

Single-Limb Collective Action Clauses and the European Stability Mechanism Reform

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Abstract

In December 2019, the Euro Summit did not approve the amendments to the ESM Treaty because of a disagreement among Member States on debt restructuring as a requirement for stability support in the case of unsustainable debt and questionable capacity of repayment. In this context, a key role is played by single-limb CACs which permit restructuring across all the bond series. On the one hand, this facilitates the restructuring process and neutralize the blocking action of vulture funds under single series. On the other hand, this poses some problems in relation to the protection of minor bondholders. The solution to these problems may come from inserting a sort of exemption clause in the model CACs that the EU Economic and Financial Committee is mandated to draft. This scenario is now exacerbated by the social and economic effects of the Covid-19 pandemic crisis that have caused a generalised increase in sovereign indebtedness and may imply debt restructuring.

Keywords

ESM treaty reform, debt restructuring, single-limb CACs, protection of minor bondholders, Covid-19 crisis

1. Introduction

In December 2017, the European Commission submitted a proposal for a Council Regulation to transform the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) and to incorporate it into the EU legal framework.¹ Since it failed to coagulate the necessary consensus, this proposal was abandoned and, in December 2018, the Euro Summit endorsed the Term Sheet on the ESM Reform submitted by the Eurogroup.² The Term Sheet was grounded on four key points. First,

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¹ COM (2017) 827 final.

² <https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf>.

the ESM would provide financial assistance to the Single Resolution Fund in the form of a revolving credit line; second, recourse to the Precautionary Conditioned Credit Lines would be possible if certain quantitative criteria were *ex ante* met; third, ESM financial assistance would be granted only to those countries whose debt is sustainable and the capacity for repayment indisputable; and fourth, the ESM and the European Commission would cooperate within and outside the financial assistance programmes.

In June 2019, the Eurogroup presented a revised draft of the ESM Treaty that acknowledged the key points of the Term Sheet to the European Council.³ However, the Euro Summit was unable to converge on the final text, because of a disagreement between the ESM Member States. One of the issues that caused major concern was the emphasis on debt sustainability and capacity of repayment as a precondition for ESM financial assistance. Under the ESM Revised Draft Treaty, stability support cannot be provided in favour of a Member State whose debt is considered unsustainable and its capacity to repay disputable, unless and until that Member State's debt burden is reduced. This implies for State to be obliged to undergo a debt restructuring process. To facilitate this process, the ESM Revised Draft Treaty provides for the inclusion of single-limb Collective Action Clauses (CACs) in all sovereign debt issuances by 2022. This clause permits contextually amending all the terms of the loan of multiple series of bonds. On the one hand, holdout creditors will no longer be able to form a blocking minority under single bond issues; on the other hand, minor bondholders will be bound by the decisions of major investors, who are driven by different investment goals and have a better capacity to cover losses. This disagreement between the ESM Member States was expected to be settled by the European Council of December 2019, but this did not occur and a final decision is still to be reached.

The issue of debt restructuring may become crucial in connection with the Covid-19 pandemic crisis. To cope with the social and economic effects of the health crisis, many countries have contracted masses of new debt. Further sources of indebtedness may come from the facilities that the EU and the ESM have arranged in favour of Member States. This inevitably is leading to an over-indebtedness that may questions debt sustainability and repayment capacity in the case of a request for stability support to the ESM and in relation to the Stability and Growth Pact. In this context, a Member State may be obliged to reduce its debt and the single-limb CACs can facilitate to reach this goal.

Against this background, the purpose of this work is to describe the introduction of CACs into the terms of the loan of sovereign bonds, to explore the operation of single-limb CACs in restructuring processes, to analyse their impact on minor bondholders and to give suggestions for providing these holders with some protection.

³ <<https://www.consilium.europa.eu/media/39772/revised-esm-treaty-2.pdf>>.

