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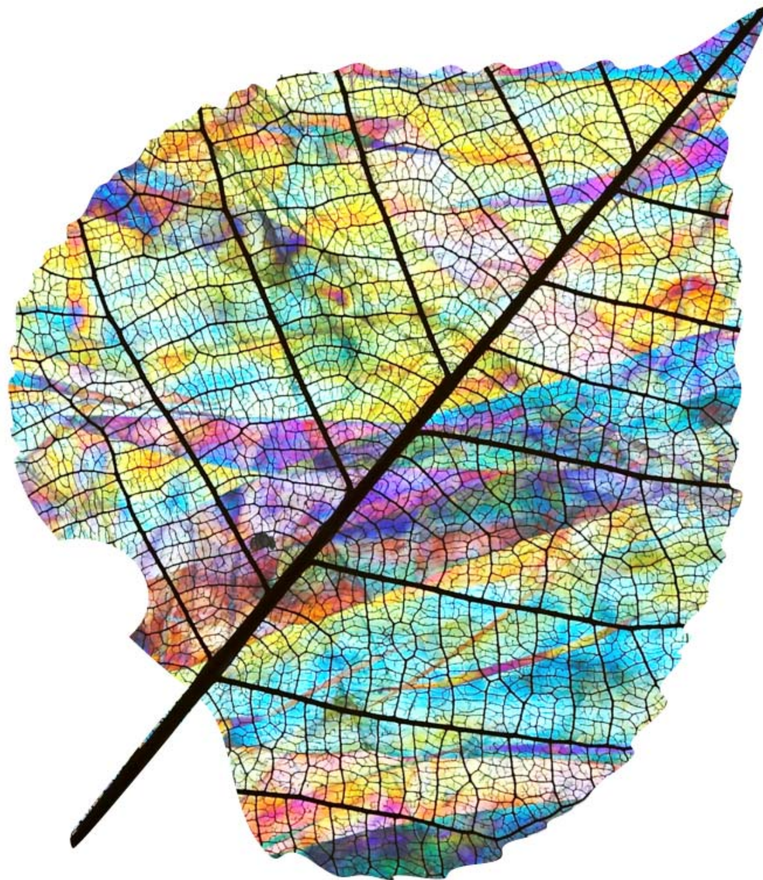

How the Greek debt reorganisation of 2012 changed the rules of sovereign insolvency

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Introduction

This paper explores how the Greek debt reorganisation of 2012 changed the rules of sovereign insolvency. It considers the ways in which this particular sovereign bankruptcy could affect future sovereign bankruptcies.

We think that there are at least 21 features, depending on whether you are a lumper or a splitter, which together represent a new momentum in the way of thinking in this field. Some of these 21 factors in one way or another, had a precedent in some previous episode, but together they heralded either a novel direction which was unexpected or a dramatic confirmation of the underlying direction of previous trends.

Greece did not actually default on its debt. But for reasons explained in more detail later, Greece was bankrupt in the generic non-technical sense of the word: the country substantially reduced bondholder claims and needed a huge infusion of bailout cash from the public sector.

Before reviewing the 21 factors, we describe the background and summarise the terms of the Greek transaction.

Mechanics of a sovereign work-out

The mechanics of sovereign debt restructurings are simple, vastly simpler than those of corporate groups.

In the typical case, the sovereign offers to exchange existing bonds held by bondholders for new bonds which are worth less and have a longer maturity than the existing bonds. For example, a sovereign state may offer to exchange bonds of 100 for new bonds worth 60 and payable, not in five years, but in 30 years. It is up to bondholders whether or not they will accept. Since the sovereign debtor often makes it clear that the sovereign debtor will not pay bondholders who do not accept – holdout creditors – the bondholders have little choice.

Indeed, in most of the major bond reschedulings since the late 1990s, usually more than 95% of bondholders accepted. These include the reschedulings of Pakistan (1999), and in the early 2000s Ecuador, Uruguay, Ukraine, Dominican Republic and Belize. The only exception was Argentina in the early 2000s where initially only about 76% accepted, subsequently increased in an amended offer.

For a discussion of state insolvency, see the Intelligence Unit paper *State Insolvency – what bondholders and other creditors should know*, 2012. See also the paper by the Sovereign Insolvency Study Group of the International Law Association, *The state of sovereign insolvency* presented at the Hague, August 2010, available also from the Intelligence Unit.

Official sector parties

The main official sector parties involved with Greece were known as the **Troika**, a moniker introduced by the Greeks for the European Commission, the European Central Bank and the IMF. The eurozone members were a collective fourth party deliberating matters in the Eurogroup and the Eurogroup Working Group.

The principal bailout vehicle of the eurozone was a company formed in Luxembourg, and owned by eurozone members, called the **European Financial Stability Facility - EFSF**. In order to raise bailout funds, the EFSF issues bonds guaranteed pro rata by member states. It is intended that the EFSF will be replaced by a corporation created by treaty between eurozone member states called the **European Stability Mechanism**.

Greece's exchange offer

On 24 February 2012, Greece invited bondholders to exchange existing bonds held by the bondholders in return for new rescheduled bonds and other consideration. The total eligible amount of bonds was roughly €205.6 billion in 135 series.

This transaction was called the Private Sector Involvement (PSI), a euphemism introduced

during one of the European summits to refer to the loss which the public sector expected the private sector to bear as part of the overall Greek rescue package.

The bonds which were subject to the offer fell into five main classes - Greek law bonds, foreign law bonds, foreign law bonds of Greek companies guaranteed by Greece, other guaranteed special bonds, and a small series of Swiss law bonds. About €177 billion were governed by Greek law and the remaining €28 billion by foreign law.

In most cases the bondholders were effectively offered 15% in cash plus accrued interest (in both cases represented by short-term EFSF notes), a new Greek government bond having a nominal amount of 46.5% of the original bonds and a detachable GDP warrant whereby Greece would pay a modest sum (capped at 1% per annum of the outstanding amount of the new bonds) if GDP growth exceeded certain official projections. The new bonds were payable over 30 years, commencing in year 11. The initial coupon was 2% escalating over time with the average coupon at around 3.4% - all very much below market rates.

The day before the offers, on 23 February 2012, Greece passed a statute whereby the government could insert collective action clauses in existing Greek law bonds. Under the collective action clauses, if the government decided to implement the clauses, then, if more than 66% accepted the exchange, then all the bondholders would be deemed to have accepted the same deal as that accepted by those bondholders who accepted the offer. In other words, if a sufficient majority accepted, holdout creditors would be bound by the same terms.

Most of the foreign law bonds already contained collective action clauses on an issue-by-issue basis. Greece proposed bondholder resolutions which would give the accepting bondholders the same consideration as the Greek law bondholders.

Before the implementation of the collective action clauses, 85.8% of the Greek law bonds accepted but only 69% of the foreign law bonds accepted with the result that the overall acceptance before application of the collective action clauses was 83.5%. So actual acceptances were well below the figures in sovereign reschedulings since 1999, except for Argentina. However, with the application of the collective action clauses on dissenting minorities more than 97% of all bonds were exchanged.

The offer did not extend to bonds held by the European Central Bank and eurozone national central banks enabling them to be paid on the due dates of their existing bonds and so have a priority. The offer did extend to sovereign bondholders and central banks elsewhere.

The final amount of new bonds issued pursuant to the offer was about €70 billion.

Timing was extremely tight as a large payment of Greek law bonds fell due for payment on 20 March 2012 and the deal had to be done before that. The result is that the normal timetable for a transaction of this sort had to be sharply truncated.

Greece obtained significant benefits from this deal. It reduced the nominal amount of its debt by €106 billion or almost 50% of GDP, although at the time its debt to GDP ratio was still forecast to be more than 120% by 2020. Greece postponed the maturities of a large part of its debt so as to improve its ability to pay over the short to medium term. The country hugely reduced its bills for interest. Finally Greece secured for itself a breathing space in order to reorganise its finances.

Public sector involvement

During early 2010, a bailout package of €110 billion was put together for Greece by eurozone countries and the IMF. The package was nearly half of Greece's GDP. Greece's financial position subsequently deteriorated and a new public sector package was agreed in 2012. This amounted to about €170 billion, although this figure included €34 billion of undisbursed fund commitments under the first official sector programme of 2010. The IMF

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portion of the second Greek bailout amounted to €28 billion.

Apart from €30 billion of EFSF loans to pay mainly for the 15% cash element of the exchange consideration, the average maturity of all the official sector bailout loans – about 15 years - was less than the average maturity of the new bonds. Most of the bailout cash bore interest at very low concessionary rates.

The public sector bailout credits were conditional on the performance by Greece of austerity measures and other reforms.

We may now turn to the 21 features which in our view together changed the rules.

1. Largest sovereign bankruptcy ever

The first distinguishing feature of the Greek debt reorganisation was its size.

The bankruptcy of the Hellenic Republic in 2012 was by far the biggest sovereign insolvency in history up until then. The combination of the fact that the bankruptcy involved a developed country and that the second largest currency in the world was threatened meant that those events together were so far the largest episode in financial history.

The amounts involved were about five times the amounts involved in the previous largest sovereign bankruptcy. This was Argentina in December 2003. The total Greek public debt was somewhere between €350 billion and €400 billion ($465 billion and $532 billion), whereas the amount involved in Argentina was about $81 billion. Before Argentina, the previous record-holder was Russia, which declared a moratorium on $31.6 billion of debt in 1998. Greece was about the same size as the bankruptcy of Lehmans in 2008. The amount involved in the Lehmans bankruptcy was $530 billion or thereabouts.

The previous largest corporate bankruptcies were Enron and Worldcom in the early part of the 2000s. Enron involved about $100 billion. The total debt on a consolidated basis of General Motors around the time of its bankruptcy filing in the late 2000s was about $172 billion and the total liabilities of Chrysler at the end of 2008 just before its filing in April 2009 were just over $55 billion.

2. Developed country bankruptcy

The second major distinguishing characteristic of the Greek debt reorganisation was that, apart from the settlement of war debts after World War II, Greece was the first rich country to get into this situation in relation to its private creditors since the 1930s.

It is true that since 1980 almost half the sovereign states in the world have been bankrupt, but they were all emerging countries or, as they were then called, lesser-developed countries. They were not part of the rich world. South Korea was caught up in a financial crisis in 1998 by way of contagion from Thailand in 1997, but South Korea was swiftly rescued and did not default on loans from the private sector.

Some would argue that most developed countries defaulted de facto in the 1970s when rampant inflation took hold which, over a decade, reduced creditor claims to a fraction of what they were.

The bankruptcy of Greece was a surprise. Everybody at the time was looking the wrong way. The financial crisis in 2007 did indeed threaten the finances of rich sovereign states by reason of the collapse of their banking systems, eg in Iceland, in Ireland, in Hungary and in Latvia. But the bankruptcy of Greece was neither a consequence of the financial crisis nor the collapse of Greece's banking system. The bankruptcy of Greece was brought about by itself, by its own overspending. It was this factor, the fact that a country which belongs in a group of the most developed countries in the world could be laid so low, which was a surprise.

Greece had avoided direct scrutiny because creditors assumed that a member of the eurozone, it had joined a group of countries which never defaulted. This belief, with no legal foundation or historical justification, was underscored by the way the Eurozone members' debt cost was measured: not in absolute terms but by reference to their spread over the eurozone's core country and perceived pillar of stability and strength, Germany. The constitution of the eurozone as a group of countries which shared a currency but which, apart from the European Central Bank, did not share any other federal institution and were governed in an autonomous sovereign manner was not something which in the years up to 2009 was scrutinised by markets.

