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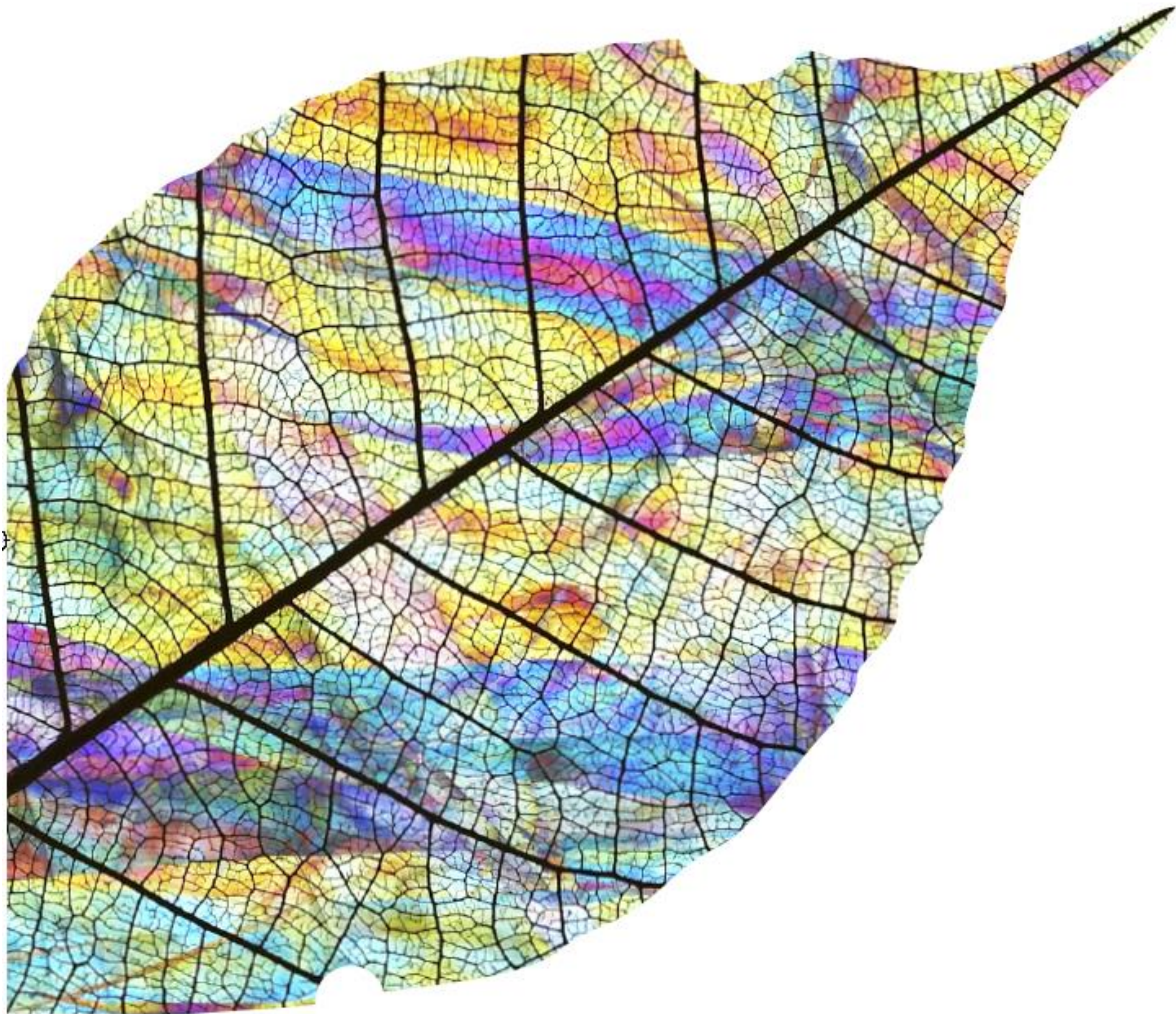

How protective are Ukraine's international bonds?

27 January 2015

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Introduction

This note contains a brief commentary on some of the main legal terms in international debt issues of or guaranteed by Ukraine. The objective is to analyse the degree to which these bonds are consistent with practice in the international capital markets and to weigh up the balance between the sovereign debtor and the bondholder creditors in terms of the rights and protections granted by the terms of the bonds.

Our main conclusion is that the bond issue legal terms seek to enhance stability for both Ukraine and the bondholders if there is a crisis.