2. Collective Action Clauses

The call for a widespread adoption of the CACs emerged in connection with the complicated picture of the Argentine debt restructuring.⁴ In December 2001, Argentina was unable to meet the maturities on its debt and declared default.⁵ Its bonded debt, which amounted to half the outstanding debt, was technically difficult to restructure as it was articulated in 152 series of bonds, governed by eight different laws and held by over 700,000 bondholders around the world.⁶ In relation to bonds governed by New York law, which constituted half the bonded debt, the loan agreements provided for unanimity in the case of amending payment terms, thus making their modification impossible. This impossibility was one of the reasons behind the unilateralism held by Argentina in the restructuring process.⁷

This unanimity clause reflected the traditional approach of bonded loans subject to New York law, under which any reduction in the amount due on bond instruments required the consent of all the affected holders. This rule, encapsulated in the 1939 Trust Indenture Act,⁸ was aimed to protect minor holders of debt instruments from the abusive decisions of major stakeholders.⁹ Although it was not meant to cover sovereign debt issuances,¹⁰ contractual practice has systematically inserted the unanimity clause in all sovereign bonds submitted to New York law. However, the problems that emerged during the Argentine debt restructuring process called for discontinuing this practice. This was a feasible step because of the contractual characterisation of the clause. Therefore, in 2002 the G-10 established a Working Group on Contractual Clauses to promote the adoption of CACs in all sovereign bond issuances.¹¹ In this context, it is to be highlighted that the broad term “collective action clauses” embraces not only majority action clauses, but also collective representation clauses, majority enforcement clauses, and engagement clauses.¹²

In February 2003, Mexico was the first country to insert CACs into a bond issuance submitted to New York law, under which payment terms could be amended by

⁴ “[B]y far, the largest and potentially most complex default the world has never known”, Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina’s Debt Restructuring* 6 Chicago Journal of International Law, 311, 317 (2005).

⁵ Andreas F. Lowenfeld, *International Economic Law*, 726-731 (Oxford: OUP, 2008).

⁶ José García-Hamilton, Rodrigo Olivares-Caminal, Octavio Zenarruza, *The Required Threshold to Restructure Sovereign Debt* 27 Loyola of Los Angeles International and Comparative Law Review 249, 257 (2005).

⁷ Cf. Porzecanski, *supra* n. 4, 324-325.

⁸ 15 USCA § 77aaa *et seq.*

⁹ Lee C. Buchheit and G. Mitu Gulati, *Sovereign Bonds and the Collective Will* 51 Emory Law Journal 1317, 1326-1328 (2002).

¹⁰ Edward F. Greene and Ronald Adece, *The Securities of Foreign Governments, Political Subdivisions, and Multinational Organizations* 10 North Carolina Journal of International Law and Commercial Regulation 1 (1985).

¹¹ Group of Ten, *Report on the G-10 Working Group on Contractual Clauses*, at <<https://www.bis.org/publ/gten08.pdf>>.

¹² Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order* 53 Emory Law Journal, 691-762, 698, note 15 (2004).

a majority of 75 per cent of the outstanding bonds.¹³ As markets responded positively, in April 2003 Mexico launched two other bond issues under New York law and again including CACs. In the wake of this success, other countries followed the same route, some with an amending threshold of 75 per cent, others with an amending threshold of 85 per cent.¹⁴ All these thresholds were referred to single issues. By contrast, always in 2003, Uruguay launched a bonded loan containing an aggregation clause under which payment terms could be modified by the vote of 85 per cent of the aggregate principal amount of all the issues affected, together with the two-thirds of the outstanding bonds under each single issue.¹⁵ This “double limb clause” gained wide acknowledgment and in 2012 the ESM Treaty stipulated that all the sovereign debt issuances of the Euro countries, irrespective of the currency in which are denominated and the applicable law, must contain this clause (Art. 12(3) ESM Treaty). In this context, under the EU Common Terms of Reference for CACs, reserved matters can be modified by an affirmative vote of not less than 75 per cent of the aggregate principal amount of the outstanding bonds present at the meeting of all the series affected by the proposed modifications or by the written consent of not less than two-thirds of the aggregate principal amount of the outstanding bonds of all the series affected by the proposed modifications. Cross-series modifications also require the affirmative vote of more than two-thirds of the aggregate principal amount represented at separate meetings of each series affected by the proposed modifications, or the written consent of more than half the aggregate principal amount of each series affected by the proposed modifications (double limb).¹⁶ In the case the required threshold is not met under a single issue, this series is not restructured.

