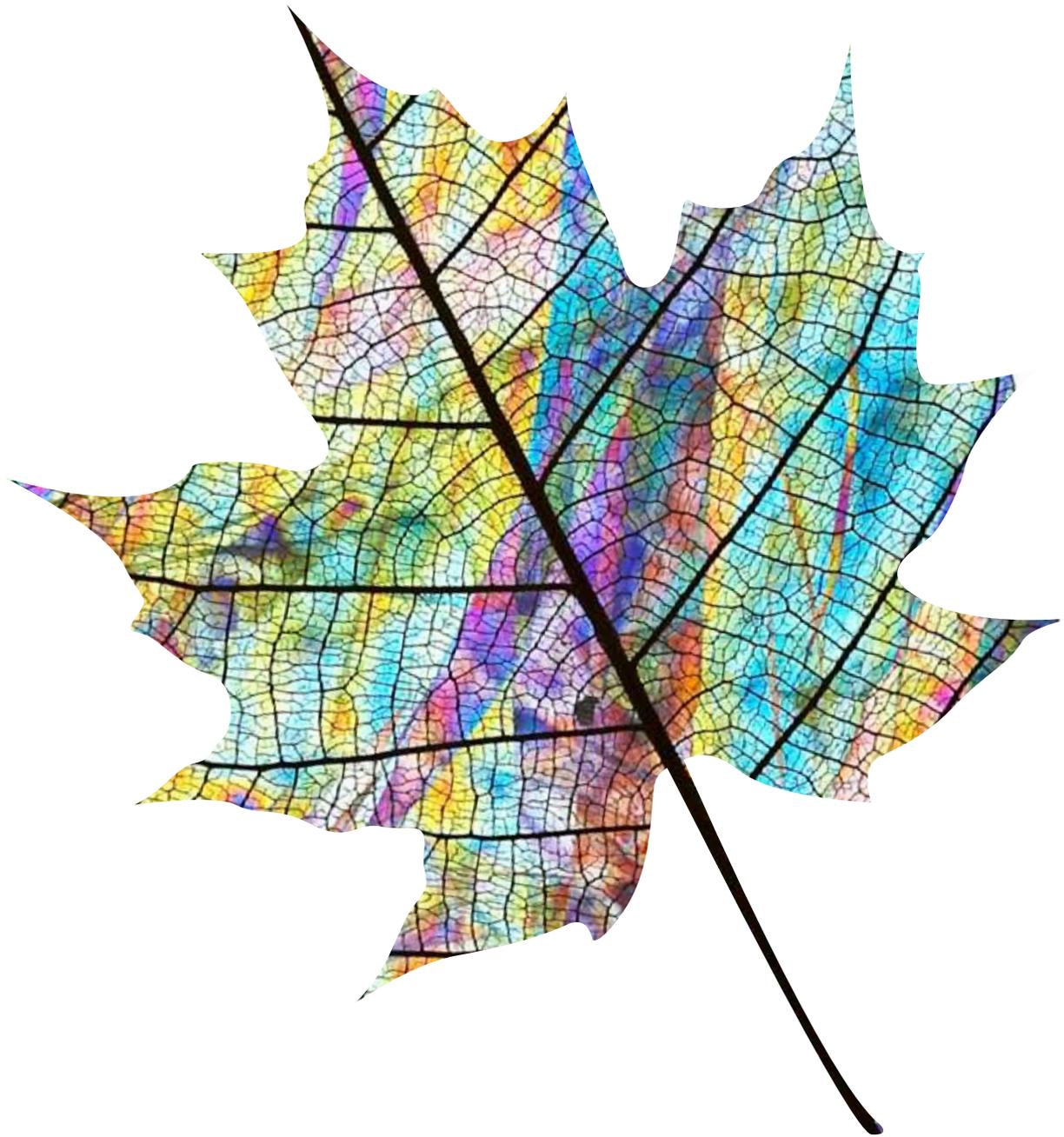


ALLEN & OVERY

GLOBAL LAW INTELLIGENCE UNIT



State insolvency –

what bondholders and other creditors should know

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Are there any rules?

Practically every aspect of financial law is regulated and controlled to the highest degree. Not so state insolvency.

When a state becomes bankrupt, there are no bankruptcy laws. There is no regulation of the insolvency. There are no stays on creditors, no realisations of the assets, no compulsory disclosure of financial condition, no cram-downs, no fraudulent preference claw-backs, no formal priorities, no punishment of the management, no bankruptcy courts, no judges, no procedures. Nothing.

Well, sort of.

Human societies cannot exist in a complete legal vacuum without some sort of rules. The object here is to discover and delineate what rules there are.

This paper mainly concerns bondholders but much of it also applies to banks and other creditors.

How many states have been bankrupt?

The background is that states can and do become insolvent. In fact they become insolvent with great frequency. The map below shows the number of states which have been insolvent in the period from 1980 to 2010. Red is insolvent and yellow is a crisis. If the state is left blank, its status has not been investigated. From this it will be seen that around 50% of sovereign states have been de facto bankrupt, even if only for a few months, during this period.

If we took the map back for a century, it would be found that virtually no sovereign state escaped bankruptcy in that period, except perhaps three.

The most unexpected twist of history is that lately it is some developed countries which have been stalked by the spectre of bankruptcy.

“States don’t go bankrupt”

Back in the late 1970s the celebrated head of Citibank, the famous Walter Wriston, claimed that “states don’t go bankrupt”. On the faith of this proposition, his bank and numerous others lent vast sums of money to emerging countries, especially in Latin America, and must have been truly flummoxed by the unexpectedness of history when indeed they did become bankrupt and threatened the solvency of the banking system itself in the United States.

One can sort of see what he meant. He really meant that states can get in the situation where they are unable to pay their debts as they fall due – but they cannot be bankrupted in the sense that it is possible for creditors to move in and force the state to realise its assets and pool the proceeds for the benefit of creditors.