International bond issues reviewed

This commentary is based on the terms set out in an issue by Ukraine of USD700 million 6.75% notes due 2017 covered by a prospectus dated 13 November 2007. We have, so far, looked at another 14 or so prospectuses covering international bonds, all governed by English law, and the relevant terms discussed in this note seem to be the same or very similar. Nearly all are for U.S. dollars. These other prospectuses are for English law issues where the prospectus is dated October 2005, November 2006, January 2007 (Swiss francs), November 2009 (Naftogas restructured guaranteed issue), September 2010, November, 2012, February 2011, June 2011, July 2012, August 2012, November 2012, April 2013 and February 2014. There are significant differences in the latter document. We have also looked through a prospectus of 7 December 2012 for an issue of around USD550m notes issued by "Financing of Infrastructural Projects" guaranteed by Ukraine where there are detailed differences compared to the direct bond issues listed above. We have not at this stage looked at the specific terms of trust deeds or the like (only at the prospectuses) or the terms of any notes which may be outstanding under earlier reschedulings of Ukrainian public debt or the terms of Ukraine's domestic debt issues.

According to various reports, in very rough chainsaw terms, Ukraine's public external and domestic debt apparently amounts to about USD74 billion or equivalent. The direct foreign debt could be around USD26bn to which one would have to add government-guaranteed debt in respect of bond issues by state entities.

In completing the picture of Ukraine's public debt, one would have to take into account (1) loans by multilateral organisations such as the IMF (including IMF loans to the central bank), the World Bank, the European Union, the European Bank for Reconstruction and Development and the European Investment Bank, (2) official bilateral loans, in particular from Russia and Japan, but also, apparently, from the United States, France, Germany and Italy, possibly among others, (3) loans from foreign banks, and (4) loans from multilaterals or from banks which might have been guaranteed by Ukraine.

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Special consideration should be given to any additional guarantees of the ordinary sort plus other contingent liabilities which may not be on Ukraine's balance sheet, such as potential liabilities to bail out failed banks (if a sovereign state becomes insolvent, this generally leads to the insolvency of the banking system), *de facto* liabilities to bail out state-owned enterprises and other contingencies, whether or not strictly legal in contract terms.

Ukraine's debt-to-GDP ratio has significantly increased since the conflict with Russia, and the IMF stated that it will likely exceed 60% in the first quarter of 2015.

This review is only in respect of the above international bond issues and, if one were carrying out a complete review of the protections or otherwise available to Ukraine, one would have to look at all the other debt contracts. For example, the classic sovereign international bond issue typically does not contain the extensive covenants and events of default which would be found in an international bank credit or indeed a loan from one of the main multilateral institutions, or an official lender.

Domestic debt

It is often the case with sovereign domestic public debt issued locally that the debt instruments are governed by local law without external jurisdiction. There are typically no events of default or waivers of immunity or covenants or collective action clauses. The general trend is for these public debt instruments effectively to be naked promissory notes without legal clauses. Apart from the absence of creditor protective clauses, the main implication is that if the debt contract is governed by local law, the issuer can generally, subject to some very basic protections, change the terms of the debt, eg by a moratorium law or an exchange control, and have this recognised by external courts. So the debtor effectively has a unilateral right to reschedule its local law debt forcibly. The U.S. recognition rule is slightly different but often amounts to the same thing in practice. A recent example of the unilateral use of a sovereign power to change its debt instruments was the introduction by Greece in 2012 of collective action clauses in its domestic law bonds so that majority bondholder voting could bind a minority. The change was effectively retroactive.

If a bond is in local currency, the central bank can inflate the currency.

Background to contract protections

The main problem with Ukraine's debt is the current political crisis and deterioration of Ukraine's economy as a result of the conflict with Russia. But it is worth sketching in some of the background to sovereign financial difficulties in general in order to show how that background affects the legal terms of sovereign bonds and what the main policy debates are about.

Where a sovereign state gets into financial difficulties, the usual practice is relatively elementary and straight-forward, not nearly as complex as a workout involving a large international corporation. The sovereign state typically makes an offer to its bondholders to exchange their existing bonds for new rescheduled bonds which would be issued at a discount to the existing bonds – the "haircut". The procedure is broadly the same in the case of debt liability management exercises designed to promote relief for the sovereign debtor.

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The whole transaction is a matter for free contract. There is no international bankruptcy law governing the financial difficulties of sovereigns. For example, there is no mandatory standstill or stay on creditors, no mandatory reorganisation plan voted on by creditors according to their classes and approved by a court, no mandatory bankruptcy ladder of priorities, no governance of the debtor's affairs by an administrator appointed by the creditors and ultimately no discharge of the debtor – in all cases except as otherwise agreed.