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Just as the world was trying to come to grips with the banking crisis and, in the case of Iceland, was trying to understand the limits of contagion that a banking crisis can have on sovereigns, Greece in 2009 revealed abysmal debt and deficit figures. For many months following the publication of these figures there was denial and anger followed by blame. The absence of federal eurozone institutions and rescue mechanisms was felt deeply as national governments sought to reassure their constituencies by emphasizing that very absence. The European Central Bank, the only eurozone federal institution, took the brunt of the hit often looking like a solitary Atlas carrying the burden of the whole world on its shoulders. The remaining institutions of the European Union representing a constituency larger than the eurozone did not have the mandate or the means to interfere. It took a disjointed eurozone many months to find its balance and start taking firmer steps towards a path that is still being defined.

The ratio of the Greek public debt to its GDP was extraordinarily high for a developed country historically – more than 160%. The IMF projected in 2011 that Greece's debt would peak at 186% in 2013.

According to Carmen M. Reinhart and Kenneth S. Rogoff in their work *This Time is Different: Eight Centuries of Financial Folly* (Princeton & Oxford, 2009) nearly half of the sovereign bankruptcies in the period 1970 to 2008 have involved countries with a debt to GDP ratio of 50% or less.

In mid-2012 a number of developed countries had debt ratios of more than 100%, including the United States, Japan and Italy. Debt ratios of over 50% are common in the EU.

The total amount of debt is not the only factor. The maturity of the debt is also important. For example, a country may have a very high debt ratio but, if it is all payable only after 50 years, the country is unlikely to be bankrupt.

3. Threat to currency union

The bankruptcy of Greece threatened a currency union involving the second largest currency in the world, the euro.

Normally, the bankruptcy of a region forming part of a currency union is not fatal to the currency union. For example, when New York City became bankrupt in the 1970s, nobody suggested that New York should withdraw from the United States. But a breakup of a currency union can be driven by the bankruptcy of member states if the bankruptcy is so large that it threatens the value of the currency itself in the eyes of the rest of the world. In that situation, the bankruptcy puts pressures on other members to bail out the bankrupt.

This bailout reflects a routine feature of currency unions. Virtually all currency unions involve a transfer of money from richer to poorer regions. Typical examples are common spending on defence, education, health, law and order, unemployment benefits and the like. For example, there are large transfers in the United States from New York State to, say, Mississippi, in Britain from the London area to the north, in Canada from Ontario to the maritime provinces, in China from Zhejiang to Guizhou, indeed in virtually every country above a certain size.

The transfers are particularly urgent in the case of the bankruptcy of a region. A striking recent example is the transfers from Abu Dhabi to Dubai, both members of the United Arab Emirates with a common currency. Another example of this was the transfer in the 1990s by West to East Germany after reunification. It is for this reason that central governments often restrict the powers of provinces and municipalities to borrow. In countries such as Britain, this close-down of regional and municipal borrowing power is almost total. But the situation is very different in, say, the United States and Italy. Indeed in some countries like Canada, the provinces have almost complete autonomy, including fiscal autonomy. The idea therefore that tax and borrowing have to be the sole preserve of a central or federal government

in order to sustain a currency union cannot be supported by logic or historical precedent.

Nevertheless, the fact that many people felt that the currency was threatened by the bankruptcy of Greece, and possible contagion, was a very significant new factor for bankruptcies of a sovereign and a province in a currency union. It had a major impact on the bargaining power of the parties, on the impetus towards political union and on the desire to control the finances of the regions of the currency union.

A debate started, particularly amongst economists, about whether it was good or bad for Greece to withdraw from the euro, a debate which became confused with whether or not it was good or bad for the eurozone as a whole to lose Greece. An important factor was often not mentioned, ie that one of the main reasons for having your own currency is the power to inflate the public debt so as effectively to pay creditors a dividend. Since nearly all Greece's debt after the exchange was governed by English law and denominated in a currency which it could not unilaterally change, Greece did not have the legal power to do this. In addition, Greece was heavily reliant on imports (particularly in key goods such as energy, pharmaceuticals and even food) and the depreciation of Drachma 2 would hugely increase its costs. It was pointed out that the hospitals would have no medicines and the lights of Athens might go out.

A redenomination would normally involve exchange controls: these are the vicious end of redenomination. For example, if you cannot move your currency, you cannot move and so the freedoms of the European Union are lost.

Whatever the merits of these arguments, it is hard to think of reasons why 17 currencies are better than one and why all the sovereign states should be granted the ability to manipulate the price and amount of their own currencies. Currency is a public utility, it is the commons.

We shall see later how the European Central Bank decided to deal with this situation.

For a discussion of the euro and currency unions generally, see the Intelligence Unit paper *The euro and currency unions*, October 2011 and *The euro: the ultimate crib (for those who haven't been reading law firm memos about the breakup of currency unions)*, July 2012.

4. Bankruptcy involving domestic currency debt

Greece was bankrupt in its own currency, a feature which has not been all that common.

The reason that a default in the domestic or national currency has not been common is that central banks, which are the exclusive issuer of the national currency, can increase the supply of the currency so as to pay their debts. As John Kenneth Galbraith remarked "the process by which banks create money is so simple the mind is repelled". It does not even have to print it. It just sends an email to the creditor stating that the central bank owes the creditor any sum it cares to name – it just types out a one followed by as many zeros as it can be bothered to complete and, hey presto, the credit has been paid. This device often leads to inflation so the reality is that the creditor is just paid a dividend but there appears to be no default whatsoever.

A few states have, in fact, actually defaulted on their domestic public debt, including Argentina in 1982, 1989 and 2001. Other countries which have defaulted on domestic debt since 1975 include Turkey, Nigeria and Russia.

If we include countries which de facto defaulted by rapid inflation or other manipulations of their currency, then there will have been many defaults on domestic debt. For example, in the 1930s the United States abrogated gold clauses and, in the 1970s there was widespread inflation in European countries which massively reduced the claims of creditors, notwithstanding the spike in interest rates. Carmen M. Reinhart and Kenneth S. Rogoff in *This Time is Different* count over 70 cases of defaults on domestic debt out of 250 sovereign debt defaults in the period 1800 to 2009, excluding de facto defaults by inflation, the abrogation of gold clauses or the like. The authors say that this is probably an underestimate.

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The curiosity of the Greek situation, however, was that, although the euro was the country's own domestic and national currency, Greece did not control the currency. It could not create the currency, it could not manipulate the currency, it could not change the pricing of the currency and it could not change its exchange rate. This is because Greece was part of the eurozone currency union so that the currency was exclusively under the control of the European Central Bank. So Greece's position was almost exactly as if it were indebted in a foreign currency.

We say almost because, politically, it did have some influence over the currency. The influence did not arise solely from its tiny minority holding in the European Central Bank. It arose from the fact that the other members of the currency union would be drawn into the protection of Greece in order to protect the common currency.

This was a new departure. While a number of sovereign states have used the US dollar as legal tender, eg Ecuador, Panama and Zimbabwe, in none of these cases did the insolvency of the country concerned induce the United States into thinking that the US dollar was threatened.

There was another major factor. Domestic currency debt is usually subject to the law of the national issuer and as we shall see, this gave Greece power over the terms of its own debt.

In addition, domestic currency debt typically has few creditor protections. Apart from the absence of an external governing law and jurisdiction, there is typically no waiver of sovereign immunity and it is rare to find events of default or other covenants such as a negative pledge prohibiting the grant of security or a pari passu clause requiring an equal legal ordering of priorities.

5. Leadership of bondholders

One of the most important innovations in the Greek restructuring was the constitution of a steering committee, effectively acting as the negotiating representatives for bondholders together with the Institute of International Finance. The negotiations were led by representatives from the IIF and from the largest bank members of the steering committee. The members of the committee were mainly banks and insurance companies, including Greek banks and hedge funds. They were chosen from a larger Private Creditor-Investor Committee, which comprised the same types of institutions.

The idea received impetus from the important role played by the Institute of International Finance. This is a club of virtually all the world's internationally active banks and is based in Washington.

It made sense for IIF management to negotiate with Greece and the eurozone in the early stages of proposals for the involvement of the private sector. It then made even more sense for the banks themselves to form a group which could act with the IIF.

This was a remarkable innovation since it is believed that there had been no major steering committee for *bondholders* since perhaps the nineteenth century, although there have been steering committees for bank lenders. In the nineteenth century, international bondholders, at least those holding bonds issued in London, were represented in their negotiations with defaulting sovereigns by a semi-official Council for Foreign Bondholders.

It is true that there have, in the past, been many competing bondholder groups with their own little committees but these were almost invariably not accepted by the sovereign debtor as a negotiating partner, let alone by the official sector.

The steering committee of bondholders took their cue from the last great steering committees of bank creditors. These were the steering committees of international banks established in the 1980s to deal with the bankruptcy of Mexico in 1982 and many other emerging countries. These committees were composed of the largest bank creditors. The banks were known as the London Club and the

official bilateral creditors were, and still are, known as the Paris Club.

In the 1980s, it was possible to organise bank creditors because typically the number of really major banks involved was not more than a couple of dozen. With the re-opening of the bond market for emerging countries in the 1990s, there was no mechanism whereby bondholders were sufficiently organised to form a representative group. There were too many bondholders and some were not subject to official pressures. In addition, bondholders may have thought that they were better off being a dangerous disorganised multitude rampaging over the countryside. There was a view that the best way to get paid was to be disorganised so that the sovereign debtor had no one to talk to.

The steering committee was self-appointed. It was not appointed by the sovereign debtor. It was not appointed by bondholders. A steering committee does not necessarily hold a majority of the bonds. Its members are legally not the representatives of anybody and they do not owe any kind of fiduciary or advisory or management duties to bondholders or the sovereign debtor. They are just an independent conduit. Their position depends entirely upon their implicit acceptability to the sovereign debtor and to bondholders generally, and the fact that both the sovereign debtor and the official sector are willing to treat the steering committee as the main negotiating party on behalf of bondholders. Major institutions welcomed the role played by the Institute of International Finance and by the steering committee on behalf of the Private Creditor-Investor Committee.

Steering committees are typically governed by a constitutional framework agreed between themselves and based on forms developed in relation to large corporate insolvency work-outs.

6. Bankruptcy without a bankruptcy law

Absence of sovereign bankruptcy law

There is no international bankruptcy law for sovereign states and, therefore the outcomes are determined by the bargaining position of the parties and free agreement.

The result of the open regime is that there are no stays or freezes on creditor actions, no petitions for bankruptcy before a court, no revocation of preferential transfers, no liability of managers for deepening the insolvency, no direct control through a creditor representative, no stays on set-off or collateral enforcement, no compulsory disclosure, no realisation of assets, no formal bankruptcy ladder of priorities, no mandatory equality of creditors on the same rung of priorities, and no discharge of the debtor.

A key question therefore is whether a legal regime, where there is no law, except free contract law, is workable. If the conclusion is that law is not necessary, then it would mean that one of the most important principles of the rule of law is that there should not be too much law.

The outcomes of a sovereign bankruptcy are determined by the bargaining position of the parties, not prescriptive law. The parties do not operate against the background of the shadow of a bankruptcy regime. In the case of corporations, this shadow plays a major role in the determination of the position of the parties in work-out negotiations because, if the work-out negotiations fail, then the corporation has to be put into a judicial bankruptcy, at which point the position of creditors is determined by the law. For example, and most importantly, corporate bankruptcy laws contain a bankruptcy ladder of priorities with the result that work-out negotiations must reflect this bankruptcy ladder. Creditors who would be on a higher rung in a court bankruptcy are unlikely to yield this privilege on a private work-out.

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Since, in the case of sovereigns, the outcomes are determined by contract and since contract law is free and liberal, allowing the parties more or less to decide what they like, subject to some very basic and primitive threshold rules, one might well be amazed that the outcomes can be orderly and disciplined. If everybody is completely free, one would expect anarchy and disruption.