3. Vulturing on *Pari Passu*

The Argentine debt exchange offer was based on swapping old bonds with new bonds bearing a significant loss for holders.¹⁷ This did not involve any change in the terms of the loan, with the result that the holdout creditors retained bonds with the original clauses. These clauses included the *pari passu* clause designed to ensure equality among unsecured creditors. Relying on this clause, certain vulture funds in possession of masses of non-exchanged bonds brought lawsuits before New York courts to affirm

¹³ Anna Gelpern and Mitu Gulati, *Innovation After the Revolution: Foreign Sovereign Bond Contracts since 2003* 4 Capital Markets Law Journal 85, 87 (2009).

¹⁴ Issuers presenting a sub-investment grade chose the higher threshold so as to launch a signal to the prospective investors regarding their commitment to respect the terms of the loan, Elmar B. Koch, *Collective Action Clauses: The Way Forward* 35 Georgetown Journal of International Law, 665, 677, note 36 (2004).

¹⁵ Lee C. Buchheit and Jeremiah S. Pam, *Uruguay's Innovations* 19 Journal of International Banking Law and Regulation, 28-31 (2004).

¹⁶ <https://europa.eu/efc/sites/default/files/docs/pages/cac_-_text_model_cac.pdf>.

¹⁷ Mauro Megliani, *Sovereign Debt: Genesis Restructuring Litigation*, 374-375 (Heidelberg: Springer 2015).

their right to be paid contextually to the holders of exchanged bonds.¹⁸ In February 2012, the Southern District Court of New York granted an injunctive relief ordering Argentina to pay the holders of the non-exchanged bonds. In October 2012, the Court of Appeals for the Second Circuit affirmed the decisions of the District Court, emphasizing that, in the absence of a sovereign bankruptcy machinery, the *pari passu* clause had the purpose of preventing the debtors from arranging, by themselves and in an arbitrary manner, the order of the payment to the detriment of the unsecured creditors.¹⁹ The court ruled that, under either interpretation of the clause,²⁰ the debtor was in breach of contract.²¹ The injunction was then remanded to the District Court for the determination of the third parties and the payment formula. In the face of Argentina's obstinate refusal to pay the non-exchanged bonds, the District Court ordered the debtor to pay the total amount due on 15 December 2012 into an escrow account.²² The orders of November 2012 were challenged before the Court of Appeals for the Second Circuit, which in August 2013 dismissed the appeal but stayed the enforcement pending a writ of certiorari before the Supreme Court.²³ In June 2014, the Supreme Court refused to hear the case, and the District Court issued an order permitting the indenture trustee to receive payments from Argentina, but without transferring the sums to the holders of the exchanged bonds. In March 2016, definitively settling the *querelle*, Argentina and the vulture funds reached an agreement under which the claimants received 75 per cent of principal and interest claimed plus compensation for legal fees. Eventually, the holdouts won.²⁴

¹⁸ Vulture funds are investment funds specialising in purchasing at a discounted market price of corporate or sovereign loans or bonds of debtors in distress. They do not simply refuse to take part in restructuring processes, but threaten to endanger the outcome of a restructuring plan by seeking judicial remedies to block or attach payments on the exchanged debts. See Christoph Wheeler and Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation* 39 *Stanford Journal of International Law* 253, 253-254 (2003).

¹⁹ *NML Capital LTD et al. v The Republic of Argentina*, 699 F 3d 246 (2nd Cir 2012).

²⁰ Under the narrow meaning, all creditors "rank *pari passu*", while under the broad meaning, creditors are to be paid "pro rata" when a payment to one of them is made. The former interpretation is to be preferred as more consistent with the bankruptcy origin of the clause. See Philip R. Wood, *Pari Passu Clauses – What Do They Mean?* 18 *Butterworths Journal of International Banking and Financial Law*, 371–374 (2003).

