

The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings

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Abstract

The Eurozone official sector has declared that the belated restructuring of Greek bonds held by private sector creditors in 2012 was a “unique and exceptional” event, never, ever to be repeated in any other Eurozone country. Maybe so. But if this assurance proves in time to be as fragile as the official sector’s prior pronouncements on the subject of “private sector involvement” in Eurozone sovereign debt problems, any future Eurozone debt restructuring will be surely plagued by the problem of non-participating creditors --- holdouts. Indeed, it is the undisguised fear of holdouts and the prospect of a messy, Argentine-style debt restructuring in the belly of Europe that has been one of the principal motivations for the official sector’s willingness to use its taxpayer money to repay, in full and on time, all of the private sector creditors of Eurozone countries receiving bailouts (the belated Greek restructuring being the sole exception).

This article argues that a simple amendment of the Treaty Establishing the European Stability Mechanism (the Eurozone’s new bailout facility) could immunize within the confines of the Eurozone the assets of a Eurozone country receiving ESM bailout assistance from attachment by litigious holdout creditors. By thus increasing the difficulties that holdouts would face in enforcing court judgments against a debtor country, the objective of the amendment is to deflate creditor expectations that staying out of an ESM-supported sovereign debt restructuring will lead to a preferential recovery for the holdouts.

This measure would also, when taken together with the other steps that the Eurozone has already implemented, substantially replicate the important features of the Sovereign Debt Restructuring Mechanism proposed by the IMF in 2002.

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The architects of every Eurozone sovereign bailout program (Cyprus is the one in the oven at the moment) must make a crucial threshold decision: what to do with the sovereign's debt maturing during the program period. Mercifully, there are only two options -- pay it or restructure it.

The "pay it" alternative

Paying maturing debt requires the country to borrow the funds from some source. Again, there are only two options: borrow from the market to refinance maturities during the program period or borrow from official sector bailout facilities like the European Stability Mechanism (ESM).

By definition, a country that enjoys market access at tolerably low interest rates would not now be negotiating an official sector bailout package, so genuine market refinancing is foreclosed. One possible solution is to arrange for an official sector actor (the European Central Bank volunteered for this role last September) to soften up the beaches by purchasing the debtor country's bonds in the secondary market in order to depress the yields on those instruments. This, the theory goes, will allow the country to issue new bonds in the primary market at coupon levels that benefit from official sector intervention. If necessary, the ESM could also purchase some of those new bonds when they are issued in the primary market. The combination of ECB/ESM intervention would thus operate as an official sector bailout masquerading as a normal market borrowing.

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The “restructure it” alternative

The obvious question in these affairs is why ever would the official sector entertain the idea of using taxpayer funds to pay out, in full and on time, a debtor country’s existing creditors? One might have thought that the official sector’s fiduciary duty to its taxpayers would require the architects of these programs to reduce or defer, to the fullest extent possible, the liabilities that will need to be covered by official sector lending. Indeed it is precisely this sense of a fiduciary duty to their own taxpayers that presumably justifies the official sector’s insistence that the recipient country pare its budget deficit to the bare minimum by embracing fiscal austerity, and maximize the country’s own contribution through privatization programs, before official sector monies are used to cover the residual shortfall.

But this sense of fiduciary duty has thus far (with one exception) stopped short of asking, or demanding, or for that matter even permitting the recipient countries to reschedule their existing debts in order to remove those liabilities from the list of items that must be paid using official sector bailout funds.¹ The bailout programs for Greece (until the official sector reversed course and permitted a restructuring of private sector debt in early 2012), Ireland and Portugal have each treated maturing debt as an inviolable component of the recipient country’s balance sheet, one that cannot and should not be subjected to any measures that would mitigate the gross amount of official sector funding that must be poured into the recipient country. The single exception to this rule was the belated, but successful, Greek debt restructuring in the spring of 2012; an event that the official sector continues to describe as “unique and exceptional” and never to be repeated in another Eurozone country. If you believe that assurance, you may stop reading this article now.²