States are insolvent when they are unable to pay their foreign currency debts as they fall due. Unlike corporate insolvencies in domestic law, the definition has little legal resonance, except in relation to such matters as events of default and rating agencies.

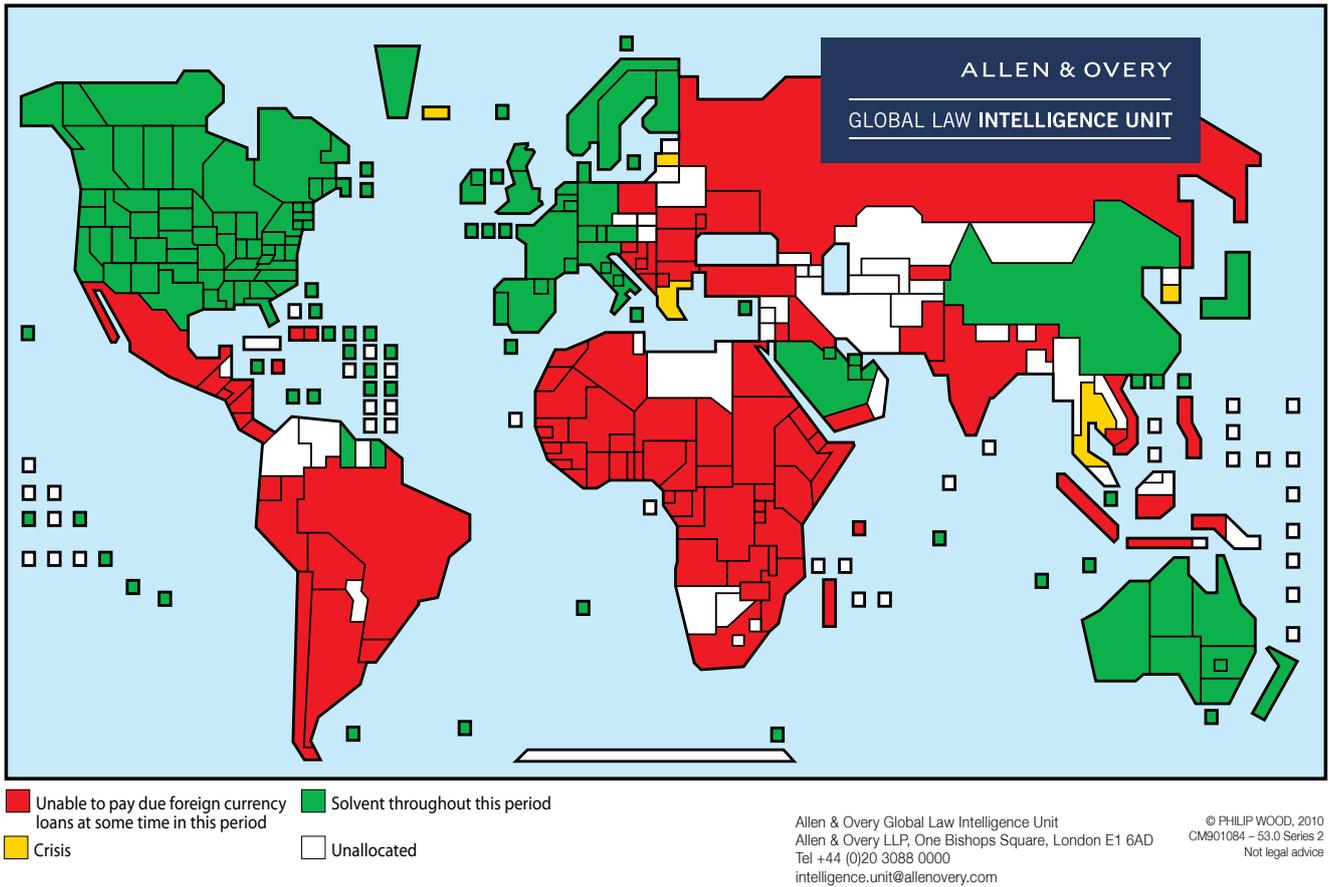
How does a sovereign bond restructuring work?

It is worth noting first what usually happens in the typical sovereign bond restructuring.

In the usual case, the sovereign debtor offers to exchange existing bonds for new bonds. Often a menu of new bonds is available, including par bonds and discounted bonds with different interest rates and maturities. Bondholders choose according to the maturities and revenues they want, their view of marketability and risk, and their tax and provisioning regimes.

The state can make this exchange offer before it actually defaults. This could affect the question of whether a restructuring event has occurred under a credit default swap.

State insolvency: 1980-2010



Corporate debt-equity conversions are not possible, but new bonds could be indexed to GDP. It is theoretically possible to arrange for existing bonds to be converted into shares of state-owned companies, but the various schemes tried in the 1980s did not enjoy much favour with creditors.

The debt eligible for exchange and rescheduling would be the specified classes of public bond debt of the sovereign state.

The sovereign debtor can be expected to agree with rescheduling bondholders that it will not pay existing eligible bondholders who do not accept the offer on more favourable terms than the rescheduled bonds – the “most favoured debt clause”. This incentivises hold-out creditors to accept the exchange.

Normally sovereign states do not formally reschedule public debt payable in the local currency and governed by local law. For reasons which appear below, they do not need to get the agreement of creditors. So normally it is only bonds payable in a foreign currency – which are often also governed by an external system of law – which get rescheduled or exchanged.

The question arises – what happens if the bond is issued by a eurozone member and is payable in euro? That is a foreign currency in the sense that the eurozone member does not control it, but it is also its domestic currency. And these foreign/domestic currency bonds are typically governed by local law.

This question is highly significant because most of the public debt of eurozone members is payable in euro and is governed by local law – well over 90% in most cases – notwithstanding the fact that it may be held by foreign bondholders.

Law as the backdrop to negotiations

This paper only describes the law. It does not speculate as to what in fact will happen. Other forces influence outcomes.