However, in practice, very few major sovereign bankruptcies are disorderly. The reason for this is that there is typically a high degree of interconnectivity between the parties which limits their freedom of action. They are held down by the chains and fetters of their linkages, by the reality that what harms another one could also harm itself.

Financial poker

A useful way to understand how the Greek transaction achieved an orderly resolution is to picture it as a gigantic game of financial poker played between three parties. This transaction was different because there were three major parties with very different interests, not just the usual two, creditors and the debtor.

Each party had its own set of cards which it could play or not play. The first essence of this card game is that everybody knows what the cards are: they are on the table and transparent. All that is unknown is whether the player will play them and when.

None of the cards are aces. The best card would be at most a five of diamonds and most of the others are threes or twos of spades or clubs.

The cards held by Greece

One may consider the hand held by Greece, although the real battle was not between Greece and its creditors but between the other two players, both of whom were creditors, or about to become creditors.

For Greece, the tree had fallen and it lay helpless on the ground, being snapped and snarled at by the other two players. Although Greece was urged to get on its feet and resurrect itself by levitation, Greece's ability to do so – in the way of firing civil servants, cutting off public pensions, suddenly collecting taxes, miraculously selling off state assets when there was nobody to finance them or otherwise converting themselves magically from a destitute bankrupt to a prosperous merchant – was limited as many of these actions would appear to pose some problems for the government and population of a democratic country unused to this novel condition of being ordered around by foreign creditors.

Debtors always have the traditional card that creditors depend on the debtor to be able to get back to financial markets and to be in a position to reawaken borrowings so that the debtor can pay those creditors who have had to wait.

In this case, Greece had another quite good card. This was that more than 85% of the Greek bonds were governed by Greek law so that Greece could ultimately impose a unilateral rescheduling on its creditors simply by passing a statute. This statute would, subject to various qualifications, be recognised in the courts of most developed countries since creditors who contract under local law take that system of law as it is from time to time. A unilateral rescheduling would be an aggressive act so that this tended to weaken this particular card for a sovereign debtor which was on a life support machine under the control of one of its main classes of creditor in the form of the eurozone. However, Greece did play a lower version of this card in the form of unilaterally introducing collective action clauses into its Greek law bonds.

In practice, Greece derived its bargaining position by piggy-backing on to the bargaining position of the other two players and using their cards, eg the fears of the eurozone about contagion.

The cards held by the global capital markets

The second main player was the global capital markets in the form of bondholders. The global capital markets are sometimes viewed as a great

dark monster rampaging like a beast over the land, pillaging and looting, drinking blood and eating children. The reality is that the capital markets mainly comprise ordinary commercial banks and insurance companies where the relevant departments are peopled by staff who spend their day going through financial statements and offering circulars, processing payments, first this way and then that, shuffling documents, coping with office politics and generally pursuing a work lifestyle that could hardly be regarded as flamboyant or devilish.

Bondholders as creditors have limited legal rights against bankrupt sovereign states. This is because the domestic assets of a sovereign are almost always inviolable by local statute and cannot be attached by creditors, something which was generally true of Greece as well. While the state may have external assets and while international bonds may contain waivers of immunity (bonds subject to local law almost never contain waivers of immunity and this was also true of Greece), most states do not own foreign assets in their own name. Instead, the foreign reserves, if there are any left, are held by the central bank. Foreign investments, in the form of shareholdings in foreign companies, would typically be held by a state-owned entity domiciled locally. In both cases, the assets concerned are shielded by the veil of incorporation. This leaves diplomatic premises and diplomatic bank accounts which would typically be shielded by diplomatic immunity and which in any event would not normally add up to much.

So, unlike an ordinary corporation, bondholders cannot attach material assets of the sovereign state in practice, nor can they liquidate the foreign state. They can be a nuisance by obtaining judgments which might chill future borrowings by the state because the proceeds of the borrowing and the repayments have to touch down somewhere and so might be caught by the attachment. This technique was successfully deployed by holdout creditors of Argentina.

Creditors can also terminate agreements, suspend drawdowns under credit agreements, close out derivatives and accelerate loans if there is an event of default, such as non-payment. Typically, these events are exercised sparingly unless the sovereign repudiates and often are not a major sanction.

Downgrades by credit rating agencies can have a much more significant effect on creditors and the sovereign itself. The downgrading of the sovereign ratings can disqualify investors from holding the debt of the sovereign, increase the capital banks are required to hold, disqualify the sovereign's public debt as eligible collateral granted to central banks, clearing systems and other market participants, increase the amount of collateral needed and increase the cost of insuring the state's debt. A downgrade can create a run on the debt and the debtor's currency.

In the case of Greece, the main card held by the bondholders was that the bondholders could threaten contagion to other eurozone states, including Italy and Spain, by declining to lend to them. The effect would have been potentially to have precipitated the bankruptcy of major eurozone countries if they were denied access to capital markets to refinance their debt as it fell due. The value of this card was enhanced by the fact that the eurozone has an ideology, a symbolic concept, an idealism, represented by its common currency. The global capital markets could therefore, if they wanted to, potentially smash this dream.

Why did they not use this card – undoubtedly the highest ranking card in the whole deck in this particular game of poker? A practical reason is that smashing a house is fine if you do not live in it. It might have helped also that the European Central Bank was, at the time, offering three-year loans at 1% so that banks could make a fine profit by borrowing from the ECB and using the money to buy the public debt of threatened countries – a transaction called the "carry trade".

There was, however, a deeper reason. This was that we believe that the banks, insurance companies and other bondholders espoused the view that order is better than disorder, that the preservation of the financial system and its

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safety is better than collapse and panic, and that financial institutions have a responsibility, not just to their depositors, pensioners and policy holders, but also to society at large, and that these various values together stand for a philosophy more powerful than anything else.

Accordingly, although bondholders held a superbly potent card, they never played it to its full extent. Nevertheless the perception of increased credit risk was displayed in higher interest rates and reduced lending to, for example, Spain and Italy.

The bondholders did have another card. This was that non-payment of banks and insurance companies could threaten the stability of these institutions, particularly when they had been weakened by the financial crisis starting in 2007. The value of this card was diminished by the fact that, by 2012, most of the important banks and insurance companies had enlarged their capital and were in a better position to bear the losses caused by a Greek default.

The fact that the firms which were hit by the losses were banks and insurance companies who, indirectly, represented the public at large (who were depositors, insureds and pension-holders) was, or should have been, an important card, but it was a card which politicians chose to ignore. The politicians could take this course because, at the time, the public were not enamoured of banks and, also, the public could not see that the public would in fact ultimately pay for the losses suffered by the banks and insurers.

The cards held by the eurozone

The third player was the body of official or governmental creditors, comprising mainly the eurozone countries and their various institutions, such as the European Central Bank and the European Financial Stability Facility. The official creditors included the IMF.

It is true that official creditors in the form of foreign governments and the IMF are present in most sovereign bankruptcies. The differentiating factor in the case of Greece was the enormous importance of the official sector and of the amount of finance provided by the official sector to bail out Greece.

The main card possessed by the eurozone was that it was in practice the only source of bailout cash. Also, it could, if it had its back to the wall, arrange for the debt of Greece, and indeed of the whole quintet of suspect countries, to be paid. The European Central Bank could buy in all the bonds concerned and pay for them by sending the selling bondholders an email stating that the bondholders were credited with the purchase price, whatever that was. Nowadays the central bank does not even have to print money or ship it out: it just sends an email.

What was against the use of this card to resolve the whole thing in the blink of an eyelid was the shadow of the hyperinflation of Weimar 1923, as expressed in the constitution of the ECB stating that the primary objective of the ECB is to "maintain price stability", meaning to avoid inflation. There are also various prohibitions in the relevant EU treaty. Article 123 prohibits overdraft facilities by the European Central Bank in favour of European governments, public authorities and the like, and prohibits the purchase from these governments, etc of debt instruments by the European Central Bank. Article 125 provides that the Union and the Member States shall not be liable for, or assume, the commitments of central government.

While there is an objection to assuming the commitments of other eurozone member states there is no prohibition on doing so by means of voluntary assistance. The initial rescue package for Greece consisted of loans advanced by the other eurozone member states. This had the distinct disadvantage that the amounts lent by each member state would have to be added to its own indebtedness so that, with very large amounts involved and the distinct possibility of further bailouts for other countries, the credit of eurozone countries could itself be threatened.

If, on the other hand, the ECB was simply to create money, albeit at the risk of inflation, then this would not have the consequence of adding to the debts of eurozone countries. The

creation of money by the central bank would not involve any taxpayer in the eurozone actually having to put his hand in his pocket to pay for Greece.

The European Financial Stability Facility was set up as a sort of shadow of the ECB, able to do things which the ECB could not do or which the ECB was disinclined to do as a matter of policy. The ECB is independent of governments, but the fundamental duty of a central bank must be the survival of the currency.

The EFSF raised bailout money by making bond issues guaranteed severally in pro rata proportions by eurozone countries, except by the debtor country. These guarantees would not, until the government accounting rules contained in ESA 95 change, have to be added to the indebtedness of the guaranteeing eurozone countries.

The fact that the eurozone could pay for Greece and was, in fact, the only source of fresh cash (apart from the IMF) meant that the eurozone had bargaining power to insist on fiscal austerity by Greece and also had bargaining power as against the bondholders who depended entirely on the eurozone to pay them since Greece would be incapable of paying them for many years.

Historically, the official sector via the IMF has always played a controlling role in most of the recent bond reschedulings since Pakistan in 1999. The reason is that other bilateral government creditors and also private sector creditors would never agree to reschedule unless the sovereign debtor had agreed a programme and a standby facility with the IMF. It was not the resources the IMF could lend to the sovereign debtor that gave the IMF its power but rather the fact that official and private creditors insisted on IMF control of fiscal affairs of the sovereign debtor via the conditionality in its standby facilities.

In addition, the IMF was typically the first to work out the debt sustainability of the sovereign debtor and what the sovereign debtor could afford and what it could not afford. The IMF therefore decided such matters as the degree of rescheduling and proposed haircut. This was communicated to the Paris Club of government creditors who inserted a clause in their minutes that all official and private creditors must reschedule on comparable terms. Hence, when bondholders went to visit the Minister of Finance of the sovereign debtor, the Minister of Finance would simply throw up his or her hands and say the whole thing had already been agreed and there was nothing he or she could do. In this way, the IMF got used to calling the shots. Its views had and still have a great deal of credibility because of its technical competence and experience.

As with the IMF, the fact that the eurozone could effectively insist on an austerity programme for Greece greatly contributed to the eurozone's bargaining strength.

How the game was played

The upshot is that none of the players played their big cards. They played smaller versions of their cards. The threat of the big card was always implicit and maybe it was just the fact that the threat was there which ensured that the resolution was orderly.

But several months after the Greek reorganisation was completed, the ECB did decide to play a higher card, as we shall see.

The Sarajevo moment

The above analysis of the poker game shows that a free legal environment does not necessarily lead to a chaotic and disruptive outcome. There is, however, another factor – the Sarajevo moment.

On that famous July day in 1914 in Sarajevo, the terrorists had already missed their target and were disconsolately walking home. But the carriage carrying the Archduke changed its course and came down a side street right in front of them. This time they did not miss.

That event led to a succession of consequences, like one iron ball hitting another which then hits another and so on, until the whole of Europe, and then practically the whole world,

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was plunged into a situation that nobody wanted.

The Sarajevo moment, therefore, is the sudden and unexpected intrusion into an emotionally charged situation of an irrational happening which upsets all common sense, all the balance of bargaining power, all the orderly momentum, and leads to a catastrophe. So it does not follow that orderly results can be always expected from the connections and linkages between the main actors.