²¹ "In short, the combination of Argentine's executive declarations and legislative enactments have ensured that plaintiffs' beneficial interests do not remain direct, unconditional, unsecured and unsubordinated obligations of the Republic and that any claims that may arise from the Republic's restructured debt do have a priority in Argentinian courts over claims arising out of the Republic's un-restructured debt", *NML Capital Ltd*, *supra* n. 19, at 260.

²² *NML Capital Ltd v. the Republic of Argentina*, 2012 US Dist LEXIS 167272 (21 November 2012 SDNY).

²³ *NML Capital Ltd v Republic of Argentina*, 2013 US App LEXIS 17645 (23 August 2013 2nd Cir).

²⁴ "On assuming that vulture funds paid the bonds an average of twenty-eight cents in the dollar, they received an overall amount of USD 2,146 billion with a total return of 1,270%". See Martin Guzman, *An Analysis of Argentina's. 2001 Default Resolution*, CIGI Paper No. 110, 16 (Oct. 2016).

4. Vulturing on Blocking Minority

The insertion of CACs in the terms of the loan of sovereign bonds should have ensured orderly sovereign debt workouts and avoided a take-it-or-leave-it approach. This was not always like that. The touchstone was constituted by the Greek debt exchange of 2012. In February 2012, the Greek authorities launched an exchange offer involving its bonded debt. The outstanding bonds falling into the exchange offer amounted to an aggregate face value of nearly 206 billion euros, of which an aggregate amount of roughly 177 billion euros consisted of bonds governed by Greek law while the remaining were bonds issued under English law. As the domestic law bonds did not contain CACs, on the eve of the launch of the exchange offer the Greek Parliament enacted the Greek Bondholder Act 2012 (Law No 4050/2012),²⁵ which introduced the possibility of amending *ex post* the terms of the loan by means of a qualified majority of two-thirds of the participating capital calculated on a quorum of at least half of the total outstanding capital (Art. 1(3)).²⁶ This meeting and voting quorum applied across the totality of all Greek law bonds outstanding (across-the-series), rather than series-by-series. In this way, the holders of domestic law bonds were given the opportunity to vote on the restructuring offer, but unlike the holders of English law bonds they were unable to form a blocking minority.²⁷ The result was that the Greek law debt exchange was successful as the meeting and voting requirements were met, while in relation to 17 English law bonds containing series-by-series CACs, certain funds were able to form blocking minorities and, thus, neutralise majorities favourable to restructuring.²⁸ This outcome constituted a further incentive for vulture funds to buy bonds of an issuer in distress at a low price and play the role of holdout creditor to be paid in full.²⁹

Against this backdrop, the Greek debt restructuring highlighted the advantages of an across-the-series vote and the limits of a series-by-series vote. These limits cannot be cured by having recourse to the Eurozone aggregation clauses, as the double-limb

²⁵ Available in English translation at <<http://andreaskoutras.blogspot.com/2012/03/better-translation-of-bondholders-act.html>>.

²⁶ In contrast with CACs incorporated by contractual agreement, the Greek Bondholder Act 2012 (Law 4050/2012) imposed CACs by statute, modifying *ex posteriori lege* the terms of the loan, see Mitu Gulati and Lee C. Buchheit, *How to Restructure Greek Debt* 10-13 (2010), at <https://scholarship.law.duke.edu/working_papers/47>. Greece made recourse to this escamotage as many dissenting voices among small and big investors risked jeopardising the outcome of the exchange offer, Sebastian Grund, *The Legal Consequences of Sovereign Insolvency – A Review of Creditor Litigation in Germany Following the Greek Debt Restructuring* 24 *Maastricht Journal of European and Comparative Law* 399, 403-404 (2017).

²⁷ Jeromin Zettelmeyer, Christoph Trebesch, Mitu Gulati, *The Greek Debt Restructuring: An Autopsy*, 11-13 (July 2013), at <https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5343&context=faculty_scholarship>.

²⁸ Zettelmeyer et al., *supra* n. 27, at 42.