In addition, unlike the position of creditors of domestic corporations or individuals, creditors of sovereign states have only very limited rights in legal terms. It is not possible to liquidate a state and realise its assets under a liquidation procedure, as would be the case with ordinary domestic debtors. Further, it is thought that virtually all sovereign states by law prohibit the attachment of public assets within their territories. Hence by far the largest proportion of a sovereign's assets are immune and insulated from creditor attachment.

Although foreign and external assets may be de-immunised by waivers of immunity in bonds and loan contracts, or by virtue of the law itself if the transaction or assets are commercial (as in the UK, the U.S. and many countries in continental Europe and elsewhere), most states do not hold their external assets beneficially in their own name. Instead the assets are held by central banks (for the foreign reserves) or state-owned corporations. These typically are not agencies of the sovereign state and are not responsible for the sovereign public debt so that their external assets are not available to creditors of the sovereign. So foreign creditors are left with diplomatic assets, which are typically shielded by diplomatic immunity, and potentially the proceeds and servicing payments in respect of future bond issues or bank loans which might touch down externally, if there are any.

This subordinated position of creditors is weakened further by the fact that creditors do not have the right to interfere through an administrator in the fiscal affairs of the state and have to rely mainly on the IMF to do this job for them. The overall result is that sovereign states are effectively above the law.

Importance of bargaining positions

The main consequence is that the negotiation of a rescheduling of state debt or a standstill depends upon the bargaining powers of the parties, since otherwise legally the matter is left to free contract. Everything has to be agreed. There is a considerable debate going on internationally as to whether or not the bargaining power of creditors and sovereign debtors achieves a fair balance so that outcomes are reached which are reasonable for those involved. These debates were particularly sparked off by the bankruptcy of Argentina in 2001 – where Argentina's conduct was regarded with disapproval by bondholders – and the case of the reorganisation of the debt of Greece in 2012, which proceeded with great pace and momentum and which, however disadvantageous for everyone involved (which it was), at least got done in a spirit of resolute financial diplomacy where all the participants wanted, and got, financial stability and order above all else.

Whatever view one has about whether the bargaining power of creditors and sovereign debtors is reasonable so as to produce responsibility and just results between all parties, we are at the moment concerned only with the protections which foreign creditors have under their bond documentation and the protections which are available to Ukraine.

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The main bargaining card of creditors in practice is the pragmatic fact that it is very hard for a sovereign state to access the private capital markets if the sovereign state has not resolved defaulted debt on its bonds. In addition, the bankruptcy of a sovereign almost invariably results in the bankruptcy of the national banking system so the access of local banks to foreign funding is cut off. It is difficult for most sovereign states these days unilaterally to declare independence from the rest of the financial world, although occasionally this utopian paradise has been attempted.

There is a major difference between modern sovereign bond issues and the syndicated bank loans to emerging countries which were rescheduled in the 1980s. In the case of the bank loans negotiated mainly in the 1970s and early 1980s, the banks would sometimes make the loan to the central bank under the guarantee of the sovereign state. The effect was that the banks had direct access as creditors to the foreign reserves held by the central bank. A bond issue by the central bank covered by a guarantee of the sovereign seems very unusual in 21st century capital markets, even for sovereigns who are below investment grade. You might say that this is because banks are more canny and subtle than big picture capital markets, but the reality is more complicated since many of the investors in capital markets are also banks. Bank loan agreements just have a different history, a different tradition and a different culture. Curiously, the situation still seems to work.

Pari passu clauses generally

The pari passu clause is a standard provision which appears in virtually all international bond issues and syndicated credits for both sovereigns and ordinary corporations. The underlying impulse of the clause arose from a crucial feature of bankruptcy which is that creditors who are in the same or similar situation should be treated equally. In practice domestic bankruptcy laws set out an immensely complex and detailed bankruptcy ladder of priorities which can have several dozen rungs or ladders. There is a de facto bankruptcy ladder of priorities in relation to the agreements reached to reschedule sovereign debt. The sovereign ladder is much less complicated than the corporate ladder.

Pari passu clauses usually state the obligations under the bond *rank* pari passu with other obligations of the issuer or borrower. This is normally interpreted, at least in the case of the English courts (probably), to mean that the obligations rank equally by law, not that the debtor will in fact pay creditors equally. It is of course perfectly possible to draft a clause which states that, once a debtor is insolvent, it will pay its creditors equally and these "most favoured" debt clauses are indeed often found in corporate and sovereign rescheduling agreements. They would be very rare in ordinary bonds and bank loan agreements because of the problems of defining what debt can be paid and what cannot. For example, a company in trouble should usually be allowed to make essential payments to keep its business going, eg to pay its employees, to pay public utilities, to pay essential suppliers and to pay the rent. Similarly in the case of a sovereign, it would often be sensible for the sovereign to be allowed to continue to pay its civil servants, its nurses and other state employees as well as pensions and also to pay short-term debt.