The justifications

Why? If official sector negotiators have learned to steel their hearts against the pleas of the old age pensioners, the unemployed, the homeless, the sick, the blind and the lame in bailout recipient countries, why should they show such solicitude for the country’s creditors? Why, to put the

¹ The philosophy behind this policy was expressed by a former member of the Executive Board of the ECB in these terms: “The only way to protect taxpayers in ‘virtuous’ countries is to avoid over-indebted countries from easily getting away with not paying their debts; the payment of debts should be enforced, through sanctions if need be.” Lorenzo Bini Smaghi, “Private Sector Involvement: From (good) Theory to (bad) Practice (Berlin, June 6, 2011) (available at <http://www.ecb.int/press/key/date/2011/html/sp110606.en.html>).

² Of course, if the Eurozone members really believed this assurance, there would have been no need for them to mandate the inclusion of an aggregated collective action clause in every Eurozone sovereign bond issued after January 1, 2013. Those clauses serve only one function -- to facilitate a future restructuring or amendment of the affected debt stocks.

question in a lurid way, should the official sector insist that cancer patients in the recipient country forego their medicine in the interests of salutary “fiscal adjustment” but simultaneously recoil at visiting some discomfort on a hedge fund manager in Greenwich, Connecticut who holds the country’s debt obligations?

The predictable answer from the official sector negotiators will be, “it’s complicated.” Here, insofar as we have been given the light to see them, are the complications:

National pride. “Europeans pay their debts”, is how former President Nicolas Sarkozy phrased it; a statement that showed a remarkably shallow grasp of European history.³ Volumes have been written about the serial debt default records of many European countries. But the spirit of President Sarkozy’s statement shines through. A sovereign debt restructuring, he believed, would be tantamount to an admission of emerging market status. It would be inconsistent with the dignity, with the gloire, of a modern European nation.

Contagion. With the entire periphery of Europe in the line of fire, might not a debt restructuring in any one of them ignite a conflagration that would soon engulf them all? If you had to restructure the debts of all of them, that would surely destabilize the global banking industry. And from there it is a short path to planetary ruin. This, more or less, is how the contagion argument is typically formulated.

Incestuous relationships. Were all of these debts owed exclusively to Greenwich, Connecticut-based hedge funds, the official sector negotiators might say, then restructuring those liabilities would be permitted, nay gleefully permitted. But they are not. A substantial part of the paper is likely to be held by financial institutions in the sovereign’s own country -- banks, insurance companies and pension funds. Restructuring those instruments will therefore undermine the health of the domestic financial system. Every euro saved in debt service might need to be spent in bank recapitalizations. Moreover, much of the balance of the paper will be in the hands of banks in northern European countries, the very countries that will be making the largest contributions to the bailout funding. To this extent, what appears to be a generous sovereign bailout of an overextended neighbor is in reality a disguised recapitalization of the banking sectors in the major contributing countries. (The lesson? All future Eurozone sovereign bond issuances should be placed exclusively with investors domiciled in the township of Greenwich, Connecticut, and secondary market transfers of those instruments should be confined to the geographical boundaries of that township.)

³ The full statement was “We will show that Europeans pay their debts.” *Upfront*, at p. 1, *International Financing Review* (Dec. 10, 2011)

Feasibility. Finally, there is the matter of the technical feasibility of a debt restructuring in these circumstances. The bane of sovereign debt restructurers over the last 30 years has been the problem of holdout (non-participating) creditors. Creditors left behind in a sovereign debt restructuring cause these problems:

- If there are enough of them, the financial predicates underlying the entire restructuring may be undone.
- If holdouts are subsequently paid in full, it makes the participating creditors look silly and this leads, in the next restructuring, to even more holdouts.
- If holdouts are not paid after the restructuring closes, they pose an on-going litigation and attachment threat to the sovereign debtor; witness Argentina's decade-long legal fight with thousands of holders of the Argentine bonds that went into default in 2001.