Non-binding guidelines

One of the techniques for dealing with out-of-court insolvencies is the development of voluntary guidelines. In the corporate sector, these commenced with the original London Approach and continued with subsequent codes such as those produced in Thailand, South Korea, Turkey, Hong Kong and Japan, as well as the INSOL Principles of 2000. In the sovereign sector there is an important set of guidelines prepared under the aegis of the Institute of International Finance called the *Principles for Stable Capital Flows and Fair Debt Restructuring*, originally published in 2004 and under review as at mid-2012.

Conclusion on bankruptcy without a bankruptcy law

The Greek debt reorganisation showed that the successful handling of a bankruptcy without a bankruptcy law can be achieved, but it does not necessarily follow that it always will be. It was achieved in this case largely because the main parties all wanted stability and order, rather than disorder, so that there was an underlying unity of purpose. There were moments when the participants held their breath and when it did seem possible that the whole thing would tip over. But that never happened.

One of the key questions is whether the relative bargaining strength of the parties did indeed result in a fair result. One could expect that each of the three parties probably felt that they had a raw deal, a deal they should never have agreed to. Thus, members of the eurozone no doubt considered that they had been forced to put in a totally excessive amount of money to rescue Greece. Greece no doubt thought that they had lost sovereignty and were being punished by a vindictive austerity programme. The bondholders no doubt felt that they had been the victims, the ones who carried the burden, in that they were tossed a junior subordinated note payable in 30 years and worth a fraction of their original debt.

The future will show the extent of inequitable treatment. A major factor in the judgment of the future may well be the effect that the Greek debt reorganisation has upon the future attitudes of the parties – the future attitudes of sovereign states to the loss of sovereignty or to how they run their finances, the future attitudes of sovereign states to bailing out other sovereign states either via the IMF or a confederation of states, the future attitude of banks and bondholders to subscribing for the public debt of countries which are not willing to exhibit discipline in their finances and the future attitude of bondholders to being subordinated to the official sector.

7. Impact on a European political union

The bankruptcy of Greece was a major stimulus to calls for greater political union. In the first place, many politicians took the view that the only way to stop the threat to the currency was to ensure that there was greater fiscal discipline on eurozone member states, especially excessive borrowing to finance budget deficits, ie over-spending by governments.

Secondly, the possibility of the issue of bonds in the financial markets which were the joint and several obligations of all the member state of the eurozone was raised.

The third strand of the thinking was that there should be a banking union. This meant that there would be a single European regulator of banks, a harmonised regime for the insolvency of banks, a central fund to finance failed banks and a common deposit protection scheme. All of these were focused on the bankruptcy of banks and the resulting adverse impact on the

insolvency of sovereign states, as in the case of Iceland and Ireland, amongst others.

Whether or not these grand schemes ever materialise remains to be seen. Apart from resistance in some members to any further erosion of national sovereignty by the EU, most of the proposals would involve the credit of strong states, such as Germany, being used to support financially weak states. But there is no question that the Greek experience, although Greece represented only 2 - 3% of the eurozone GDP, enlivened the pulse of the major European movement towards greater union.

This shows once again that bankruptcy, since it is a spoliator and a destroyer, is a great driver of politics and law. It awakens passions which would otherwise remain dormant and through these passions generates debates and change.

These political and fiscal proposals were paralleled in the early history of the United States where there was considerable collision between the rights of the individual states and the concept of a federal union. In this conflict, money and bankruptcy played an important role. The conflict ultimately resulted in the terrible Civil War of 1861 to 1865. For sure, the struggle there was extensively about slavery, but it was also about political union. In addition, it was also about a common currency, a currency which symbolised the idealism of those in favour of union, an idea which also inspires the federalists in the European Union.

8. Expeditious outcome

The Greek debt reorganisation, at least from the time of the involvement of the private sector, took nine months. For those watching, it seemed that the transaction lasted an eternity and also seemed to be characterised by fractured dysfunctions and disorderly disputes.

For those experienced in work-outs, the transaction was conducted at great speed and exhibited a high degree of cool financial diplomacy by the representatives of each of the three main players – the Eurogroup, the EWG and the EFSF, the bondholders and Greece itself. By way of contrast, very large corporate work-outs can go on for many years and be coloured by indignation, rants, stand-offs between competing creditors, rages between the body of creditors and the debtor, and a general atmosphere of chaotic uncertainty. For sure, the Greek transaction was not the quickest of recent bondholder reschedulings, but it was much quicker than some other sovereign reschedulings, notwithstanding the enormous political complexity. For example, the Argentine reorganisation took several years. See for example the comparative work on this topic by Christoph Trebesch.

9. No moratorium

Greece, though bankrupt in the non-technical sense, did not default on its debt.

In most cases of sovereign insolvency over the past three decades, the sovereign debtor has declared a moratorium resulting in an actual non-payment, a default. Typically a state will declare a moratorium for, say, 90 days accompanied by a statement that during that period the state intends to achieve an orderly resolution with its creditors. In the case of Greece, there was no moratorium and no actual non-payment, at least not as at mid-2012.

Both Greece and the Troika consistently held out that the exchange was voluntary. One reason for this is that there was initially a reluctance to trigger credit events under credit default swaps in case this implied a default by Greece. Another reason was that the eurozone was very sensitive to the fact that a member should default by reason of bankruptcy – because of the threat of contagion to other eurozone states and the threat to the currency. A further reason was that the ECB would not accept collateral consisting of a defaulting country's bonds, thereby inhibiting the efforts of the ECB to provide loans to Greece and other banks.

The fact is that markets were under no illusion that Greece was bankrupt. A debtor that pays only a 25% dividend to its bondholders is not solvent, as this is normally understood.

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In the sovereign context, the technical legal definition of bankruptcy has quite minimal importance compared to corporate bankruptcies. In corporate bankruptcies, the condition of insolvency is typically defined in bankruptcy statutes as either an inability to pay debts as they fall due or as an excess of liabilities over assets (balance sheet insolvency) or both. The most usual definition is inability to pay debts as they fall due.

The definition has great importance in relation to corporate bankruptcy statutes because, for example, the condition of bankruptcy enables creditors to petition for a judicial liquidation and the demise of the corporation. In addition, the revocation of preferential transfers and payments by the debtor usually hinges upon actual bankruptcy as defined, whether or not declared. The liability of directors for deepening an insolvency may crystallise when the company is de facto bankrupt.

None of these consequences arise in the case of sovereign states because there is no statutory bankruptcy regime. The typical results of the condition of bankruptcy are, firstly, events of default in bond issues and loan agreements, hinging on failure to pay, and the possibility of sparking off cross-default clauses and, secondly, a downgrade in the sovereign's ratings by credit rating agencies. Hence, when one describes a state as bankrupt, one is describing the substantive effect of insolvency rather than satisfying a technical definition which leads to legal consequences.

The fact that the eurozone insisted that the exchange offer had to be voluntary meant that, in theory, Greece was not able to incentivise bondholders to accept its exchange offer by a declaration that Greece would not pay creditors who did not accept the offer. This technique had invariably been used in sovereign exchange offers in previous cases, leading to very high rates of acceptance – usually above 95% – in the few sovereign restructurings since 1999, always excluding Argentina.

In practice, Greece did use this ploy, although less directly. Greece made it clear in the risk factors in the offering documents that it was unlikely that Greece would be in a position to pay bondholders who did not accept.

Accordingly, bondholders who did not accept and were holdouts ran the risk that they would be bound in any event by the implementation by Greece of collective action clauses (which did, in fact, happen) or they ran the risk that a large number of other bondholders would also hold out with the result that the offer would fail altogether. The position might then be that there could have been a disorderly default followed by a forcible rescheduling by Greece of Greek law bonds by unilateral statute.

10. Substantial haircut

An intriguing feature of the transaction was the very large haircut imposed on bondholders. This result seems even more extraordinary in view of the fact that the sovereign debtor is nominally in the rich country club and, therefore, one would have thought, capable of giving greater satisfaction to its creditors than it did.

A haircut is the jargon term for the reduction in a creditor's debt. For example, if a creditor is owed 100 and is paid only 70, then the haircut is 30. The actual value of a package offered to debtors is notoriously difficult to work out, but some estimates put the net present value of the package at about 25%, ie the bondholders took a loss of 75 for every 100 of debt. Apart from the desire to achieve an orderly solution quickly, the main bondholders were probably encouraged to go along with this because of the fact that, at the time of the exchange, they received both accrued interest on existing bonds and also 15% in cash, both in the form of short-term notes issued by the EFSF and both financed by Greece through loans from the EFSF.

There are several objections to massive haircuts of this type. In the first place, such a large haircut must inevitably discourage investors from subscribing for the public debt of other eurozone countries considered to be vulnerable or to have high debt ratios.

The other objection is that the people actually being deprived, the people actually having to pay, are ultimately not just the bondholders. If we strip aside all the veils of incorporation, all the fictions of legal imagination, the real creditors of sovereign debtors are not the nominal banks and insurance companies. They are the depositors who put their money in the banks and the individuals who have insurance policies and pensions payable by the insurance companies. It is therefore the citizen who has to pay ultimately. This objection is intensified by the fact that the average citizen does not know this is happening and cosily thinks, a thought mostly not discouraged by politicians, that somebody else is paying. It hardly seems right to run our societies on the basis of this kind of opaque cloaking of reality.

In the end, the bondholders went straight to the end-game, without intermittent steps. On the other hand, although the terms of the eurozone credits were concessionary, the eurozone lenders did not go to the end-game because they wanted to preserve bargaining power over Greece so as to be able to enforce austerity policies – the famous short-leash approach. The result is that the eurozone official creditors are likely to be the next in line for haircuts or an extension of maturities if the Greek debt continues to be unsustainable.

In mid-2012, the new bonds were trading at less than 25c per euro. They had lost more than three-quarters of their exchange value. In most recent sovereign bankruptcies, the new bonds have held their market value and so the collapse of the price of the new Greek bonds was remarkable. It was probably driven by the fact that the outlook for Greece seemed so bleak that the credit ratings of Greece remained very low and this excluded pension funds and certain other institutional investors from holding on to the new bonds. The perceived subordination of the new bonds was also not particularly encouraging.

11. Contagion risk

The Greek bankruptcy involved a major risk of contagion prejudicing other developed countries in the eurozone.

All major insolvencies generate the risk that the insolvency will spread, not because other debtors are bankrupt, but because creditors suspect that similar debtors are likely to be in a similar situation to the bankrupt. This contagion risk may also be grounded in the reality of the domino or cascade or ripple insolvency, whereby the default of counterparties who do not pay results in the creditors concerned being, in turn, unable to pay. Contagion is therefore often a mix of the imagined and the real, illusion and actuality.

This menace of spreading sickness was distinctly observable in the crisis of the lesser-developed countries in the 1980s and also, again, in the case of the Asian financial crisis in 1998 where the near bankruptcy of Thailand spread quickly to other countries, such as Malaysia and South Korea. But the risk of contagion became a fundamentally important risk in the case of Greece, partly because of the fact that developed countries were involved, so that the amounts were extremely large, and because there seemed to be a threat to the second largest currency in the world.

At the time, there were frequent and increasingly unconvincing assertions that Greece was a special case and that Greece was "ring-fenced".

The main form of ring-fencing was to increase the bailout funds to the EFSF but at the time the amounts were not sufficiently convincing to disarm fears about the spread of the risk to other countries in the eurozone.

The risk of contagion was compounded by the fact that the banking sector was in a bad state. Banks had been badly hit by the bursting of the property bubble. It was not easy for them to raise additional capital to replenish their existing capital or to satisfy the massively increased capital requirements imposed by regulators. The inter-bank market was virtually

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moribund. Banks were under other regulatory attacks, including government requirements to break them up. The result was that banks reduced their lending and there was a marked tendency for them to move back within their national boundaries. So one of the main supports of the capital markets was restrained in the help it could give and was very vulnerable to the contagion of sovereign bankruptcy which inevitably brings down the banking system in the country concerned.