If pari passu clauses were interpreted to require equal payments, as opposed to the absence of mandatory legal subordination, then a debtor would not be able to make essential payments. This could be harmful to creditors generally and in particular a holdout creditor might veto a legitimate payment and thereby disrupt negotiations and acquire disproportionate power to get a full pay-out at

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the expense of other debtors. The fact that holdouts could compel full payment could incentivise them to hold out from an exchange offer which the majority of other creditors supported.

The two interpretations collided in the famous recent New York case *NML Capital v Argentina* in 2012 (still on-going) which seems to hold that the pari passu clause meant that, once the sovereign is insolvent, it must make rateable payments to its creditors, although only in very special circumstances.

Ukraine's pari passu clause

The pari passu clause in our Ukraine example is more or less in standard form and has the usual two limbs. The first relates to the ranking of the notes between themselves and states that, subject to the negative pledge clause, the notes "rank *pari passu* without any preference among themselves". The second limb states that the "payment obligations of the Issuer under the Notes shall rank at least *pari passu* with all other unsecured and unsubordinated obligations of the Issuer, present and future, save only for such obligations as may be preferred by mandatory provisions of applicable law".

Note that the pari passu clause covers all debt, including presumably the telephone bill and salaries of civil servants and the military. The debt is not limited, as is sometimes the case in sovereign bonds, to external debt or to external debt represented by marketable instruments. On the other hand, the clause excludes obligations which are preferred by mandatory provisions of applicable law.

In the example quoted, this clause would be interpreted in accordance with the governing law which is English. It is considered most unlikely that the English courts would follow the New York interpretation of the pari passu clause propounded in the New York case of *NML Capital v Argentina*.

In any event, this particular version of the clause excludes obligations preferred by mandatory laws which seem to completely deprive the pari passu clause of any significant force. But then in the sovereign context it never really had any significant force and was primarily ceremonial chest-beating – at least until the Argentinean litigation came along. Even in the Argentinean case, the Argentinean government had passed a law – the Lock Law – which prohibited payments being made to hold-outs in relation to the Argentinean restructuring of its bond debt around 2005 and the court not unreasonably treated this law as subordinating the hold-outs and therefore a violation of the pari passu clause.

Negative pledge

The negative pledge is a pervasive contract protection in loans and bonds which prohibits the borrower from creating security in favour of other third party creditors.

The negative pledge in our example is fairly typical of the very weak negative pledges traditional in international bond issues, whether issued by sovereigns or investment grade corporates or banks. The typical capital markets negative pledge normally only regulates the grant of security for similar tradable debt. This merely preserves the market value of the unsecured bonds but does not prevent the subordination of the bonds to non-marketable debt such as bank loans. By contrast, the negative pledges in bank loans normally prohibit security for all other debt of whatever kind, subject to

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permitted exceptions, and often also extend the prohibition to title finance transactions such as finance leasing, repos and other security substitutes.

The clause in our example states that the issuer "will not grant or permit to be outstanding, and it will procure that there is not granted or permitted to be outstanding, any Security Interest (other than a Permitted Security Interest) over any of its present or future assets or revenues or any part thereof, to secure any Relevant Indebtedness" unless in substance Ukraine grants the same or equivalent as security to the notes. The term "Relevant Indebtedness" means

> "any indebtedness (whether being any principal, premium, interest or other amounts considering such indebtedness), present or future, of Ukraine in the form of or represented by notes, bonds, or other similar instruments whether or not (a) incurred by means of a loan, the making of which has been directly funded by the issue by a fiduciary (or other person whose liability is conditional upon the payments due in respect of the loan) of notes, bonds or other similar instruments; or (b) issued directly by Ukraine, where, in any such case, such notes, bonds or other similar instruments are (i) capable of being traded on any stock exchange or other securities market and (ii) denominated in a currency other than the legal currency of Ukraine."

Although this is not completely clear, the relevant indebtedness must (apart from loan participation notes) be a note, bond or similar instrument which is capable of being traded on security markets and is denominated in a foreign currency. It does not have to be actually traded on the securities market. The mere fact that tradable debt is held by a non-resident is not enough – it must be denominated in a foreign currency.