One must distinguish between the strict legal position and the political position or what happens in practice. The legal position, the black-letter law, determines the bargaining position of parties if they do not agree otherwise – which they often do. It is the backdrop to negotiations.

The legal position is only one of the factors that bondholders must take into account in assessing their overall position.

Governing law and unilateral rescheduling

The first rule for bondholders to appreciate is that, unlike ordinary corporations, sovereign states have legislative powers. They have sovereignty over their own money. They have sovereignty over their legal systems.

Every country in the world has its own legal system. Some countries have quite a lot of internal legal systems. There are 194 sovereign states. However there are about 320 legal jurisdictions in the sense of territories where the legal system is more or less different from other legal systems. Thus there are about seven different legal systems in the British Isles.

A rule which has been developed in private international law is that if a creditor contracts under the governing law of a particular state, then if the state changes that governing law, this change of law is built into the contract itself. The governing law includes its laws. You cannot freeze a legal system at a particular moment in time. Legal systems move forward, they have energy and motion.

Therefore according to English law and that of a great many other jurisdictions, if a state imposes a moratorium or changes the currency of its obligations or alters payment terms or imposes voting clauses or something of that order, then the statute may be absorbed into the governing law and the contract itself is changed. For example:

- When in the 1920s a British bank made a loan in sterling to a German borrower and in 1933 the German government, oppressed by reparation payments and indignation, required all foreign currency loans to be paid in Reichsmarks to a custodian in Germany, it was held that the British lender was subject to this change of law, which was absorbed into the loan contract. This is because the loan contract was governed by German law.
- However in another case, involving an amalgamation of two Greek banks after World War II, the Greek legislature reduced the interest rate on bonds issued by the merged banks. The House of Lords, at the instigation of a bondholder Mr Metliss, who insisted on the old rate of interest, declared that the Greek statute was ineffective to change the interest rate. This is because the bonds were governed by English law. A Greek statute could not interfere with an English contract.

Act of state doctrine

The U.S. legal approach to this problem is roughly the same, although slightly different. The U.S. courts apply what is known as the act of state doctrine, which holds that a sovereign state can validly expropriate and deal with assets only if the assets are within its territorial domain. Hence if the loan is “located” outside the territorial domain of the legislating foreign state, the legislating foreign state has no jurisdiction to change the loan contract or to expropriate the creditors. The U.S. courts will readily find that a loan is located abroad if it is payable abroad and is governed by a foreign law, eg a U.S. dollar loan governed by English or New York law.

The difference is that under English law there is complete freedom of contract to insulate via a choice of external law, whereas under U.S. law there is not.

The U.S. law is grounded on a number of cases, involving especially Cuba, Vietnam, Turkey, Costa Rica and Mexico.

Whether these adverse rules apply if the state changes its *own* obligation (so that it varies its own contract) remains to be decided. It is commonly thought that this makes no difference, but there might be an argument.

Other states have got various other rationales whereby they insulate the contract from a change of law by the sovereign state.

It was this insulating effect of a foreign or external governing law which was one of the reasons for the rise of the use of English law in the late 1960s and early 1970s when massive bank loans were made out of London to emerging countries. They were almost always subject to English law in order to insulate the obligations from legislative changes in the borrower’s country. Many countries do not regard foreign creditors with great sympathy, especially when the country is bankrupt and the citizens are throwing stones in the street.

There is still the question of recovery, which depends upon external assets. But it is one thing to have a good valid claim which is available for attaching external assets, it is quite another thing not to have a claim at all.

In order to protect the insulation achieved by an external governing law, it is necessary for the sovereign debtor to submit in proper form to the jurisdiction of external courts. If this were not the case, then external jurisdiction might be problematic and, if an action could only be brought in the courts of the debtor state, then naturally the local courts will apply the mandatory moratorium law of their own government.

The overall effect is that, if a state contracts under its own law, it can reschedule unilaterally without consent. This is not to say that it will in fact use a power likely to alienate its creditors in the future. This paper is only concerned with the law – and, as we shall see later, this unilateral power might be affected by bilateral investment treaties.

Article VIII 2(b) of the IMF Agreement

Few people have ever heard of Article VIII 2(b) of the IMF Agreement. Yet it has a famous history.

This article, together with most of the Fund Agreement establishing the IMF, was the brain-child of the British patrician John Maynard Keynes, a great hero of economists around the world, and the American left-winger Harry Dexter White. They had little in common personally, except that they shared an enthusiasm for state intervention.

They had in mind that there should be some sort of Chapter 11 for sovereign states. They therefore drafted an article which states that if a country passes an exchange control which is in conformity with the IMF policy guidelines, then any exchange contract which is contrary to those exchange controls will not be enforced by the courts of any member state. Since the member states of the IMF are practically the whole world, except North Korea and a few others, this would mean that a state which passed an exchange control, in effect a moratorium on its foreign currency obligations, could have the moratorium recognised in virtually the whole of the rest of the world and therefore have the power unilaterally to change its obligations and to defeat creditors. This would override the insulation of an external governing law.

Keynes was not always right

Being economists, Keynes and his fellow-traveller White got it wrong. They should really have had a good lawyer to help them out. The drafting was ambiguous. The result is that the courts of many important states have side-lined this article by applying interpretations so narrow as to completely neuter it. These rejecting jurisdictions include England, New York and Belgium. In their view the article does not apply, for example, to loans or bonds. However, the courts of some other states, wishing to be noble in their genuflection to international comity, extended the article so that it did apply to loan contracts. These states included

France, Germany and Luxembourg. Whether they still have this view remains to be seen.

Article VIII 2(b) lies there as a dormant volcano. We hope.

Bankruptcy ladder of priorities

Bondholders should think about the order of priorities.

The bankruptcy laws of ordinary legal systems erect elaborate bankruptcy ladders, often with 30 or 40 steps or rungs. It is often said that on bankruptcy everybody is equal, *pari passu*, and lies in the dust together. In fact nowhere is the hierarchy, the ladder, more potent than on bankruptcy, as creditors struggle for the squeezed bubble of oxygen at the top as the swirling tides of debt rise up below them.