Another major factor was the redenomination risk, that is, the fears by many that the bankruptcy bailout pressures might lead to a fragmentation of the euro and the introduction of depreciated national currencies.

Notwithstanding the picturesque metaphor of some terrible plague spreading across the country, the mechanics of contagion are simple and routine and do not involve some special dark forces which are unknowable. In the case of bondholders, all that happens is that the credit or investment committees of banks or insurance companies decide that they are not going to subscribe for the debt of a particular sovereign state because it is seen as too risky. These firms have duties of prudence. If enough credit and investment committees make this decision, then the sovereign is cut off from access to new funds to refinance its maturing debt. It is a fact of modern credit economies that, if creditors decline further credit and call in their existing credits, then most individuals, and certainly most businesses, would instantly be bankrupt since few people or companies can pay all of their debts immediately out of ready cash.

A run on a debtor is the most extreme form of contagion. In the case of a run, such as a run on banks, the creditors of the bank simultaneously demand repayment of their deposits and loans and also refuse to provide any further credit. If a theatre-goer shouts “Fire!” and everyone rushes for the exit as the same time, the result is a situation which is entirely rational from the point of view of each individual but is completely irrational when everybody acts together. The same can happen to sovereign states.

It was mentioned earlier in this paper that if the eurozone had its back to the wall, it could buy the bonds of suspect countries and create the necessary amount of money. They could do this in particular if the contagion was so dangerous as to threaten, not only the finances of major eurozone sovereigns, but also the common currency as well. The European Central Bank moved resolutely in this direction when it announced after the summer of 2012 that the ECB would provide unlimited liquidity in the secondary sovereign bond markets.

On 6 September, 2012, the ECB announced the features "regarding the Eurostystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. These will be know as Outright Monetary Transactions….. A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM programme" which must "include the possibility of EFSF/ESM primary market purchases" and only continue "as long as programme conditionality is fully respected…No ex ante quantitative limits are set on the size of Outright Monetary Transactions". The ECB added that the "liquidity created through Outright Monetary Transactions will be fully sterilised". Details of the transactions would be published weekly.

In other words, the unlimited liquidity would be provided only if the sovereigns concerned agreed to a financial reform programme, no doubt including austerity measures.

The ECB sought to deal with the objection that the creation of money could be inflationary by confirming that the cash created would be "fully sterilised". The term "sterilisation" means that the central bank would take out as much money as it created, e.g. by demanding deposits from eurozone banks.

There is no question that this announcement was a breakthrough and an extremely important step.

12. Political complexity

A further new factor was the extreme political complexity of the process. This was mainly because on the eurozone side Greece was negotiating with 16 other governments in the eurozone, with bit parts by non-eurozone countries such as Britain and Sweden.

The result was that obtaining an agreement amongst this group of creditors, who were the ultimate paymasters, was a tortuous process. It was rendered even more tortuous by the fact that decisions, or the lack of them, were coloured by the fact that policy was subjected to the views of national voters who were not always well-informed on the relentless logic of bankruptcy.

Another result of the political complexity was a comparative lack of transparency and disclosure between creditors. A major requirement for a successful work-out is candidness and the sharing of information between all the parties. Indeed, this information exchange is mentioned in virtually all of the leading soft principles for work-outs developed in the corporate and public sectors.

13. Austerity measures

The disbursements of financial assistance to Greece by the European Financial Stability Facility were made conditional on the adoption by the Greek government of an austerity and reform programme.

Typically in the past, these requirements, known as "conditionality" have been a preserve of the IMF as a condition of the advance of new money. Other creditors have traditionally declined to reschedule unless the sovereign debtor adopts the IMF requirements. In the case of Greece, the requirements were imposed mainly by the eurozone, together with the IMF.

The key eurozone measures can be grouped into four main categories:

– Severe cuts in public expenditure and the setting of fiscal targets so as to end deficits. There was to be a reduction in pharmaceutical spending, the defence budget, pension expenditures and subsidies. Many public employers were to be effectively dismissed. Certain taxes were to be increased and special levies were to be introduced.

– The Greek government committed to proceed with the sale of state-owned land, utilities, ports, airports, entertainment and mining rights. The privatisation programme was not exactly a success, probably because there were few people willing to pay for assets in such unpredictable circumstances and even fewer willing to finance a purchase.

– The Greek government was required to introduce "structural reforms" which included the opening up of various professions and trades to competition, ranging from accountants to tourist guides, a reduction of the monthly minimum wage and the weakening of collective wage agreements. Social security contribution rates payable by employers were increased. Greece was required to implement reforms to fight tax evasion.

– The disbursement of financial assistance to Greece was made conditional on the recapitalisation of Greek banks. The finance was to be provided by the eurozone credits via a government fund established in Greece.

This programme ignited a passionate debate, not only in Greece but elsewhere in the world, as to whether policy should introduce austerity or whether it should stimulate growth by larger public expenditure. The debate transformed itself into a much bigger dispute between the economic ideologies of Keynesianism as against Friedmanism, between the strict and the liberal, between the ruthless and the generous, and other grand philosophical points of view about the nature of existence.

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Bankruptcy has a terrible logic. If people are on a raft and there is not enough brandy and biscuits to go round, there are two options. Either those on the raft can fight for their share of the brandy and biscuits and eliminate the weakest. This is what happened on the famous raft of *The Medusa*, a ship wrecked on the west coast of Africa in 1816 where 147 people got on the raft and 15 got off. The rest were mainly killed in the fighting. The other option is to have a plan for the available resources. The Chilean miners who found themselves embedded in rock several kilometres under the Chilean desert in August 2010 had a plan. They survived.

14. Impact on banking sector

The Greek reorganisation give impetus to the movement in favour of strong-arm bank resolution statutes. Under these statutes the conduct of the insolvency of banks is transferred to regulators from creditors and courts. Bankruptcy law is nationalised.

The Greek banks were not recapitalised during the bailouts. The idea was that they would be recapitalised after the bond exchange out of EFSF money.

The insolvency of a sovereign state almost invariably leads to the insolvency of the country's banks. This does not necessarily have to be the case but, in practice, this is what happens. One reason is that, if a sovereign state is not able to pay its debts as they fall due, foreign creditors will not grant credit to domestic banks.

There are four major channels whereby the bankruptcy of a sovereign has an impact on banks. First, the banks often have large holdings of their own government's debt. Secondly, the higher sovereign risk reduces the value of collateral that can be used for funding. Thirdly, if the sovereign credit rating is downgraded, the rating agencies will usually downgrade banks similarly. Finally, the sovereign risk reduces the value of the implicit or explicit government guarantees given to banks.

15. Governing law and jurisdiction

The Greek debt reorganisation involved a major re-appraisal of the importance of the role of an external governing law for public debt for the law of the issuing sovereign.

More than 85% of the bonds involved were governed by Greek law. The others were governed by various other foreign legal systems, mainly English law.

The effect of this was that Greece could change the terms of the Greek law bonds, and courts of most developed countries would recognise the change unless the change was penal, grossly discriminatory or otherwise unconscionable. This result is codified in the EU by a regulation known as Rome I. The reason for the principle is that, if you choose a legal system to apply to a contract, then inevitably you have chosen the legal system as it applies from time to time, as it flies through time like an arrow. You cannot freeze a legal system or stop its onward trajectory because then you would only have chosen part of the legal system, its historic part. All contracts must be governed by some system of law: they cannot exist in a vacuum and be a law unto themselves. There are around 320 legal systems to choose from and, where there is an external or foreign choice of law, the most common choices in the case of bonds are English or New York law. The United States has a somewhat different rule about what law governs, although the effect is often the same.

In any event, if a foreign system of law is chosen, then Greece could not by its own statute change the foreign system of law – it is not Greece's system of law and not within its territorial control. The result of this situation was that, in the case of Greek law bonds, Greece could potentially, by statute, impose a unilateral change on bondholders. It could write down the amount payable under the bonds, it could reduce the amount of interest, it could postpone the dates for repayment and it could impose exchange controls. And, it could insert collective action clauses into existing bonds governed by Greek law so as to allow a

majority of bondholders to override a minority by voting – as indeed Greece did.

The fact that Greece did change the bonds by inserting collective action clauses forcibly brought to the attention of the international creditor community the overriding importance of a foreign governing law as insulating the bond obligations from unilateral interference by a local statute. It was at once appreciated that it was dangerous to have a situation where the debtor could, of its own volition, completely change its debt obligations just by passing a law.

Why were the bonds governed by English law?

If Greece did insist on Greek law for the new bonds, the market might have taken this as a signal that Greece intended to reserve an option to change the obligations unilaterally and hence bondholders would not be willing to participate. The success of the project would be jeopardised, risking further contagion.

Probably all of the official loans in the current eurozone crisis have been subject to an external system of law, usually English law. The relevant bonds issued by the EFSF and the European Union were governed by an external system of law. The German public sector entity Kreditanstalt für Wiederaufbau used English law in the Greek context.

English law is like a public utility. It is generally familiar to financial markets and acceptable to them. In addition, English law is an EU system of law. The use of an EU governing law was therefore an EU solution.

Some of the existing Greek debt was governed by a foreign law. It may have been unfair to switch those bondholders to Greek law.

A market perception that the new Greek bonds had an inherent weakness would not have assisted the Greek domestic banking system in returning to the markets and ending its dependence on the ECB for liquidity, a major aim of the official sector Greek rescue programme.

The new bonds would contain collective action clauses which were fully consistent with current EU thinking. Hence, if Greece wished to put some new proposal to the bondholders in the future, there was a mechanism for bondholder voting on the proposal whereby the vote of the prescribed majorities would bind minority and hold-out creditors. Greece had not lost complete sovereignty.

There were fears that the use of English governing law for the documents governing the Greek debt reorganisation could disturb the existing practice whereby public debt of eurozone member states is often governed by domestic law, but these proved unfounded.

For various reasons, it was not considered appropriate to use the law of a eurozone state instead of English law. The UK is a member of the EU but not the eurozone. These reasons were technical legal reasons. They included the fact that nearly all eurozone states either did not recognise the trust (which was an important feature of the initial structure negotiated in July 2011) or had adverse case law on an obscure but important article of the IMF agreement. Article VIII 2b provides for the universal recognition of the exchange controls of a member state, thereby overriding the insulation of the governing law if strictly applied, which it is not in some countries such as the UK and the US.

The application of public international law was not considered appropriate. This is because the contract rules of public international law are nowhere near the sophistication of domestic contract law and because the issue of whether public international law insulates against debtor redenominations, moratoriums and exchange controls appears unclear.

It was not considered possible to protect creditors by a provision that the governing law was Greek law frozen as at some date in 2011. A stabilisation clause freezing the governing law in this way is not considered an inviolable protection.

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16. Public sector bailout and priorities

Introduction

An extraordinary feature of the Greek debt reorganisation of 2012 was the enormous quantity of public or government money poured into Greece by the eurozone and the IMF, and the consequent development of a very unusual ladder of priorities between creditors.

Bankruptcy ladder of priorities

The heart and central core of corporate bankruptcy regimes is the bankruptcy ladder of priorities which determines the hierarchy of claimants on final liquidation.

Even the most cursory examination of the law of corporate bankruptcy internationally shows that the pari passu rule is nowhere honoured. Nowhere is there a flat field. On the contrary, creditors are paid according to a scale of priorities. There is an intricate series of steps as creditors scramble upwards, gasping for more air to escape the swirling tides of rising debt and to breathe in the squeezed bubble of oxygen at the top.