Scope of permitted security

There are exemptions for security interests arising by operation of law, security interests existing on property at the time of its acquisition, security interests upon property to secure indebtedness incurred for the purpose of financing the acquisition of the property, certain security interests in connection with project financings and renewals or extensions of the above provided that the debt is not increased. These permitted security interests have detailed definitions.

The result would seem to be that Ukraine would not be prevented by this clause from raising certain types of debt which could be secured. The non-violating debt could, for example, include bank loans not evidenced by marketable securities, loans in domestic currency and title finance transactions such as repos and finance leases. Ukraine may be bound by tighter negative pledges in other contracts. Consider whether or not the definition of relevant indebtedness extends to guarantees given by Ukraine: if not, then Ukraine could grant security for its guarantee of notes but not for notes issued by Ukraine directly. That would be a quixotic result and one would normally expect to construe a reference to "indebtedness" as including guarantees.

The grant by a sovereign issuer of security is now very unusual but not completely unknown. Unsecured bondholders are not likely to welcome the grant of security to other creditors which in effect subordinates the bondholders. The notion of equality is fundamental to international creditors. Few things would be more likely to dismay foreign creditors and disincline them to be helpful than a case where another creditor leap-frogs them in the ladder of priorities.

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Events of default

The events of default are fairly typical of those generally found in contemporary sovereign bonds. Again, the events of default which are routine in capital markets are normally much less stringent than those found in bank loan agreements or in loan agreements with multilaterals.

Events of default generally fall into two classes – non-payment, which is the main thing which matters to creditors – plus a number of other events which are advance warning of non-payment, ie they are anticipatory.

Accelerations as a result of an event of default are very unusual in the case of sovereign bonds. The effect of an event of default is rather to improve the bargaining power of the creditors and in that way to give them a vote or a set of cards in the poker game, however weak those cards may be. In other words, the contract replicates to some much lesser degree the vote which would be attached to shares in a corporate context.

In our main example, the events of default include non-payment (with a grace period of ten days), breach of other obligations (subject to a grace period), a cross-default discussed below, authorisations and the like ceasing to be in full force and effect, a moratorium discussed below, unlawfulness of the issuer's obligations and invalidity or contestation of the issuer's obligations.

Cross-default

The cross-default in our example makes it an event of default if "any Relevant Indebtedness shall become due and payable prior to the stated maturity thereof following a default or any security therefore becomes enforceable or Ukraine fails to make any payment of any Relevant Indebtedness on the due date of payment thereof or if applicable, at the expiration of any grace period originally applicable thereto or any guarantee or indemnity in respect of any Relevant Indebtedness of any other Person given by Ukraine shall not be honoured when due and called upon", subject to an aggregate threshold amount of EUR25m or equivalent.

The basic cross-default therefore has three main limbs – acceleration, security becoming enforceable, or non-payment of other relevant debt. Contrary to many bank loan agreements, it is not an event of default if other debt is capable of being accelerated or a mere non-payment default occurs under another debt instrument. In other words, the cross-default only sparks off at a late stage in financial difficulties when, apart from security enforceability, there has actually been an acceleration – very unusual – or other debt has not been paid.

Relevant Indebtedness has the same meaning as in the negative pledge as described above, ie it is mainly limited to external marketable debt, it seems. Hence it would not normally, for example, cover ordinary bank loans not represented by instruments. Note that the cross-default specifically includes guarantees or indemnities in respect of relevant indebtedness.

The cross-default is a leading equality clause. The effect is that all creditors can be at the table at the same time. If this were not the case, then the creditor with the power to accelerate could negotiate a special deal without other creditors being involved. On the other hand, the cross-default can give rise to a degree of creditor inertia because the result of one creditor accelerating is that everybody accelerates. In the words of the old song, if everybody is somebody, then nobody is anybody.

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Moratorium

The moratorium event of default makes it an event of default if "Ukraine shall suspend payment of or admits its inability to pay Relevant Indebtedness or any part thereof, or declare a general moratorium on or in respect of Relevant Indebtedness or any part thereof or anything analogous to the foregoing shall occur".

Again the definition of Relevant Indebtedness is as before. Note that it applies to any *part* of Relevant Indebtedness so the suspension of payment or moratorium does not have to be general. The scope is somewhat wider than is often found because it also applies to analogous events. Mere inaction by the issuer is not enough. Sovereign debtors in trouble have often in the past proposed a 90-day standstill to enable negotiations to take place.

There is no provision that makes it an event of default if the sovereign issuer commences negotiations with the view to a restructuring of its public external debt by reason of financial difficulties. Such a clause might well appear in a bank loan but would be unusual in the capital markets, which again goes to show that bondholders ask for less than banks.