There is no compulsory legal order of priorities in the case of state insolvency. But there are priorities – a hierarchy or ladder – by consensus and practice. To queue is human.

How the ladder works in practice

It is universally accepted by markets that the IMF and the other major multilaterals will be kept current, ie will be paid in priority to creditors who are rescheduled. The reason that the IMF is kept current is that they provide last resort emergency new money. Everybody agrees that the provider of new money should rank first and indeed this new money priority is written into quite a few corporate bankruptcy statutes. Their sacrifice saves the ship.

The rationale underlining the priority of the World Bank is not the same but they do have arguments. People dispute whether institutions like the European Investment Bank also qualify for this multilateral priority by consensus.

Other consensus priorities have sometimes included small creditors, possibly short-term treasury bills (to maintain access to emergency finance), and trade payments (if there are any), in the same way that in a corporate judicial reorganisation, it is necessary to keep the business going – and the administrator is usually allowed to pay off these ordinary course of business creditors. The exclusion of

retail creditors could be considered, but it may be hard to distinguish between retail and institutional bondholders.

It remains to be seen whether bondholders will accept that other government loans advanced as emergency last resort money should rank ahead, ie be kept current even though bondholders are rescheduled.

Who decides the rescheduling?

Historically, the creditors who did get rescheduled fall into three classes – the Paris Club creditors comprising governmental creditors, the London Club creditors who are or used to be commercial banks, and then the bondholders who are rather chaotically organised into competing bondholder committees.

The Paris Club operates if the creditors are developed countries, ie rich creditor nations, and the debtor is an emerging country.

Typically the IMF sends in a team who establish the state's financial condition. They advise the Paris Club governments what the debtor country can bear and what degree of rescheduling is required.

The Minister of Finance of the debtor state accepts the Agreed Minutes of the Paris Club which sets out on a page or so the terms of the rescheduling. These Agreed Minutes also contain a clause stating that eligible creditors, eg banks and bondholders, must not be offered better terms – the most favoured debt clause. The Agreed Minutes further state that the debtor state must agree to an IMF standby which contains various economic and other conditions. This sets out conditions as to how the debtor state should run its financial affairs in its essentials. The technique is the best equivalent of a trustee in bankruptcy, though framed as loan conditionality so as to protect national sovereignty. Other creditors do not normally agree to reschedule unless this IMF programme is in place.

The effect is often that the Minister of Finance is already committed to rescheduling terms before bondholders start negotiations: it is a *fait accompli*.

Therefore the above is another practice, though not a legal rule, which bondholders need to think about in advance.

These various clubs are undergoing change. Bondholders do not really have a club. The membership of the London Club has dwindled and has not had much to do recently. The Paris Club is a club of developed country creditors dealing with an emerging country debtor. If in fact it is one of the members of the Paris Club or another developed country which gets into financial trouble, then the Paris Club is dealing with one of its own members. A rather different situation.

Collective action clauses

Another rule which may interest bondholders concerns collective action clauses.

Some history is in order. In the 19th century a great many sovereign states defaulted, something which had been going on for centuries before.

In those days most of the loans were made out of London as Britain exported vast amounts of capital. In response to defaults, English lawyers developed clauses whereby bondholders could, by a majority vote, change the payment and other terms of the bonds so as to reschedule them. These clauses subsequently came to be called collective action clauses in the late 20th century.

What are collective action clauses?

Strictly there are three sub-types of collective action clause, as follows:

- A specified majority of bondholders can change the terms of the bond in any way they like, even by completely obliterating the bond, and the hold-outs are bound (bondholder voting). The percentages range from 50% for lesser matters to 66 ⅔ to 75% for important changes.
- Only a trustee can accelerate the bond on an event of default or take any action on the bond unless, say, 15% to 25% of the bondholders give the trustee a direction to act (the no-action clause).

– After an event of default the issuer must pay all amounts to the trustee via the paying agents and the trustee will then distribute the proceeds pro rata to the bondholders (pro rata clause).

The practice for the first limb of bondholder voting became so indelible that it has lasted to this day in international sovereign bonds governed by English law. The others did not really take hold as against sovereigns.

Local currency bonds almost never contain collective action clauses – they generally do not need to because of government legislative sovereignty.

U.S. and Switzerland agree

Meanwhile something completely different happened in the United States, Germany, Switzerland and other countries.

Let us take the United States first. During the Great Depression, whispers got about that the wicked banks were voting their rights on corporate bonds in order to reschedule the bonds so that the issuer would be free to pay the banks' private loans first – ahead of the hapless bondholders, who were all widows and orphans. This conspiracy, widely accepted by the credulous, was put an end to by the Trust Indenture Act of 1939, which provided that bondholders could not by majority resolution change the terms of payment although they could change other clauses. Subsequent amendment allowed a minor change to interest payments.

The Trust Indenture Act did not apply to sovereign debt but the whole idea of not having collective action clauses because there was something inherently evil about them clung on in New York practice.

The result was that when the New York market reopened to emerging country bonds after the Brady Plan resolving the problems of emerging country bank debts in the late 1980s, the terms and conditions of New York market bonds issued by emerging countries did not contain any provision for collective action.

Later in the 1990s, bondholders felt that they had little negotiating power in the case of the Pakistan, Ukraine and Ecuador reschedulings (although these all attracted more than 97% acceptances). In addition the IMF became concerned that it would simply put in money to pay out the bondholders. Bondholders should bear part of the pain themselves and should not assume that the IMF would be there to bail them out. Hence pressure grew for collective action clauses to be inserted in bonds and indeed many states did insert these clauses as a matter of market practice.

In the meantime, before all this took place, bonds governed by, say, German or Swiss or Japanese law also similarly did not have collective action clauses. This arose from another historical approach. According to this doctrine, the best way for bondholders to get paid was to ensure that there was absolutely no means whatever of organising bondholders so that, unless issuers offered a decent solution, their lives would continue to be wrecked by anarchic bondholder muggers rampaging over the land.