Various techniques have been deployed in an effort to cajole, seduce, bludgeon or rope recalcitrant creditors into the restructuring process, none of them wholly successful. Holdouts were not a lethal threat in the Greek debt restructuring of 2012 for only one reason: 93% of Greek bonds were governed by local (Greek) law. This permitted the Greek Parliament to retrofit a collective action mechanism on the local law debt stock that operated to sweep potential holdouts into the deal. Greece did have a small holdout population in this restructuring (equal to about 3% of the total eligible debt), but these holdouts were concentrated in the country's foreign law-governed bonds. Not every Eurozone country, however, enjoys this local law advantage. Local law-governed bonds represent a minority of the overall debt stocks in some of the smaller Eurozone countries and in the borrowings by many sub-sovereign entities such as provinces and municipalities. In addition, many Eurozone sovereigns will have some portion of their debt stock in the form of foreign law-governed bonds; the most fertile ground for the sprouting of holdout seedlings.

The threat of a significant holdout creditor population will therefore haunt the debt restructuring of almost any Eurozone country. The conventional method of minimizing such holdouts -- threatening to consign all those who refuse the restructuring offer to the outer darkness of permanent default -- is unlikely to be effective in this situation. Local holders of such bonds may possibly be persuaded by the government to roll their positions. But foreign holders can literally smell the official sector's fear of a messy sovereign debt workout in Europe. No one is eager to bring Argentina to the belly of Europe. If the market had any lingering doubts about the matter, a surfeit of official sector statements over the last three years have painted

such an event as a catastrophe rivaling the Pleistocene ice age.⁴ In short, some creditors will surely call the bluff of a threatened permanent sovereign default in the Eurozone.

What can be done?

As shown by the Greek debt restructuring of 2012, with a bit of ingenuity and courage the other concerns about a Eurozone sovereign debt restructuring -- national pride, risk of contagion and incestuous sovereign/banking sector linkages -- can be satisfactorily addressed. Holdouts, however, will be a ubiquitous problem.

The choice of a foreign law to govern a sovereign debt instrument will place it beyond the reach of the debtor's own legislature. The holder will therefore in all likelihood be able to reduce the claim to a foreign court judgment, sometimes within a matter of months. With that judgment in hand, the creditor can then begin to exert pressure on the sovereign borrower by attempting to attach the sovereign's off-shore assets (other than those, like embassies, that enjoy a special immunity), interfere with the sovereign's fund-raising efforts abroad and perhaps (the subject of pending litigation in New York at the moment) intercept payments made on the borrower's other debt obligations. It is in this ability to exert post-judgment pressure on the sovereign borrower that the hopes of a holdout creditor for a preferential settlement principally reside.

The first step in assessing the potential legal threat posed by holdout creditors is to read the underlying debt instruments to see what defenses the documents might provide to a sovereign defendant in a firefight. The Republic of Cyprus Euro MTN documentation (June 17, 2011), for example, offers a good illustration. Condition 7(c) of the Terms and Conditions of the Cypriot Notes provides:

All payments are subject in all cases to any applicable fiscal or other laws, regulations and directives, but without prejudice to the provisions of [the tax gross-up clause].

⁴ See, for example, the spectacularly ill-timed and ill-titled IMF Staff Position Note, "Default in Today's Advanced Economies: Unnecessary, Undesirable and Unlikely" (Sept. 1, 2010) (available <http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf>). This paper was released ten months before Greece, largely at the insistence of the IMF, was told to restructure what remained of its private sector debt.