There are various carve-outs in the events of default for specified old notes and old loans denominated in Deutsche Marks.

Scope of event of default protections

The scope of the event of default in the case of the Ukraine's bonds is not fine-trigger and indeed this distancing is routine in sovereign issues in capital markets. The only events of default that really matter are non-payment cross-default and the moratorium clause and even these are not as tough as one would find in bank loans. Further, a bank loan with a sovereign would often have a material adverse change clause designed to cover significant adverse changes in financial condition and also other events which it would not be diplomatic to mention expressly, such as civil war or hostilities or a revolution.

In addition, bank loan agreements with sovereigns would sometimes contain other events of default which are more fine-trigger, especially in the case of emerging countries, such as creditor attachments and executions (probably not very important in practice), a cross-default which crystallises on another creditor having the capability of accelerating even though the other creditor has not actually accelerated (eg because of a grace period or notice requirement) and the commencement of restructuring negotiations because of financial difficulties.

Even in bank loans to sovereigns, specific financial covenants of the type found in corporate credits, especially financial ratios, would be very unusual outside official bailout-loans, eg a limit on budget deficits or a public debt to GDP ratio, let alone one which included both legal and de facto contingent liabilities, such as the need to bail out banks.

Note that there is a maximum debt ratio of "state debt and state guaranteed debt" of 60% of "the annual gross domestic product of Ukraine" in a large consolidating issue under a prospectus dated 17 February 2014. The sole lead manager was VTB Capital. The total amounts, together with an issue of December 2013, were stated to be about USD5bn. There was a set-off prohibition. The definitions of Relevant Indebtedness also included any indebtedness owed to "the" Noteholder or any entity

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controlled or majority owned by the Noteholder. The official debt-to-GDP figures will probably be released in March 2015.

Trustee

All the bond issues we have looked at are constituted by a trust deed and the appointment of a trustee on behalf of the bondholders. Generally speaking, the presence of a trustee facilitates bondholder voting, restrictions on bondholder accelerations and no-action clauses. A trustee can also more easily distribute post-default partial payments to bondholders rateably.

Trustees are by no means standard for sovereign issuers. A trust deed can enhance the powers of a trustee to monitor the issuer and trust deeds often contain a long series of monitoring covenants.

There appears to be no provision for the appointment of creditor committees paid for by the issuer, but ultimately one would have to investigate the trust deeds for this. Steering committees tend to be formed at the time if there are problems. The eurozone model clauses do not contain a clause for appointing a representative committee of bondholders at the cost of the issuer. Some English law issues by other sovereigns do contain this clause.

Accelerations

In broad terms, in the example note issue, the trustee has a discretion to accelerate but must do so if requested by noteholders of at least one-quarter in principal amount of the outstanding notes or if so directed by an extraordinary resolution. In the case of a default other than in relation to a payment obligation, the trustee must have first certified that the happening of the event is in its opinion materially prejudicial to the interests of the noteholders and, in all cases, to the provision of a trustee indemnity etc. As mentioned, actual accelerations are very rare in the case of sovereign states unless the state repudiates or the like.

No-action clause

No-action clauses are not standard in sovereign bond issues but they are very common in those governed by English law.

There is a no-action clause which provides that no noteholder "may proceed directly against the Issuer unless the Trustee, having become bound to do so, fails to do so within a reasonable time and such failure is continuing". It is also provided that, after any of the notes have become due and payable and remain unpaid, the trustee may at any time at its discretion institute enforcement proceedings against the issuer. But it is not bound to do so unless it has been directed to do so by a quarter in principal amount of the notes or by an extraordinary resolution and has been indemnified, etc.

It follows from the above that Ukraine does have some protections against individual bondholder action unilaterally. The classical form of bond would typically give bondholders individual rights to accelerate and enforce against a sovereign on the occurrence of an event of default.

The eurozone model collective action clauses do not contain mandatory provisions for no-action clauses but there are supplemental provisions containing a no-action clause which are recommended.

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Collective action clauses – bondholder voting generally

One of the main purposes of bondholder voting is to ensure that, if the requisite majority of bondholders agree to an exchange, then holdout creditors will be bound by the deal if they are in the minority. If this were not the case, then holdout creditors could continue to launch legal attacks against the sovereign issuer which might disrupt the deal and chill future access of the sovereign issuer to capital markets and hence reduce the likelihood that new issues could be used to retire existing debt.