The concept of a ladder of priorities is so potent that there is a consensus ladder in relation to state insolvency, even though state insolvency is not governed by any mandatory bankruptcy laws and there is no compulsory ladder of priorities. But there are priorities, a hierarchy or ladder of consensus and practice. To queue is human.

How are priorities granted in the case of a sovereign state?

In the case of corporate bankruptcies, the basic ladder of priorities is based on liquidations. A liquidator collects the assets of the bankrupt, sells them and then uses the proceeds to pay the creditors in the prescribed order of priorities. In other words, the priorities are an order of payments out of a pool of assets already realised.

Since there is no liquidation and there is no realised pool of assets in the case of a sovereign, the priorities must be achieved in a different way. In practice, the priority is realised by the order of payment in time. For example, a creditor who is paid in full on Monday will often, in practice, rank prior to a creditor whose debt is due on Tuesday because, after the payment on Monday, there may be nothing left to pay the creditor on Tuesday.

Thus, the priority achieved by the IMF results from the fact that the IMF debt is kept current, without any delay or haircut, even though other creditors are rescheduled. Once the IMF is paid on its due date, then the sovereign may have less cash to pay other creditors whose rescheduled debts mature on some future date.

This priority depends on the agreement of all the creditors involved. It is not laid down in any statute. If, say, bondholders did not agree to the IMF preferred status, then the remedy of the bondholders would be not to accept a rescheduling and simply to accelerate their debt if the sovereign state defaulted.

Priority according to maturities is only a de facto priority and applies only if an earlier payment makes it impossible for the debtor to pay a later maturity. This is one reason why a priority order for medium term or long term debt is a debatable proposition.

Preferred status of the European Stability Mechanism

The treaty establishing the European Stability Mechanism states in paragraphs 13 and 14 that the ESM will have preferred creditor status like the IMF. The text of the recitals is as follows

"(13) Like the IMF, the ESM will provide stability support to an ESM Member when its regular access to market financing is impaired or is at risk of being impaired. Reflecting this, Heads of State or Governments have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF

over the ESM. This status will be effective as of the date of entry into force of this Treaty. In the event of ESM financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of this Treaty, the ESM will enjoy the same seniority as all other loans and obligations of the beneficiary ESM Member, with the exception of the IMF loans.

(14) The euro area Member States will support equivalent credit status of the ESM and that of other States lending bilaterally in coordination with the ESM."

The EFSF did not, in or outside its constitution, claim preferred status.

Priorities in the Greek debt reorganisation

The potential Greek ladder of priority based on payment maturity is as follows in the worst case:

Rank

First	Bondholders 15%	Upfront payment of 15% of their bonds plus accrued interest to the bondholders, paid at the time of exchange, out of a loan of €30 billion by EFSF to Greece
Second	Holdouts	To the extent that they are paid. Some have been.
Third		Any non-financial debt
Fourth	T-bills	Repayment of Greek treasury bills (€9 billion up to end 2014, total €16 billion?), depending on maturities
Fifth	IMF	First bailout (reported to have a five-year maturity), plus €28 billion second bailout (reported to have a ten-year maturity), plus any future bailouts
Sixth	ECB/NCB/ EIB	Greek bonds apparently issued in return for €56.5 billion ECB/NCB bonds. European Investment Bank holdings. Priority rank depends on maturities
Seventh	ESM	Future new bailouts (ESM treaty claims preferred status) – none are anticipated and all current undrawn commitments are from the EFSF which has not claimed priority status.
Eighth	Future bondholders	Future market money borrowed and repaid before existing bondholders

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Ninth	Eurozone/ EFSF	€110 billion first bailout (including €34 billion undrawn as at Feb 2012). Maturity believed to be shorter than new bonds
		€25 billion second bailout. Bank recapitalisation. Maturity believed to be shorter than new bonds
		€35 billion, second bailout. Maturity believed to be shorter than new bonds
	EFSF	€5 billion second bailout to pay accrued interest, 20-year maturity, starting after ten years
Tenth=	EFSF	€30 billion, second bailout to pay 15% to bondholders, 30-year maturity, with amortisation starting after ten years. Covered by a pari passu Co-Financing Agreement with bondholders
Tenth=	Bondholders	€70 billion exchange bonds, ranking equally with EFSF €30 billion, 30 year maturity, with amortisation starting after ten years

Some claims are unaccounted for. The table does not consolidate credits in the Target 2 payment system or the collateral reported to be given to Finland.

The result was that the official sector almost uniformly gave itself a potential priority over the private sector, except for the EFSF €30 billion to finance the cash element of the exchange.

Discussion of the rationale of priorities

In the case of corporate bankruptcies, the bankruptcy ladder of priorities is, after the basic freezes on creditor actions, by far the most important and controversial element of the concept of bankruptcy. This is because the priority ladder decides who will survive and who will be drowned and determines the degree of risk. The predictability of the bankruptcy ladder is of crucial importance to creditors.

It is worth comparing the sovereign and corporate ladders. In the case of banks and ordinary non-financial corporations, the typical ladder has six basic categories. Each is divided into a multitude of sub-categories, especially near the top of the ladder where you get some finely graded mini-steps, taut and stretched. There can be 30 or 40 distinctive rungs across the whole ladder.

The main corporate categories are as follows:

1. **Super-priority creditors** These are typically creditors with collateral, set-offs and property rights under trusts, such as custodianship. Trusts are not recognised in many jurisdictions. Many countries either do not permit bankruptcy set-off or restrict it. Many countries weaken security interests in various ways. These interferences do not apply to sovereign states, except for non-recognition of the trust and local limitations on security interests. The result is that set-off and collateral are generally super-priority in the sovereign ladder.

2. **Priority creditors** In the case of corporations, there is a long list of preferred unsecured creditors, which can sometimes include depositors at banks, insureds with insurance companies, the taxman, employees for their remuneration and benefits, post-commencement new money and post-commencement expenses. These are tracked in the case of sovereign bankruptcies by, for example, the preferred status of the IMF and other multilaterals, the priority of sovereign deposit insurance schemes (which take over any depositor preference by subrogation) and, in the case of Greece, an enormous priority for last resort new money, plus central bank money.

3. **Pari passu creditors** These are typically banks, bondholders and suppliers. Suppliers are not a large claimant in sovereign bankruptcies. In corporate bankruptcies, banks and bondholders may convert into equity. In both corporate and sovereign bankruptcies, banks or bondholders or both are typically by far the largest class of creditors. They expect to rank equally between themselves.

4. **Subordinated creditors** These are creditors who agree to be subordinated in their original documents. Typically there are no subordinated creditors in formal terms in the case of sovereigns, but the same effect can be achieved by postponing the debt for, say, ten or 15 years.

5. **Equity** If a corporate is insolvent, then the equity is not paid. The shares may be diluted by conversion of senior pari passu debt into equity, thereby wiping out the existing equity who would in any case receive nothing. There is no equity in the case of sovereign states but effectively an exchange into notes of anything over, say, 20 years, is effectively equity in priority terms because it is similar to a perpetual claim. It does not really make sense to talk about priority of maturities over seven to ten years which is why the table given above in relation to Greece is somewhat ambiguous.

6. **Expropriated claimants** In corporate bankruptcies, these are claimants whose claims are not recognised or are otherwise demoted to such a degree as to be worthless. An example is the compulsory conversion of foreign exchange debt into local currency at the commencement of the corporate bankruptcy – a near universal rule. If the local currency is depreciating, as it often is, the effect is that foreign currency creditors are not paid. Other expropriated claimants are those for foreign taxes or penalties. These expropriated claimants are often not exactly replicated in sovereign bankruptcies but you can get a similar effect.

What therefore is surprising is how closely the corporate model, with all of its sophisticated refinements, is replicated in very crude and primitive terms in the case of a sovereign bankruptcy. However the corporate model has the certainty of the priorities being clear and binding. The issue in the Greek case was that the priorities were not certain and priorities were unexpectedly asserted by the public sector leading to market fears as to what the priority ladder would be in the future, including whether the ECB and NCBs would assert priority for all of their holdings.

Greek priority of public sector finance: the pros and cons

Everybody has their own reasons as to why they should enjoy a priority and one cannot go into the rationale of each creditor listed above in the ladder.

In the case of Greece, unquestionably the most unexpected outcome was the enormous priority of the debt of the public sector. It is worth discussing the pros and cons.

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The arguments which might be said to be in favour of the public sector priority include the following:

– Emergency last resort rescue money, often referred to as "new money", sometimes does enjoy priority in corporate bankruptcy practice.

– New money which pays out existing creditors should have priority.

– The public sector provided a colossal proportion of the bailout and therefore bore most of the burden.

The ECB might also have maintained that participation in a debt rescheduling might violate the letter or at least the spirit of the prohibition in the EU treaty on direct financing of sovereign states by the ECB.

The reasons which might be said to be against the official sector priority in the case of Greece include the following:

– The magnitude of the priority was huge, way beyond the amount of the typical IMF priority and way beyond anything that would be encountered in the corporate sector.

– The exercise of the priority could be interpreted as the exercise of state power and over-reaching by the public sector by the subordinating of private rights.

– The priority could have the effect of discouraging investment by the private sector in eurozone public debt of all eurozone countries.

– Very few corporate reorganisation statutes give new money an automatic priority: the new money priority, if it is codified at all, is typically subject to major qualifications and safeguards and may be subject to creditor agreement. The key point is that the subordinated creditor should agree to the priority as being in the interest of all creditors.

– If bailout money from the ESM has a long maturity, it is in any event effectively equity. So why not simply say so, ie that it is subordinated to senior creditors?

– If the public sector claims a massive special treatment, then the message to the private sector might be that the whole financing is being taken over by the public sector and, therefore, the private sector has no further role since they are, in any event, relegated to the sidelines.

– The priority might discourage access to new finance by the previously bankrupt countries so as to chill the availability of new money and restore access to capital markets.

– If the eurozone wishes to rescue its members and its currency, and in particular to prevent a run on sovereigns and their banking systems, the new finance should be junior and subordinate. Thus, if governments rescue depositors, they do not do so by putting in new money ranking ahead of depositors: the new money is typically hybrid convertibles or the like, ranking after senior creditors and ranking after depositors.

– The official sector priority fundamentally affects contract and property rights.

– Public debt involves such large amounts that legal predictability is crucial. Currently there is no stated maximum of the ESM priority.

– The IMF priority is a special case. It was developed in the context of a global fixed exchange rate mechanism with currency controls and was subsequently accepted by private sector creditors in sovereign restructurings because its financial contribution was proportionately small and it acted as the guarantor of sound fiscal reforms through conditionality.

– The European Stability Mechanism, which claims preferred status like the IMF, is a regional body unlike the IMF and therefore does not have the universal diplomatic status of the IMF.

– Although the EMS statement of its preferred status was very carefully worded, assertions of priority could lead to destabilising litigation, especially before courts which are less respectful of the literal interpretation espoused by, say, the English courts, amongst others.

– The ESM is claiming priority over other foreign official creditors who may be bondholders such as foreign central banks and sovereign wealth funds.

– The transfers through the ESM are provided to stabilise the imbalances within the eurozone as a whole and priority may well adversely effect the ability of the deficit countries to improve their position as access to capital becomes more expensive or is curtailed.

No doubt, each side in the debate will strenuously support the arguments in favour of its position.

Future treatment of the ECB

In the ECB announcement in the first week of September that the ECB intended to provide unlimited liquidity by buying bonds in the secondary bond market if necessary, the ECB in addition stated that it would not be seeking priority for the bonds it bought pursuant to this programme. The announcement stated that:

> "The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds".

This surrender of priority is considered a welcome and sensible step which was much needed in the context of potential contagion in the eurozone.