Contrary to this freedom-loving view, quite a few countries have got bondholder community statutes which typically set out the issues which bondholders can vote on and the majorities needed to bind minorities. There are bondholder community statutes in, for example, Belgium, France (a fascinating version), Germany (dreamt up in 1899), Japan, Luxembourg and Switzerland and therefore perhaps in many more civil code countries. It appears that there is a bondholder community statute in Greece. On the other hand it seems that these statutes typically apply only to the bonds issued by a local corporation and would not usually cover sovereign bonds so as to introduce statutory collective action clauses into sovereign bonds.

Exit consents

What does all this amount to then? The reality is that when a state gets into financial difficulties and has to reschedule its debt, the sovereign state does not formally use its collective action clauses.

The state makes an offer of a menu of new rescheduled bonds to its bondholders. If there are collective action clauses in the old bonds permitting voting, then when bondholders accept the offer – which they usually do – the bondholders sign an exit consent whereby they grant a mandate or proxy or authority in favour of a representative of the debtor government to vote in favour of a bondholder resolution that amends the terms of the outstanding bonds so that they are the same as the rescheduled terms. The result is that any hold-out bondholders are incentivised to join in since they are going to be rescheduled in any event.

If there are no collective action clauses, this technique cannot be used and hold-out creditors are left with the original terms of their bonds to collect as best they can. If the rescheduling is priced correctly, the mainstream experience so far is that nearly all bondholders go along with it. Argentina has been an exception. Only 74% accepted the first offer in 2005 because bondholders did not accept that the rescheduling terms were reasonable but the result of a recent further offer to the hold-outs is that reportedly more than 92% have accepted.

Monetary sovereignty: something out of nothing

The next principle for bondholders to consider is monetary sovereignty.

Money is created out of nothing. It can be created with amazing ease and in complete silence. All the central bank has to do is to send an email to a bondholder or another central bank saying that the central bank owes the creditor the figure of one, followed by as many noughts as it has time to type out before the money is needed.

The effect of this is that the creditor now has the money. In practice, the central bank which creates the money is not quite so crude as that. What central banks usually do is to buy an asset of the creditor, such as a debt security, and pay the purchase price by crediting the seller with this money. The result is that the balance sheet of the central bank looks better. It has a new debt on one side which it has

just created (the purchase price which it has miraculously paid) but it has an asset on the other side which hopefully balances out, even though the asset is often worthless.

This “magic with a fairy wand” is available if the central bank is dealing with its own currency. It can use this technique to pay the country’s civil servants, to pay its judges, to pay its army, to pay its suppliers – and to pay bondholders who have bought a local currency debt.

What the fairy wand does not do

The creation of the currency in this way is not without adverse consequences sometimes. Doubling the amount of money can have the effect of halving the value of the currency. In practice it is much worse than that if one takes into account the velocity of the new money around the economy, which tends to act as a multiplier of the actual amount of money originally created.

The result of the excessive creation of fictional money is to vaporise real money so that local currency creditors are paid a dividend. Instead of being paid 100 in terms of real money, they are paid 50 or even less in the devalued currency.

Sovereign states which have issued bonds in a foreign currency cannot do this. They have no legislative sovereignty over another country’s currency and therefore are helpless. The only thing they can do is borrow more in the foreign currency, if creditors will allow them, or else their companies and citizens have to export things so that they can earn the foreign currency in order to pay back these foreign currency creditors.

From the strictly legal point of view, the worst situation for a creditor of an insolvent sovereign state, therefore, is to have a bond which is governed by local law which the sovereign state can change and also to have a bond which is in the local currency which can be inflated away.

The best situation to be in is for a bondholder to have an external governing law and a foreign currency bond. So the main questions for bondholders are: (1) is there a gold standard governing law (yes), and (2) is there a gold standard currency (probably not).

Monetary sovereignty, the euro and bail-outs

Countries which are members of the eurozone and therefore use the euro as their domestic currency are in a different position. It is true that they do not have legal monetary sovereignty, ie they cannot individually order the European Central Bank to issue them with some more money and thereby pay off their creditors with a devalued euro.

On the other hand creditors of a eurozone member can bring a great deal of political pressure to bear on other eurozone countries to protect the euro as a currency and therefore to bail out an insolvent euro member, as in the case of Greece. So although members of the eurozone do not have legal monetary sovereignty over the euro, they have a sort of weaker de facto monetary sovereignty by virtue of the common agenda of European Union countries so far as financial stability is concerned.

There are provisions in articles 123 and 125 of the consolidated version of the EU treaty prohibiting official bail-outs. Article 123 prohibits “Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States... in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States”. It also prohibits the “purchase directly from them by the European Central Bank or national central banks of debt instruments”. These reflect German provisions pre-euro, driven by Weimar 1923.

Article 125 provides that “the Union and the Member States shall not be liable for or assume the commitments of central governments”.

But Article 122 provides that where a member state is in difficulties, or is seriously threatened with severe difficulties caused by “exceptional occurrences beyond its control”, the European Council can by qualified majority grant Community financial assistance to the member state concerned.

The various prohibitions do not stop member states from making loans to another member state, nor is there a prohibition on a state-owned company or specially formed vehicle from guaranteeing the obligations of bonds issued by it. According to public reports, the eurozone members (except Greece) have set up a company which could issue bonds guaranteed by its members. The proceeds could be used to fund maturing debt of a member state.

The “no bail out” provisions do not close all doors.

Article 127 of the consolidated treaty states that the “primary objective of the European System of Banks... shall be to maintain price stability”. So presumably actions by the ECB, such as buying sovereign bonds from banks, would be guided by this primary objective.

Can a eurozone country abandon the euro?

The withdrawal of a member state from the euro or the collapse of the euro itself would be a major event and would be dealt with more at the political than the legal level. Nevertheless it is worth examining the technical legal position, theoretical though it may be.