Further, in order to get rid of the nuisance of holdout creditors, the sovereign issuer might choose to pay the holdout creditors with the result that they would get a priority over the other creditors who had agreed to reschedule. The holdouts might get 100% when the majority had agreed to, say, 40%. Also the payment of holdouts may leave nothing with which to pay the rescheduled creditors. The effect would be the subordination of and discrimination against the consenting rescheduling creditors and a priority treatment of the dissenting holdouts. There are various other advantages of collective action clauses – for instance, binding holdouts who might otherwise assert that a pari passu clause required rateable payments in fact.

Bondholder voting can be used for other purposes, eg modifying covenants or the like, but by far the most important use is to bind holdouts.

Generally speaking, collective action clauses in relation to sovereigns are upheld in both New York and England although they may be set aside in England if they are oppressive or there is gross discrimination and for certain other reasons. In practice it is desirable for holdout creditors bound by majority bondholder voting to get the same deal as accepting creditors.

Collective action clauses have had a stormy past. For example, in the U.S., the Trust Indenture Act of 1939, as amended, does not allow majority bondholders to impose their views on minorities in relation to payments, apart for a minor exception for interest. The Act does not apply to sovereign issuers.

International bonds governed by English law have long contained collective action clauses – since the 19th century in the case of corporate bonds. In around 2002, market organisations backed collective action clauses in sovereign bonds as an answer to a proposal by the IMF to introduce a modified international bankruptcy regime for sovereigns. That proposal did not go ahead. In 2002, the G10 recommended the adoption of a form of sovereign collective action clause for foreign bonds and in 2004 the International Capital Market Association (ICMA) published a model form which is now being revised. In October 2010 the Institute of International Finance recommended the inclusion of collective action clauses and in 2012 Eurozone states agreed to adopt a form of model collective action clause for almost all sovereign issues by members of the Eurozone as from the beginning of 2013.

Of course financial democracy has always applied to shareholder voting and also to creditor voting on plans in relation to corporate bankrupt reorganisations. It is not so surprising that the idea of democracy should now be widely adopted in relation to sovereign bonds, notwithstanding that some bondholders continue to think that their bargaining power against the sovereign debtor is thereby weakened.

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Ukraine bondholder voting

The trust deed in the case of the main illustrative Ukraine issue contains provisions for convening meetings of noteholders to consider matters relating to their interests, including the modification of the terms of the notes or trust deed by the terms of an extraordinary resolution of noteholders. A meeting may be convened by the issuer or trustee at any time but the trustee is required to do so (subject to an indemnity etc) on request by 10% of the noteholders. The quorum at any meeting convened to vote on an extraordinary resolution is "one or more persons holding or representing more than half of the aggregate principal amount of the outstanding Notes or, at any adjourned meeting, one or persons being or representing Noteholders, whatever the principal amount of the Notes held or represented". Certain major decisions such as accepting an exchange offer or changing maturity dates or the amounts or currency of payments require an extraordinary resolution (passed at a meeting of noteholders at which one or more persons holding or representing not less than two-thirds or, at any adjourned meeting, one-third of the aggregate principal amount of the Notes form a quorum. There are various subsidiary powers of the trustee to make changes in minor cases. On the whole the various quorums seem quite relaxed.

The prospectuses do not appear to state (but the trust deeds would) what majorities are required to pass an extraordinary resolution but in the case of the important reserved matters, such as an exchange offer, one would expect the usual voting majority would be 75% of those voting. The combination of the 75% vote requirement and the two-thirds quorum would be that resolutions on reserved matters must be approved by at least a majority of all the notes outstanding (because 75% times two-thirds is 50%). At an adjourned meeting, an extraordinary resolution on a reserved matter, where the quorum is only one-third, could then be passed by around 25% of the noteholders.

Aggregation clauses

The illustrative note issue does not appear to contain an aggregation clause. Under traditional English practice and the practice elsewhere if there are collective action clauses, bondholders vote issue-by-issue. The result is that one or more of the issues could vote against a resolution which had in fact been approved by sufficient noteholders of others issues to amount to the two-thirds or three-quarters majority required. The result would be to disrupt a plan which enjoyed the support of the majority of the holders. Determined holdout creditors could buy out blocking votes in one or more small issues at no great expense and in that way hold the issuer and also the other noteholders to ransom. Argentina had 152 bond issues outstanding in 2005.

In order to prevent this, the practice developed in the early 2000s of using aggregation clauses whereby if a majority of all the bondholders across all the series of outstanding bonds voted in favour, then all the issues would be bound, notwithstanding that one or more issues dissented. In order to protect the holders of particular issues, there is usually a double voting requirement, ie that, say, three-quarters of all the bondholders voted in favour and that at least, say, 50% of the bondholders of each issue voted in favour, ie less than the super-majority, but still a majority. If less than the majority voted in favour, then the aggregation fails.