The Co-Financing Agreement

One of the most unusual innovations in the Greek transaction was the Co-Financing Agreement. This is an agreement between Greece, the Bank of Greece (as common paying agent), the trustee for the bondholders and the EFSF whereby the trustee and EFSF agreed to share payments under the new rescheduled bonds and payments in repayment of the EFSF €30 billion loan made by EFSF to Greece to finance the 15% cash portion of the consideration for the exchange of old bonds into new bonds. The idea was that, if Greece paid official creditors first, then it could not do so without also paying the bondholders, thereby limiting discrimination between creditors if there was a shortfall.

Unusually the Co-Financing Agreement extends to all recoveries, not just direct payments. For example, it includes recoveries by set-off and so is similar to pro rata sharing clauses in bank syndicated credits.

There are several significant limitations on the Co-Financing Agreement. For example, it applies only to the €30 billion loan made by EFSF to Greece, not all of the public sector money. There are other cases in which the sharing does not apply.

Pari passu clauses

If creditors wish to rank equally, is there any way that they could deal with this in their documentation?

The leading clause which deals with the equality of creditors on bankruptcy in the case of a bond (and also in the case of bank syndicated credits) is the famous pari passu clause. This clause is more important in the context of corporate insolvency with a fixed ladder of

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priorities than in the case of state insolvency with its loose priorities ladder. It serves to assert the principles of equitable treatment and fairness. It also has, as will be seen, some concrete legal bite. In addition, the clause is taken as a measure of debtor good faith so that a weakening of the clause is taken as a signal of bad faith: the clause has high symbolic value.

Greece 2012 pari passu clauses

The pari passu clause in the terms and conditions of the 2012 new Greek rescheduled bonds was in common form and provided:

> "The Bonds constitute direct, general, unconditional, unsubordinated and, subject to this Condition, unsecured obligations of the Republic. The Bonds rank, and will rank, pari passu among themselves and with all unsecured and unsubordinated borrowed money of the Republic. The due and punctual payment of the Bonds and the performance of the obligations of the Republic with respect thereto are backed by the full faith and credit of the Republic."

The clause affirms the mandatory ranking of debt where there is competition between creditors. It is not an agreement that the debtor will in fact pay debts pro rata without discrimination after the debtor is actually insolvent, ie the clause asserts legal ranking, not equal payment in fact, and not equal treatment. An equal treatment clause would require that, after actual insolvency, the debtor will pay all its debts pro rata, including trade debt and the milk bill, which is usually both impracticable and undesired.

If indeed the clause did mean that, once a sovereign state has become de facto insolvent, it can only pay its debts pro rata, the impact would be that sovereign states could not at that point, where there is competition with creditors, pay their armed forces or pensions or the judiciary or their public servants without also paying bondholders. It is obvious that nobody intends that this is what the clause means in the case of sovereign states and it is considered that it is well-established that the pari passu clause only strikes at changes to the mandatory order of ranking, as opposed to the actual order of payment.

If the pari passu clause only applies to borrowed money or external borrowed money, then of course supplier and other non-financial debt would not be caught.

If the parties meant to prohibit the borrower from making unequal payments, they could simply provide that the borrower will not pay any other debt unless it simultaneously pays at a rate that is in proportion to any amount then due under the agreement.

Case law on the pari passu clause

There has been some international case law regarding the pari passu clause in Belgium, California, New York and England, but for various reasons none of it was very conclusive.

In a recent Argentinean case in New York, *NML Capital Ltd v Republic of Argentina,* decided in September 2011, the court held that a pari passu clause was infringed, but this was because Argentina had passed a specific statute changing the legal ranking. Law no 26.017 in 2005 provided, in effect, that bondholders, who did not accept Argentina's exchange offer to replace defaulted bonds by new bonds would not be paid. The statute changed the legal ranking. Most commentators agree that a statutory subordination is a change to the legal ranking and is therefore an infringement of the pari passu clause.

In the second round of *NML Capital Ltd v Republic of Argentina* in February 2012, the New York court held that, if Argentina did pay any other creditors, Argentina would have to pay the bondholder pro rata so that, in effect, the court imposed the sanction of contempt of court for non-compliance and was ordering specific performance of the pari passu clause. The breach of the clause was not just an event of default. The case may be appealed.

Paris Club reschedulings and comparability clauses

The comparability clause customarily used by the Paris Club is an interesting example of a more effective equality clause.

The Paris Club is an informal association of creditor nations which deals with the rescheduling of official debt, ie inter-government debt.

The key clause in the Paris Club Agreed Minute settled between the club and a sovereign debtor is the comparability requirement. A sample clause is as follows:

> "In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Republic of [ ] commits itself to seek promptly from all its external creditors debt reorganisation arrangements on terms comparable to those set forth in the present Agreed Minute, while trying to avoid discrimination among different categories of creditors.
>
> Consequently, the Government of the Republic of [ ] commits itself to accord all categories of creditors and in particular creditor countries not participating in the present Agreed Minute, and private sector creditors treatment not more favourable than that accorded to the Participating Creditor Countries for credits of comparable maturity."

The clause requires comparable treatment, not the same treatment, so there is some flexibility. Credits to the IMF and the like are expressly excluded. In addition, other excluded debt is not caught, eg short-term trade debt and small debt. So the main debt which is caught is commercial bank and bond debt.

Bank rescheduling agreements: most favoured debt and pro rata sharing clauses

The practices developed in the 1980s to reschedule commercial bank debt were much more protective of the equality of commercial banks than sovereign bond restructuring practice from 2000 onwards.

The most significant equality clause in the context of bank reschedulings of sovereign debt is the "**most favoured debt**" clause which provides that if any other foreign currency debt, eligible for the rescheduling, is paid out more quickly, then the borrower must repay the rescheduled debt. The clause will then go on to exclude certain categories of debt which can be paid in priority, eg IMF debt, trade debt, foreign exchange contract obligations, interest and other agreed categories. One effect of this clause is to encourage all eligible creditors to come into the rescheduling so the clause is primarily directed against holdout creditors. The clauses are theoretically difficult to monitor but, in practice, states have an interest in complying.

It has been unusual to find a most favoured debt clause in sovereign rescheduled bonds issued in exchange for old bonds since 1999. Belize 2005 was an exception.

A **pro rata sharing clause** is another typical bank equality clause. It provides that if any bank receives a greater proportion of its share, it must pay the excess to the agent bank which redistributes to the banks pro rata and the paying bank is subrogated to the claims paid. These clauses appear only in bank syndications and bank rescheduling agreements, not sovereign bonds.

Rescheduled sovereign bonds do not normally contain a pro rata sharing clause. The Greek Co-Financing Agreement of 2012 discussed above was an exception. But if there is a trustee for bondholders, the trust deed may provide that, after a default, the trustee will distribute recoveries to the bondholders pro rata.

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Conclusion on priorities

The question of who ranks where on the bankruptcy ladder of priorities is undoubtedly one of the main issues which inflames the most passionate debate, including in relation to sovereign insolvencies.

Restructured bondholders could seek to negotiate clauses which insist on rateable payments once a sovereign is de facto insolvent, eg because it cannot pay its debts as they fall due or without a write-down of its debt directly or by an exchange. They did not do so in the case of Greece and indeed the issue would be contentious.

In the case of the Greek transaction, the main issue is whether the public sector creditors over-reached themselves by granting themselves a de facto priority in such an enormous amount. For the future, the main issue is whether the European Stability Mechanism will claim preferred status. The uncertainty surrounding this issue might have a potentially destabilising effect on the market.

In this context, the ECB decision in future cases to forego the priority it had required in the Greek reorganisation was a very positive step.

17. Collective action clauses

A major feature of the Greek debt reorganisation 2012 was the forcible retroactive insertion of collective action clauses in to the bonds governed by Greek law – in practice, more than 85% of the bonds which were rescheduled.

There are three types of collective action clause:

1. Provisions for majority voting by bondholders to change the terms of the bond so that the dissenting minority is bound by the change.
2. A clause whereby no bondholder can accelerate or take action against the issuer without the consent of a specified proportion of the bond, often between 20% and 25%. This is commonly called a "no-action clause".
3. A provision whereby post-default recoveries by a trustee for the bondholders are shared amongst bondholders pro rata.

The most important clause for present purposes is bondholder voting.

Use of collective action clauses in the Greek debt reorganisation

The collective action clauses, notably bondholder voting and no-action clauses, were used in the following ways in the Greek 2012 debt reorganisation:

– **New bonds** The new rescheduled bonds issued in exchange for existing Greek bonds contained collective action clauses. The trustee of the bondholders under the new rescheduled bonds was Wilmington (Trust) Limited.

– **Existing bonds** Existing old bonds governed by Greek law did not contain collective action clauses of any kind. However, nearly all the Greek bonds governed by an external system of law, such as English law, did contain collective action clauses.

– **Unilateral insertion of collective action clauses in existing bonds** Greece unilaterally inserted collective action clauses into existing bonds governed by Greek law pursuant to the Greek Bondholder Act of 2012.

As discussed above, the basic rule adopted by the courts of many developed countries is that if a debt obligation is governed by local law, then a local statute can change that law, subject to some basic safeguards. In other words, creditors contracting under local law accept that law as it is from time to time. In the case of bonds governed by an external system of law, the normal rule is that a Greek statute cannot change a bond governed by, say, English law. In other words, an external governing law insulates or immunises or shields the bond against changes by statute in the country of the issuer.

Most of the Greek sovereign bonds were governed by Greek law and were therefore vulnerable to the statutory insertion of collective action clauses.

Objectives of bondholder voting

The main purpose of bondholder voting is to ensure that majority bondholders can bind dissenting minorities – holdouts. The aim of binding holdouts is to reduce the risk that (1) holdout creditors disrupt a deal which the majority consider to be favourable to the interests of bondholders as a whole, and (2) holdout creditors achieve a de facto priority because they are not rescheduled but are paid ahead of the rescheduled bondholders.

Holdout creditors are one of the most significant problems in relation to the reorganisation of the debt of an insolvent state. If a significant number of creditors do not accept the exchange offer, then the lack of consensus can significantly disrupt the exchange offer and lead to a disorderly default. A disorderly default, while clearly disadvantageous to the sovereign debtor, can also adversely affect the consenting creditors who did accept the exchange because the continuing disruption could inhibit the ability of the sovereign debtor to raise capital in the international markets in the future and therefore weaken the ability of the sovereign to pay the existing bondholders. The presence of litigation and creditors marauding over the land does not encourage peace and calm. So both the debtor and the bondholders have an interest in ensuring a successful high rate of participation and a satisfactory way of dealing with holdouts.

There is a contrary view that any clauses which promote the organisation of bondholders and which allow minorities to be overridden are hostile to the payment prospects of bondholders. According to this theory, bondholders are more likely to get paid if they have individually inviolable rights and can therefore unilaterally cause trouble by litigation and other tactics.

International market practice on collective action clauses

The current mainstream international practice for restructured sovereign bonds is to include bondholder voting and a no-action clause. The practice for ordinary issues of sovereign bonds governed by foreign law varies, though English law bonds have typically included such clauses since the nineteenth century. Sovereign bonds governed by local law normally do not contain collective action clauses. But the EU proposes that collective action clauses will be included in relevant public debt instruments of eurozone member states starting in January 2013.

In the United States, the Trust Indenture Act of 1939 prohibited collective action clauses whereby a majority of the bondholders could bind the minority to a change in the terms of payments (apart from a minor exception), eg a rescheduling or reduction in the amount of payments or a change in the interest rate. This is still the position in relation to corporate bonds in the US so that if it is desired to change payments, the company has to go through a formal insolvency procedure. The Act does not apply to sovereigns but, until recently, the New York practice was not to include collective action clauses in sovereign bonds, thereby following the policies of the Act. Recently, there have been many divergences from this practice in the case of sovereign bonds governed by New York law.