The basic strict legal rule is probably that a eurozone country can abandon the euro and adopt a new home currency in place of the euro only by ceasing to be a member of the European Union itself or with the agreement of all the other members of the European Union, including non-eurozone countries like the UK.

Article 50 of the Treaty of Lisbon allows a member to withdraw from the European Union under an agreement approved by 72% of the members of the European Council. If no agreement is reached, the member state can exit the European Union unilaterally after two years. This would probably carry with it a departure from the euro, although legally not necessarily.

The European treaties are vague on the delicate subject of leaving the euro because, at the time of negotiation, it was felt that explicit rights of withdrawal might damage confidence

in the new currency. So the treaties skirt around the problem, leaving room for any scholarly arguments you like, rendered possible because of all legal topics the law of constitutional treaties must be one of the most elusive. So it is to be expected that some people have different views from the above.

Impact of unilateral withdrawal from the euro

A treaty is just a contract; and contracts do get broken. The question therefore is what the background legal position might be if a eurozone member unilaterally decided to withdraw from the eurozone in violation of the treaty and to resurrect its own currency at some specified rate of conversion.

The unilateral withdrawal of a eurozone member would presumably occur only in the context of a much wider political breakdown. We keep to the legal position. If a country were to withdraw from the euro in breach of the European treaty, then the following legal consequences might ensue:

- Under article 260 of the consolidated version of the EU Treaty, the Court of Justice of the European Union could impose an unlimited penalty or fine. This would seem somewhat pointless.
- The departing member might not be entitled to get its own reserves back from the European Central Bank or to recover its capital contribution to the European Central Bank. The European Central Bank holds the foreign reserves of eurozone member states. An insolvent state is not likely to have large foreign reserves.
- It seems unlikely that EU private sector individuals and firms, such as bondholders, would have direct rights of action for compensation against a non-complying member state under what is called the Francovich principle (whereby EU individuals and firms can sometimes, and subject to various conditions, bring action against the authorities for a breach of European Community law). This is because there are probably no rights of direct action under the treaty in relation to this issue.

– A private investor might have rights under bilateral investment treaties entered into by the departing member with mainly emerging countries. Most members of the eurozone have entered into many of these treaties. They typically provide protection against such matters as expropriation, require fair and equitable treatment of investors, and require that investments will not be subjected to discriminatory treatment. Normally these bilateral investment treaties confer direct rights of action on eligible investors in the countries concerned, provided they can show that there is an “investment” within the treaty. Bonds often are eligible investments but this is not always the case. The eligible investors must generally come from the emerging country concerned, eg be a company incorporated there.

– Usually there must be something more than incorporation in a treaty state to qualify as an investor, eg seat, headquarters, real business activities, and control by nationals of the country. Only a few treaties exceptionally allow the foreign controllers of an entity incorporated in country x also to benefit from country x’s treaties. Mere nominee ownership could be problematic, but sometimes indirect beneficiaries located in a treaty country may have a claim even though the bond is legally held by a custodian elsewhere. If the bonds are not already held by an eligible investor in an eligible country, structuring the ownership so as to qualify for treaty protections can be a complex exercise. Transferring bonds after the event giving rise to the claim so as to qualify under the treaty would normally be suspect. The claims are made in the arbitral tribunal specified in the treaty.

– A treaty claim is just a claim for compensation. That claim takes its place in the queue of creditors. The tribunal will not order a state not to do something contrary to the treaty, only order damages.

– Claims under the European Convention on Human Rights or national constitutional provisions protecting private property may not be successful in view of the various exits from these constitutional protections.

What happens to bonds denominated in euro?

The impact of the switch of currency from the euro to a new domestic currency of the departing state depends.

If the bond is governed by the law of the departing member state, then in principle that sovereign state can change its law by changing the currency of its bonds. External courts might recognise this because, as discussed, a creditor contracting under local law usually takes the risk of changes in that law.

In fact, historically there have been a large number of cases where countries have changed their currency, eg the 1924 shift from the worthless German Mark to the new Reichsmark and the 2002 switch to the euro. This has led to a rule, which seems to be universally accepted, that other countries must recognise the change of currency. In other words, the law of the state which issues the currency decides what the currency is when the time for payment arrives and what the rate of conversion is from an old to a new currency. If at the time of the issue of the bond the currency is the euro but at the time of payment the euro has been universally replaced by the Thaler, the creditor's claim is for Thaler, regardless of the governing law of the bond. Creditors are also stuck with the issuing state's rate of conversion, even if this is depreciatory.

In the quaint Latin phrase, the *lex monetae* applies. But this seems to come into play only where an old currency completely disappears. In our case, unless the euro totally collapses and is “everywhere annihilated”, there would still be a currency called the euro.

In this situation, courts might still decide that the law of the country issuing the currency applies if the debt instrument could be construed as treating the euro as whatever is the domestic currency of the departing member state, even though it is used by other countries. They could still grant freedom and control to the departing member state and let it decide the currency.

If the obligations were governed by an external system of law, then the departing member state could not change the currency of the obligation. At least this would be so unless external courts treat the euro as intending to mean the domestic currency of the departing state, whatever it may be from time to time, and so apply the law of the state issuing the new currency. This seems unlikely, but again it would box in the creditors.

What would be the impact on derivatives?

If there is a change of currency of a bond, there can be knock-on implications for interest rate swaps, credit default swaps, foreign exchange contracts and the like. The solutions are a matter of applying the above principles plus any special provisions in the instrument about successor currencies. There is much learning on this, developed especially when the eurozone switched to the euro. Then there is the impact on cash collateral to consider.

Covenant protections: what do they protect?

The next rule for bondholders to have in mind is that in most cases they have few formal legal protections in terms of potent covenants in the normal form of foreign currency bond, let alone a local currency bond. Bondholders would argue that they do not need them.