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Aggregation clauses appeared first in the rescheduling of Uruguay's bonds in 2003 and were applied in subsequent sovereign reschedulings, including the Dominican Republic in 2004 and Argentina in 2005. Recent cases include the rescheduling of the debts of the Seychelles and St Kitts and Nevis.

This principle of aggregation has been adopted by the eurozone model clauses.

The main impact of bondholder voting is to ensure that holdout creditors are bound by an exchange or a rescheduling if the required quorums or majorities are in favour.

Disenfranchisement

One would expect the trust deed to contain provisions disenfranchising the votes of noteholders who are closely related to the issuer. The eurozone model clauses on this point are quite narrow but ICMA proposes a wider disenfranchisement provision.

Governing law

In our main example, the governing law of the trust deed and the notes is English law. The main effect of this is to insulate the holders of the notes against changes to the notes by a Ukrainian law. The basic rule, at least in the case of the English courts, is that a debtor's obligation cannot be changed unilaterally by a local law, such as a rescheduling or exchange control, if the notes are governed by English law as a foreign system of law. The position is otherwise if the notes were governed by Ukrainian law in which case, subject to some very basic protections, a moratorium or other Ukraine law would often be recognised by external courts because the change arises under the law of the contract.

It is because of this feature, as well as other factors such as familiarity and confidence, that English law, along with New York law, is a public utility widely used by the international financial community for substantial bond and syndicated bank transactions.

Submission to jurisdiction

The issuer in our main example submits to the exclusive jurisdiction of the English courts but without limiting the right of the trustee or noteholders to take court proceedings against the issuer in any other court of competent jurisdiction. The trustee also has an option to refer disputes to arbitration under the rules of the London Court of International Arbitration. The seat of arbitration is London and the language is English. The alternative of arbitration seems rather odd and may well have reflected a fad for optional arbitration in the case of countries where reciprocal enforcement of judgments was doubtful, in contrast to the enforcement of arbitration awards under the New York Arbitration Convention of 1958.

Waiver of immunity

Ukraine waives immunity from suit and execution in relation to proceedings in England or any other jurisdiction. But there are some (quite modest) limits. It seems that the waiver does not apply to a pre-judgment attachment. The issuer reserves the rights to keep sovereign immunity under the U.S. Foreign Sovereign Immunity Act 1976 with regard to actions in any U.S. court under any U.S. federal

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or state securities law. Securities law in the U.S. is evidently considered particularly ferocious. Ukraine does not waive immunity in respect to certain diplomatic or military property or any property "located in Ukraine and dedicated to a public or governmental use (as distinct from property dedicated to a commercial use)".

In practice, it is thought that all or nearly all commercial countries do not permit the attachment by creditors of public assets located internally so that almost invariably internal property is immune.

Note that the waiver of immunity applies only in respect of proceedings against Ukraine. As mentioned, often it is the case that external assets are de facto insulated from creditors in any event because they are beneficially held by a separate state-owned entity which is not the debtor, eg the central bank.

Conclusion

All in all, the Ukraine bonds we have looked at contain quite classical terms as regards the pari passu clause, the negative pledge and the events of default. The moratorium event of default is somewhat wider than would sometimes be found elsewhere. On the other hand, Ukraine has a complete set of collective action clauses, ie bondholder voting with modest quorums, a no-action clause and controls on acceleration, but no aggregation clause. The waiver of immunity is reasonably comprehensive for external assets, subject to the apparent exclusion of pre-judgment attachments.

Some bondholders think that any erosion of the unilateral rights of bondholders to accelerate and enforce their bonds is necessary to redress an imbalance in bargaining power. There is also a view that collective action clauses make it easier for an issuer to impose a solution on bondholders. Other participants in the capital markets argue that the absence of fine-trigger accelerations and the principle of control by a majority pursuant to the concept of a financial democracy lead to greater stability which is desirable for both creditors and sovereign debtors.

No doubt these colliding viewpoints will continue to be disputed. However, the Ukraine bond issues do show what the market can do when the market decides to favour the idea of stability.

Our main conclusion is that the legal terms we have reviewed seek to preserve stability and to discourage precipitate action by individual bondholders if there is a crisis but to protect bondholders' collective contract rights if Ukraine fails to pay.

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The views expressed in this paper are not necessarily the views of the firm or its clients or the listed contacts.

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