Does this include Cypriot laws, regulations and directives? Nota bene that the provision does not say “laws, regulations and directives *in the place of payment*”.⁵ Read literally, therefore, it makes all payments subject in all cases to any Cypriot laws, regulations and directives. Our research suggests that in approximately three-quarters of the other sovereign bonds that contain this provision, the crucial words “in the place of payment” modify the phrase “laws, regulations and directives”.⁶ The absence of this qualifying phrase in Cypriot bonds is thus both noticeable and arguably significant.

Sticking with the Cypriot MTNs for a moment, Condition 19(e) of the Notes states that:

“The waivers [of sovereign immunity for Republic property] and consents [to enforcement proceedings in foreign courts, including enforcement against Republic assets] ...do not apply to the Republic’s title or possession of property ... necessary for the proper functioning of the Republic as a sovereign state.”

This is a very unusual way to phrase a carveout from the waiver of immunity for sovereign property devoted to a public purpose. It is hard to imagine that an issuer benefiting from such a carveout would not, in a litigation scenario, argue that *all* of its property held abroad was necessary for the proper functioning of the sovereign state and therefore immune from seizure by a disgruntled creditor.

While a close textual analysis of the sovereign’s bond documentation may yield some potential litigation defenses, such defenses are obviously useful only in an enforcement proceeding commenced by a holdout creditor. The whole point of the exercise is to persuade creditors in advance not to stay out of the restructuring and litigate. A more generally applicable legal tool may be required for this purpose.

We believe that the Eurozone has within its power a unique ability to deflate expectations on the part of prospective holdouts that they will realize a higher recovery by staying out of the sovereign restructuring. The goal of such a measure would be to affect the creditor calculus of whether to stay out of a Eurozone sovereign debt restructuring in the first place. Nothing can realistically be done to keep a holdout from obtaining a judgment in a foreign court on a foreign law-governed debt instrument. Attempting to unseat basic tenets of contract law in countries like the United Kingdom (most foreign law-governed Eurozone sovereign bonds choose

⁵ The place of payment will typically be a foreign location such as Luxembourg or London.

⁶ This provision is typical in bonds governed by English law.

English law) will meet fierce resistance. But the Eurozone governments could immunize from creditor attachment the assets of a Eurozone country (held within the Eurozone) if the country was engaged in an ESM-supported adjustment program.

The appropriate mechanism, we believe, would be an amendment to the 2012 Treaty Establishing the European Stability Mechanism (“T/ESM”). Something along these lines:

ARTICLE ____

Immunity from judicial process

1. The assets and revenue streams of an ESM Member receiving stability support under this Treaty which are held in, originate from, or pass through the jurisdiction of an ESM Member shall not be subject to any form of attachment, garnishment, execution, injunctive relief, or similar forms of judicial process, in connection with a claim based on or arising out of a debt instrument that was eligible to participate in a restructuring of the debt of the beneficiary ESM Member after the effective date of this Treaty.
2. The immunities provided in the preceding paragraph shall automatically expire when all amounts due to the ESM from the beneficiary ESM Member have been repaid in full.

The objectives of such an amendment to the T/ESM would be:

- to ensure that the financial support being provided by the ESM to one of its members is not diverted to the repayment of an existing debt obligation of that member that was eligible to participate in a debt restructuring but declined to do so;
- to assist the beneficiary member state in any ESM-approved restructuring of its debt by deflating the expectations of prospective holdouts that they will be able to extract a preferential recovery through the

pursuit of legal remedies after the restructuring closes;
and

- to provide a safe harbor in the Eurozone for the recipient state to hold its assets and conduct its financial affairs without fear of harassment by holdout creditors.

An amendment of the T/ESM for this purpose would become effective within the jurisdiction of each of the Eurozone countries. The potency of the measure would obviously be enhanced if other EU members, particularly the United Kingdom, were to enact comparable immunities in their domestic law. A country such as the United Kingdom might for selfish reasons wish to incorporate such immunities into its own law; failure to do so could drive financial transactions away from London.