There are no financial ratios of any kind in the usual form of sovereign bond (and this is also true of investment-grade corporate bonds), so there are no early warning signals. For example, there are no maximum ratios of public debt to GDP, or restrictions on budget deficits.

The negative pledge in foreign law bonds usually prohibits only security for other tradeable bonds constituting external debt (various definitions) so that banks can take security if they want to. There is a wide variety of negative pledges in eurozone foreign bonds, ranging from the extremely weak to the quite strong.

The *pari passu* clause, which often provides that the bonds rank *pari passu* with all other unsecured external debt of the sovereign debtor, is toothless because it is violated only if there is a mandatory rule of law which establishes a bankruptcy ladder of priorities. Mandatory statutes subordinating one class of debt of sovereign states to another have been seen but they are extremely rare. Notwithstanding a case in California and another in Belgium which have implied the contrary, there is little doubt that the *pari passu* clause does not require that payments are in fact made on an equal basis when the state is de facto insolvent and unable to pay its debts as they fall due. If it meant this, then states would not be able to pay their defence forces, their diplomats, their doctors, their nurses or anyone else if they were in financial difficulties, without violating this clause. They would not be able to pay the IMF and the World Bank in priority.

Pari passu clauses are standard in international bonds but unusual in domestic currency local law bonds.

Asset-backed new money

For various reasons the grant of security for sovereign bond debt is extremely rare.

Theoretically, however, states in financial difficulties could often raise emergency finance backed by assets, provided the debt is not in the form of bonds or other tradeable securities in the normal case (although, as said, some eurozone negative pledges are tougher). States could usually raise secured money from banks, for example. In practice, however, emergency last-resort secured money is unusual in the case of sovereign states, although there have been special cases, such as commodity accounts and pledges of foreign government bonds.

Even if the negative pledge did extend to catch security for any other debt, negative pledges of the type seen in sovereign bonds would usually be quite easy to get around. A possible avoidance technique is a repo because many negative pledges do not catch title finance security substitutes. Other examples are sale and leasebacks of land owned by the state.

Ingenious structuring specialists can set up deals whereby public land or other assets are transferred into a specially formed company owned by the state and it is this company which issues notes in the capital markets and grants a charge over the assets or their proceeds. It is very rare for even fuller forms of negative pledge in sovereign bonds to apply to state-owned companies, although the World Bank negative pledge may do so. U.S. case law on the success or otherwise of negative pledge avoidance techniques would have to be considered.

Some negative pledges permit security if the debtor state grants equal and rateable security to the bonds. Some eurozone bonds so provide.

Other ways of enhancing new money

Structures similar to the Brady Bonds could be considered. In the late 1980s sovereign debtors bought U.S. Treasury zero coupon debt securities out of money borrowed from the IMF and the World Bank. They then used these U.S. government securities as collateral to secure the principal (but not the interest) on Brady Bonds issued by the sovereign debtors to commercial banks in exchange for defaulted commercial bank loans. The effect therefore was that the Brady Bonds were secured on U.S. government securities and were therefore safe.

Other governments, perhaps through specially formed vehicles, might give a guarantee of some or all of the new bonds issued in exchange for old bonds. There might also be room for guarantees by multilateral credit institutions.

It is sometimes said that states cannot sell their assets. Legally they can. Remember the Louisiana Purchase? Remember privatisations?

If there are collective action clauses, then a negative pledge in existing bonds can be overridden by a majority vote. If the bonds are governed by local law, the sovereign may be able to negate it by statute.

It must always be remembered that bondholders are not the only creditors who have negative pledges. The negative pledges in syndicated credit agreements between sovereign states and commercial banks are typically comprehensive and might well prohibit any kind of collateral for any kind of debt and may also be extended to prohibit transactions, such as repos, which have the same commercial effect as a security interest.

Bank loan agreements might also extend the negative pledge to cover the central bank, and, in the case of sovereign debtors with a low credit rating, even state-owned companies, just as a negative pledge in a syndicated credit with a corporate borrower covers subsidiaries.

It is rare to find negative pledges in local currency bonds or, in the case of eurozone members, in their local law euro bonds.

Historically, the absence of full covenant protection against security interests has been of limited importance. In the first place insolvent states often did not have any foreign assets in sufficient quantity to deliver collateral – this is why they were insolvent (although they might have had domestic assets which they could have sold for foreign currency). Secondly, granting security to one set of creditors could have been inflammatory so far as the others were concerned and infected their willingness to enter into a favourable rescheduling or to continue credit.

Events of default

As regards events of default, there is typically a distinction between international bonds in the foreign currency governed by an external system of law and internal public debt bonds denominated in the local currency (which in the case of eurozone members is the euro). In the case of international bonds governed by a foreign system of law, there often will be a cross-default, though with high thresholds. This cross-default typically makes it an event of default if any another external debt (which may be limited to borrowings or even bond debt) is not paid when due or is accelerated. The other events of default would typically

be non-payment, non-compliance, occasionally illegality or repudiation, but would not include any material adverse change clause.

In public bonds governed by local law and payable in the local currency, there may be no events of default at all or, if there are any, they would typically be limited to non-payment and non-compliance. No cross-default.

Does it really matter? When the state is in serious financial difficulties, there is often an actual payment default. So in that case the availability of other events of default which are fine-trigger advance warning could be academic. Yet one can imagine situations where it would matter.

Are sovereign states immune?

The short answer to the question of whether sovereign states are immune from court judgments against them and enforcement against their external assets is that most developed countries recognise the standard waivers of immunity from jurisdiction and enforcement which usually appear in foreign law bonds. Sometimes the waiver is watered down by minor qualifications, such as an exclusion of heritage or military assets. There are more comprehensive limitations on the waiver of immunity in the bonds of many eurozone members.

Nevertheless, although sovereign states are therefore apparently stripped bare in face of the force of the law, the reality is very different. This is because in almost all countries there is legislation which provides that, although actions may be brought against the sovereign state internally in the courts of the country, it is not possible to levy execution against public assets within the territory of the state. So the largest proportion of the assets of the state is effectively immune from seizure and is lost to creditors. It is usually unlikely that a contract waiver will negate the domestic immunising statute. Therefore the de-immunised assets are only the foreign assets of the state, and even these, as we shall see, often do not include foreign reserves held by the central bank.