A proper collective action clause should contemplate that dissenting bondholders in a particular issue are bound if the required majority of all bondholders for all issues vote in favour. This is known as aggregation and is intended to prevent bondholders of a single issue from blocking the whole deal.

There are provisions as to the required majorities according to the gravity of the decision and for quorums. The mainstream view is that not less than a majority of 66% should be required for a change to the terms of the amount and maturity of payments.

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Typically, there are provisions which prevent the debtor and its controlled entities from voting.

Conclusion on collective action clauses

The overall effect of collective action clauses is to introduce into sovereign bonds a rough equivalent of creditor voting on a corporate judicial reorganisation plan so that contract replicates typical corporate insolvency regimes. So contract begins to fill in some of the gaps left by the absence of a bankruptcy law.

There are different views as to whether Greece acted properly in forcibly changing the rules of its existing Greek law bonds. As to new bonds, there seems much less opposition now to the use of financial democracy in sovereign bonds at the time of issue.

18. Bondholders' documentary protections

The legal terms and conditions of the new Greek bonds reflected the practice developed since the late 1990s in relation to other bond reschedulings and, therefore, confirmed existing trends. In general, there has always been a pari passu clause, sometimes limited to external debt, and there has been a typical weak bond market negative pledge, generally prohibiting only security interests for tradable securities. The events of default have typically been limited.

The framing of the key clauses, in particular the negative pledge and events of default, were designed to give Greece a free hand in dealing with holdout creditors and to enable Greece to restructure its debt in the future without sparking off defaults under the new bonds. For example, if Greece chose not to pay holdout creditors, this would not normally trigger a cross-default under the new bonds, thereby destroying the stability of the new exchange.

One can have different views as to whether this approach was right from the point of view of bondholders, but one has to take into account another significant reality relating to the culture of the capital markets as opposed to commercial banks when it comes to protective clauses in loan documents.

There is an enormous divergence in the sovereign rescheduling practice of commercial banks developed in the 1980s compared to the rescheduling practice of bondholders after 1999. These differences have always existed when one compares ordinary bank syndication practice with the ordinary practice for sovereign international bonds.

There could be various reasons for this divergence, eg that bondholders are less equipped to monitor complex covenants, or that bondholders rely on banks to do the monitoring through tougher bank covenants (but there may be few syndicated credits in the case of sovereigns to fall back on), or because bondholders take the view that, in practice, the clauses do not matter, or because bondholders rely on extra-legal powers, such as the ability of capital markets to withhold credit. Also, bondholder documentation is traditional and driven by precedent.

Whether or not the practice of bondholders will be justified by the future, when the future becomes history, remains to be seen.

19. Credit default swaps

First developed country credit event

The Greek debt reorganisation involved the first time that a credit event occurred under a credit default swap in relation to a developed sovereign state.

What are credit default swaps?

Under a credit default swap the seller of protection, who is in the position of a guarantor commercially (although these are not guarantees in law), agrees to pay the buyer of the protection, ie the party guaranteed, the difference between the nominal amount of the bond and its market value when a credit event occurs. The standard credit events for European sovereign credit default swaps using the definitions of the International Swaps and

Derivatives Association are (1) failure to pay, (2) repudiation/moratorium, and (3) restructuring. All of these have very detailed and technical definitions.

Thus, if a credit event occurs and the value of a 100 bond is now 20, then the seller of protection must pay the buyer of protection 80, so that the buyer of protection ends up with the full 100. Unlike an ordinary guarantee, the seller of protection does not then take over the whole bond by way of subrogation because the seller of protection does not pay the whole bond. In addition, the seller of protection does not have a right of indemnity against Greece as the issuer – a right which a guarantor would have.

Bondholders who buy credit protection are likely to want a credit event to happen.

There is a separate Intelligence Unit paper of October 2011 entitled *Sovereign state restructurings and credit default swaps* which contains a description of credit default swaps and a detailed analysis of the typical sovereign credit events.

The politics of a restructuring credit event

The eurozone was initially very reluctant to contemplate the occurrence of a credit event in relation to Greece. Presumably, officials thought that a credit event was likely to be perceived by the market as a default and likely to affect the future credit ratings of Greece. Some sovereign states had hostile views on the credit default swap market, which they blamed for publicising and exaggerating their financial woes. Some commentators may have regarded credit default swaps as exotic speculation mainly carried out by evil hedge funds determined to profit from the misery and misfortune of others, a view perhaps more consistent with the thirteenth century in Europe than the twenty-first.

The attitude of regulators tended to depend upon who they thought were the ultimate beneficiaries of the credit default swap and who, ultimately, would have to pay. If they thought that banks' exposures would be reduced by credit default swap protection, and if they thought that banks were not sellers of protection, then they would favour the crystallising of a credit event. A default by a significant sovereign state could have had serious repercussions for the banking system and could, in the worst case, have resulted in threats to financial stability and another financial crisis. Banks are very vulnerable to contagion effects and the falling of one domino can knock down the others so as to give rise to a systemic crisis. Regulators were sensitive to the systemic consequences of credit default swaps partly by reason of the disasters experienced by the United States-based insurance group AIG in 2008.

If, on the other hand, the regulators thought that the sellers of protection were largely banks as well, then their attitude was likely to be different: they were unlikely to favour the crystallising of a credit event.

Greece credit events 2012

Whether or not there has been a credit event is decided quickly by an ISDA Determinations Committee which also calls for an auction to determine the market price.

On 9 March 2012, a Determinations Committee decided that a forcible exchange of existing bonds for new bonds, and the additional consideration by Greece's implementation of the new collective action clauses, was a restructuring credit event in the case of the Greek law bonds because the exchange was not voluntary and because the existing bonds were cancelled by statute. In substance, the existing bonds were changed.

In the case of foreign law bonds, there was a voluntary exchange, but the existing collective action clauses in the bonds were implemented by Greece with the result that all bondholders of each series, which were bound by a successful amending resolution, received new bonds and other consideration, and the resolutions reduced the amounts payable on the existing bonds to zero. This was a restructuring credit event.

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The total amount of payments was reported as about $3 billion. The amount was determined by an ISDA auction on 19 March 2012. The auction used the price of the new Greek 30-year bonds which were then trading at 21.5 cents on the euro. This meant that buyers of protection were paid 78.5% of the net outstanding amount of the credit default swaps. Investors could not use old Greek law bonds for the auction because they had been replaced by the exchange. Foreign law bonds which had not yet been exchanged were trading at higher prices. Auction prices are based on the "cheapest to deliver" which was the new 30-year bond. The 30-year new bond traded at similar levels to the old Greek bonds so that, normally, there were no surprises and unfairness on the ground that the new bonds were the cheapest to deliver.

Conclusion of credit default swaps

Market fears that the standard conditions for sovereign credit default swaps would not produce the expected results were assuaged by the Greek outcome.

The market had been concerned that there would only be a voluntary exchange with the result that buyers of protection would not get paid because there was no credit event – a voluntary exchange without changing the terms of the old bonds is usually not a credit event. They were also concerned that there might be a famine of deliverable obligations so that an auction could not be held to fix the price. In fact, both adverse events did not materialise and the contracts did what they were supposed to do, ie pay out if in effect Greece went through a bankruptcy restructuring.

20. GDP securities

One of the special features of the Greek transaction was that detachable GDP securities were issued to exchanging holders together with the new bonds to permit holders to benefit from any upturn in the Greek state's economic recovery. They were quite unique instruments since only a handful of comparable instruments have been issued. The Argentinean GDP warrants were the most notable example but they were also issued in the case of Bosnia. The GDP securities gave holders something akin to an equity participation right in the economic performance of the Greek state and were intended to offer some limited comfort for the haircut on the bonds and the very low interest rates.

The GDP securities contained an annual payment trigger commencing October 2015 and ending in 2041 whereby when particular conditions were met, any annual excess real GDP growth exceeding the official baseline projection would trigger a payment to holders, subject to a 1% payment cap on the notional amount of the GDP securities, reducing in parallel with the amortisation of the bonds. In the absence of these conditions being met, the holders got nothing. The notional amount of the GDP securities carried no repayment obligation and was purely a reference source used to calculate the amount of any annual payments under the GDP securities.

It remains to be seen whether GDP securities become a common feature for sovereign debt restructurings yet to come.

21. Disclosure

Unlike previous offering circulars or information memoranda or prospectuses for an exchange of sovereign debt on bankruptcy, the Greek offering documents did not contain any economic, financial or political disclosure, other than the terms of the new bonds and a list of various risk factors, some of them quite formulaic.

The reasons may have been that disclosure was considered irrelevant or that there was too

much prophecy which was bound to be unsafe, or that the figures were so unsteady and volatile or that there would be liability risks for Greece, or that nearly all the bondholders were sophisticated institutions who had access to their own information about Greece or that there was plentiful public information in various IMF and EU reports on Greece in connection with their bailouts, or simply that there was not enough time to get involved with the elaborate verification process which accompanies disclosure. Much expense and delays can be involved in the production of the famous 10b-5 letter – broadly, a letter from a law firm to the underwriters saying that nothing had come to their attention which made them conclude that the offering circular had a material misstatement or omission. Rule 10b-5 is a fraud regulation in US securities law and the 10b-5 letter supports the underwriters due diligence defences in relation to the disclosure document.

It remains to be seen whether non-disclosure will become the norm or whether sovereigns will revert to the former practice of the whole paraphernalia of a verified offering circular.

The fact that there was no disclosure document meant that it was much more difficult for either Greece or the steering committee of bondholders to market the exchange offer during the offer period because of the liability risks and, in fact, they did not do so.

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Conclusion

One can see that many questions still hang over whether the Greek reorganisation will or will not be a precedent for the future.

A larger and more profound question is whether Greece 2012 was just an unfortunate accident, the sort of mistake which fallible people can make, which proves nothing more than that people, especially people acting in a herd, are prone to occasional lapses of attention with resulting unfortunate consequences. Or else was Greece a symbol of something else much darker? That is, was Greece the first tolling of the great bell for the end of an era for many countries in the West, not just Greece?

Time present is still too close to time past to be able to see how the Greek transaction will impact on time future.

Notwithstanding the many predictions of apocalypse, one must always maintain a sense of proportion. Sovereign insolvency can indeed result in widespread misery, but it rarely results in universal destitution and it is not the onset of the Black Death, nor is it as bad as universal war. Indeed in many instances it is the opportunity for a new beginning.

Global Law Intelligence Unit

This paper is a production of the Allen & Overy Global Law Intelligence Unit, headed by Philip Wood, with contributions from Katrina Buckley, Marc Florent, Matthew Hartley, Yannis Manuelides and Aaron Weaver. All of these named people acted for the Steering Committee of bondholders in relation to the Greek debt reorganisation of 2012. The assistance of other members of the firm in this paper is gratefully acknowledged. This paper is limited to matters in the public domain. The views expressed in this paper are not necessarily the views of the firm or its clients. The paper is not legal advice. For further information, please get in touch with any of the following:

Contacts

Katrina Buckley
Partner
+44 20 3088 2704
katrina.buckley@allenovery.com

Marc Florent
Partner
+44 20 3088 3705
marc.florent@allenovery.com

Matthew Hartley
Partner
+44 20 3088 2824
matthew.hartley@allenovery.com

Yannis Manuelides
Partner
+44 20 3088 2575
yannis.manuelides@allenovery.com

Aaron Weaver
Senior Associate
+44 20 3088 2033
aaron.weaver@allenovery.com

Philip Wood
Special Global Counsel
+44 20 3088 2552
philip.wood@allenovery.com

For further information visit:
www.allenovery.com/intelligenceunit
or email intelligence.unit@allenovery.com

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