The policy justification for such an amendment of the T/ESM is self-evident and compelling. The ESM member states will be pouring taxpayer resources into a recipient country. If a restructuring of private sector claims is deemed essential to restore that country to a sustainable position, the members funding that bailout should not wish to see the assets and revenue streams of the recipient sovereign being seized by creditors who elect not to participate in the restructuring. Every euro that is so seized and applied toward the immediate repayment of such a claim will logically require a corresponding one euro increase in the amount of ESM bailout assistance. To put the matter into the geographic terms used earlier in this paper, this would amount to a funds transfer from Stuttgart, Germany to Greenwich, Connecticut. The ESM members have a legitimate interest in minimizing such transfers.

The precedent

There is a precedent for just this sort of measure.

In May 2003, following the coalition invasion of Iraq to oust Saddam Hussein, the United Nations Security Council adopted Resolution 1483 (May 22, 2003).⁷ Among other things, that Resolution encouraged the new government in Iraq to restructure the roughly \$140 billion debt stock that Saddam had accumulated during his tenure. In the context of “the desirability of prompt completion of the restructuring of Iraq’s debt”, the Resolution immunized all petroleum assets of Iraq against “any form of attachment, garnishment, or execution”, and clothed the proceeds of Iraqi oil sales (as well as the bank account into which the proceeds of all such oil sales were to be directed) with privileges and immunities identical to those enjoyed by the United Nations itself.

⁷ http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1483%282003%29

Resolution 1483 was enacted pursuant to Chapter VII of the Charter of the United Nations. It was therefore binding on all members of the organization and the Resolution instructs each member state to “take any steps that may be necessary under their respective domestic legal systems to assure this protection” of Iraqi oil and financial assets. These UNSC-mandated immunities were periodically renewed and eventually expired on June 30, 2011.⁸ In Europe, the immunities for Iraqi assets were implemented through EU Regulation 1210/2003 (July 7, 2003) and amended from time to time thereafter in response to UNSC Resolutions.⁹

It worked. In late 2004, Iraq negotiated an 80% nominal writeoff of its debt owed to Paris Club countries and a long-term restructuring of the balance of the claims. This translated into an 89.75 percent reduction in the net present value of those claims. That same NPV haircut was then offered to the holders of roughly \$21 billion of Saddam-era debt owed to private sector creditors and virtually all of those holders accepted it. The UNSC-mandated immunization of Iraqi assets undoubtedly helped to dampen any hope that a better recovery could be achieved at the sharp end of a litigation.

Broader implications

An amendment of the T/ESM along the lines suggested above would, together with the other measures already taken within the Eurozone, substantially replicate the key features of most corporate insolvency regimes and would cover much of the ground that the IMF’s proposed Sovereign Debt Restructuring Mechanism sought to address in 2002. Specifically,

- Supermajority creditor control of a future Eurozone sovereign debt workout will be effected through the use of the aggregated collective action clauses that the T/ESM mandates be included in all Eurozone sovereign bonds issued after January 1, 2013. Control of the workout process by a supermajority of affected creditors, and the ability to bind any dissident creditors to the will of that majority, is a fundamental feature of most insolvency regimes.
- Supervision of the workout process will in practice be the province of the Troika (the ECB, the IMF and the European Commission) in much the same way as they have been doing in the bailouts of Greece, Ireland and Portugal. This supervision implicitly covers issues such as assessing whether a debt restructuring is required in the debtor country, whether the terms proposed in any such restructuring are proportional to that country’s needs, whether the country is undertaking appropriate macroeconomic adjustment

⁸ See http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1956%282010%29

⁹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:169:0006:0023:En:PDF>

measures, and whether the burden of the adjustment is being shared equitably among all stakeholders (citizens, creditors and official sector sponsors).

- Although there will be no “automatic stay” preventing the initiation of creditor lawsuits against the sovereign debtor, the amendment to the T/ESM proposed above would effectively shield the debtor country’s Eurozone-based assets from compulsory seizure by holdout creditors.

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