It is unusual for local currency bonds governed by local law to contain a waiver of immunity, although a few do. However, in many countries, the commercial transactions of foreign states, including loans, and their commercial assets, are de-immunised. This is somewhat diluted in view of the power of a sovereign state to postpone its obligations when they are governed by local law. The bondholders might also have problems in finding a foreign court which has jurisdiction. Some countries, eg the U.S. and Switzerland, may not de-immunise if the jurisdictional contracts are ephemeral or slight – they do not wish their courts to be used for other people’s embarrassing arguments with sovereign states.

What happens to the central bank and state-owned companies?

When commercial banks lent money to sovereign states (as they used to do in vast quantities), they lent the money to the central bank under the guarantee of the state. Therefore, if something went wrong, the banks had a direct right of recourse against the foreign reserves, which would typically be held by the central bank and not by the state.

Bondholders on the other hand typically just take a covenant from the state itself, leaving the central bank out, and disregard the fact that in most states the foreign reserves are held by the central bank and are therefore outside the reach of creditors of the state itself.

The courts of many countries have held that it is quite easy to establish that a central bank is a separate legal entity, even though it is owned by the state and even though the state appoints the governing directors of the central bank and directs monetary policy.

The same applies to state-owned entities which are legal corporations. It is almost invariably the case that these are treated as separate legal entities which are not liable for the debts of the shareholder parent. There is plenty of international case law to that effect, with only a few exceptions.

Accordingly, a state which gets into financial difficulties can effectively insulate its foreign assets by locating them in specially formed state-owned entities or in the central bank so that the veil of incorporation shuts off the foreign creditor. There are at least two historical cases (Cuba and the USSR) where, even when the central bank was the debtor of record, the debtor state simply wound up and dissolved the central bank and created a new central bank which received the foreign reserves. The result was that creditors of the old central bank, were left either with a “shell” or with a company which had totally disappeared. A case in the English courts (involving Cuba) alleging that the whole thing was a fraudulent preference did not succeed.

Although in principle creditors cannot usually fix liability on state-owned entities or the central bank in law, it is true that in the run-up to the insolvency the state may, for example, guarantee the banking system, including not just the deposits of the banks but also debt securities issued by the banks, as happened in the 2007 financial crisis.

Foreign law and local law bonds

It is apparent from the above that there is a big difference between the legal position of bondholders whose bonds are governed by an external governing law and are payable in a foreign currency and those whose bonds are governed by local law and payable in local currency. In principle, the holders of local law bonds may be subject to a forced rescheduling or to a change of currency by statute of the sovereign debtor which might be recognised in external courts. They also typically have very weak documentary protections: for example, typically there are no negative pledges, events of default are absent or very limited and there are no waivers of immunity.

Local law bondholders have to fall back on political constraints on the use of strong-arm legislative powers by sovereign debtors.

What will happen next?

From time to time there have been calls for a more “orderly” system of managing sovereign insolvencies. In particular, some have called for a moderate form of state bankruptcy law which would impose a stay on creditor attachments and executions if, say, 75% of the relevant creditors, such as bondholders and banks, voted in favour. The object would be to impose a freeze on actions by hold-out creditors so that a restructuring backed by a substantial preponderance of private sector creditors could go ahead.

The law could be made internationally binding by simply upgrading Article VIII 2(b) of the IMF Agreement. This requires an 85% vote – the U.S. has a blocking 17%.

Those in favour of this scheme argue that most state insolvencies would still be conducted by an agreed or consensus workout but that the presence of the statute would encourage greater discipline: the workout would be carried out in the shadow of this bankruptcy law. Ultimately hold-out creditors could be bound by a majority plan.

Those in favour also assert that it is fair that there should be some method of achieving debt forgiveness if after many years the state continues to be burdened by debt which it will never be able to pay. Just as the debt of liquidated corporations is wiped away and just as individuals in most countries can secure a discharge after a waiting period and good behaviour, so should states ultimately be able to clear their debts.

Opponents of a bankruptcy law for sovereign states say that existing arrangements have worked quite well in most cases. They add that there is a balance of bargaining power in view of the fact that state debtors are immune from realisation of their domestic assets and creditors are not able to take over the management of the bankrupt state.

Sometimes arguments are made on the basis that the number of potential sovereign debtors, (about 194 sovereign states) is minuscule compared to the number of other potential debtors, such as corporations (of which there are many millions) and individuals (of whom there are about 6.5 billion). Therefore, it is said that the problem is manageable. But the number of people actually affected by a sovereign bankruptcy can be devastatingly large.

There is also discussion about the fact that for most countries, other than the really big economies like the United States and Japan, the amount of sovereign debt is quite small. Thus Greece is said to have a public debt of around EUR320bn. Argentina, the biggest sovereign collapse up to 2001, involved debt of somewhere between USD90bn and USD130bn. By contrast the insolvency of Lehman Brothers in 2008 involved debt of around five times as much as Argentina (around USD530bn) even though Lehman Brothers was a comparatively small bank compared to the biggest banks in the world. The insolvency of General Motors was even bigger, and the bankruptcy of Fannie Mae and Freddie Mac ran into trillions. The balancing argument is that contagion to other sovereign states can multiply the amounts.

Sovereign debtors do not usually have the same diversity of creditor applicable to ordinary private sector corporations. This is because they do not normally carry on commercial trade and do not have suppliers or other trade creditors. They do not have tax creditors. They do not generally have secured creditors. Therefore a work-out is said to be simpler. Or it should be.

Conclusion

Despite the apparent absence of a bankruptcy regime for sovereign states, work-outs do get done. One reason may be that, when one delves down, there is in fact a foundation of rules. Some of these rules have real bite.

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