performance Assessment (DeMPA) tool, require that legal advisers be involved from the first stage of the negotiating process to the conclusion of the legal agreements related to the external borrowing (World Bank, 2009).

The intended distribution of the bond has significant implications for the legal documentation. For example, for a global bond to be offered to all US investors, the issuer must fulfill extensive documentation requirements of the Securities and Exchange Commission (SEC), such as the 18-K form. Another option where such documentation doesn't need to be prepared is to issue the bond under the exemption of the 144A rule of the Securities Act, but then the offer to US investors will be restricted to a particular set of investors (Qualified Institutional Buyers – QIB). Finally, bond issued under Regulation S (Reg S) cannot be offered or directly bought by US investors, but can be offered in the rest of the world.

First time issuers have additional choices to make. Firstly, a new issuer might face the issue of having to obtain a sovereign rating for the first time. Market practice typically requires getting ratings from at least two of the three major rating agencies. Secondly, new issuers have to choose a clearing house. Finally, it must carefully review its national legal framework to ensure there is a clear mandate to issue abroad and what are the legal borrowing purposes (that might directly affect the use of proceeds).

If a government is forced to restructure its debt in a time of distress, CACs in bond contracts could help achieve a more orderly and efficient resolution (IMF and World Bank, 2014)**.** The design and incorporation of collective action clauses in the documentation of bonds issued under foreign law have received increasing attention in recent years. These clauses allow a qualified majority of bondholders to bind all bondholders within the same issue to the financial terms of a restructuring, and limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default. In a sovereign debt restructuring process, there is a risk that a minority of holdout creditors could slow or disrupt an agreement that a qualified majority would be prepared to support. CACs contribute to more orderly and rapid public debt workouts. Given these potential benefits, debt managers should, when issuing international sovereign bonds (i.e., bonds issued or guaranteed by a government or a central bank and either governed by a law other than the law of the issuer, or subject to jurisdiction of a foreign court), consider including such clauses in new borrowings, in consultation with their financial and legal advisors.

The choice of a fiscal agent or an indenture trustee may also support the resolution of collective action problems. Currently, most sovereign bonds include a fiscal agency agreement. The fiscal agent is in charge of a set of administrative functions (receiving proceeds from the issuer and distributing to creditors etc), solely serving the issuer and having no obligation towards the bondholders. On the other hand, a trustee would represent the interests of bondholders and might have the power to accelerate debt and initiate legal action in the name of individual bondholders, which could be a complement to CACs in addressing collective action problems.

Recent Discussion on Pari Passu clauses and CACs

The recent Argentine litigation and the Greek debt restructuring have provoked extensive debate on collective action and *pari passu* clauses. On the one hand, the US federal court decision on the interpretation of the *pari passu* clause in the Argentine litigation generated concern about the potential

impact on future debt restructurings. On the other hand, in the case of Greece, the standard CACs allowed a group of creditors to buy blocking positions, forcing some individual debt series out of the overall restructuring (Gelpern, 2014).

The International Capital Market Association (ICMA) has published a new set of standard collective action and *pari passu* clauses to address these issues. These clauses were drafted by a working group comprising developed and emerging market issuers, market participants, multilateral institutions, and academics. Afterwards they went through several rounds of consultations with issuers, investors and other service-providers such as clearinghouses, and their use was strongly supported by the IMF (IMF, 2014).

The recommended new language for the *pari passu* clause explicitly excludes the obligation to pay creditors on a ratable basis. There is strong international support on the need to clarify the *pari passu* clause to explicitly avoid the interpretation given by the US court in the Argentine litigation. This is because there is a common view among issuers and market participants that the recent court interpretation does not reflect the intended meaning of the clause and that there are no major drawbacks in making it clearer.

There is also a consensus on strengthening the CACs. Basically, new CACs should include a more robust "aggregation" feature to limit the action of holdouts by pooling together holders of multiple series, instead of the current series-by-series approach. The use of new language for the CACs might not be as immediate as in the case of *pari passu* clauses, as some aspects may generate more debate. For example, the standard clauses suggested by the ICMA allow for a one or two-limb voting procedure, to be decided by the issuer when a default event occurs, while the IMF and the US Treasury have been advocating a one-limb procedure only.

Various issuers have already modified the language in their international bond documentation to include these changes. Kazakhstan was the first country to issue an international bond using new language for both the collective action and *pari passu* clauses. Other countries, such as El Salvador and Panama, modified the *pari passu* clause, but not yet the CACs. Mexico was the first major emerging market issuer to promote changes in its US SEC documentation, although it hasn't issued a bond to date. Mexico has also recently appointed an indenture trustee, instead of its previous fiscal agent scheme.

Issues for Discussion

- What are the most relevant legal choices a sovereign issuer has to make when issuing an international bond?
- What are the common legal pitfalls when accessing the international market for the first time?
- What are the key differences between NY and English law with regards to sovereign debt?

- What are the pros and cons of choosing a fiscal agent or a trustee?
- What are rating requirements for first-time issuers and what are the challenges to obtain ratings for the first time?
- What might be domestic legal restrictions to accessing the international markets and using the proceeds?
- What are the legal implications of different modalities of bond issuance?
- What are the recent trends in terms of sovereign debt contracts?
- Should CACs provide for one and two-limb voting procedures or only for one-limb procedure?
- How to select legal advisers for international issuances and what's the role of in-house lawyers?

References

- Gelpern, Anna, "A Sensible Step to Mitigate Sovereign Bond Dysfunction". Peterson Institute for International Economics, 2014.
- Häseler, Sönke, "Trustees versus fiscal agents and default risk in international sovereign bonds". European Journal of Law and Economics, 2010.
- International Capital Market Association – ICMA, "Standard Aggregated Collective Action Clauses (CACs) for the Terms and Conditions of Sovereign Notes", 2014.
- International Capital Market Association – ICMA, "Standard Pari Passu Provision for the Terms and Conditions of Sovereign Notes", 2014.
- IMF, "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring", 2014.
- IMF and World Bank, "Revised Guidelines for Public Debt Management", 2014.
- World Bank, "Debt Management Performance Assessment (DeMPA) Tool", 2009.