²⁹ See Anna Gelpern, Ben Helle and Brad Setser, *Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds* in Martin Guzman, José A. Ocampo and Joseph E. Stiglitz (eds.), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises*, 109, 121-122 (New York; Columbia University Press, 2016).

Euro-CACs require over two-thirds per cent vote in each single bond issuance. This means that the holdout problem faced by Greece could emerge again. To solve this problem, in 2014, the International Capital Market Association (ICMA) laid down the Standard Aggregated CACs for the Terms and Conditions of Sovereign Notes Governed by English Law, which provides for aggregate voting procedures for multiple series of bonds. In the case of “Two Limb Voting”, reserved matters can be modified by a majority of at least two-thirds of the aggregate principal amount of the outstanding bonds of all the affected series and of more than 50 per cent of the aggregate principal amount of the outstanding bonds of each single series. In the case of “Single Limb Voting”, reserved matter can be modified by a majority of at least 75 per cent of the aggregate principal amount of the outstanding bonds of all the affected series.³⁰ This single-limb clause was endorsed by the ESM Revised Draft Treaty, which has stipulated that by 1st January 2022 the ESM Member States will be required to insert single-limb CACs in the terms of the loans of all government debt issuances, domestic and international alike, whatever the currency in which they are denominated and the law by which they are governed. To serve this purpose, the ESM Member States mandated the EU Economic and Financial Committee to draft the single-limb CACs, consistently with the national constitutional requirements, so as to ensure that their legal impact is identical (Whereas No 11).³¹

5. Single-Limb as a Mandatory Rule

Debt sustainability is a pre-condition for ESM stability support that is aimed at preserving the objective of the stability of the monetary union (Art. 136(3) TFEU).³² To achieve this objective, preventive and curative measures have been envisaged. Preventive measures include maintaining sound and sustainable finance. When this goal is not met and the ratio of general government debt to gross domestic product exceeds the 60 per cent, the Revised Stability and Growth Pact³³ stipulates that the Member State concerned will be put in an excessive deficit procedure (even if its deficit is below 3 per cent), after taking into account all relevant factors and the impact of the economic cycle, if the gap between its debt level and the 60 per cent parameter is not

³⁰ <<https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/primary-market-topics/collective-action-clauses>>.

³¹ The insertion of single-limb CACs into the Eurozone sovereign debt issuances had been envisaged in the Meseberg Declaration with the purpose of improving debt sustainability. Franco-German Declaration of 19 June 2018, available at <<https://www.diplomatie.gouv.fr/en/country-files/germany/events/article/europe-franco-german-declaration-19-06-18>>.

³² European Council Decision of 25 Mar. 2011 Amending Article 136 of the Treaty on the Functioning of the European Union with Regard to a Stability Mechanism for Member States Whose Currency is the Euro (2011/199/EU), [2011] OJ 91/1.

³³ The Stability and Growth Pact consists of a set of rules aimed at ensuring that EU countries pursue sound public finance and coordinate their fiscal policies. Cf. <https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en>.

reduced by 1/20th annually (on average over three years). Curative measures include debt reduction to a sustainable level. This implies that the outstanding debt must undergo a restructuring process. Failing a proper debt statutory mechanism,³⁴ restructuring takes place by inserting CACs in the terms of the loan.³⁵

Single-limb CACs are to be appreciated against this background. Under Greek law No 4050,³⁶ single-limb CACs were qualified as mandatory rules, i.e. rules of immediate effect and prevailing over any other contrary legislation, aimed to protect a supreme public interest (Art. 1(11)). Broadly speaking, mandatory rules may be classified under three headings: rules that express an absolute command and cannot be avoided by the parties; rules that express an absolute command but that can be put aside by the parties in cross-border transactions; rules of national or supranational origin that find application whatever the governing law.³⁷ This last category covers public order laws that are generally indicated as reinforced or overriding mandatory rules.³⁸ These are provisions the respect for which is regarded as crucial for safeguarding the public interest of a specific country, such as its political, social or economic organisation, that are to be applied irrespective of the applicable law.³⁹ Anti-trust laws, embargoes and economic sanctions, regulations of stock exchange and exchange controls fall in this purview.⁴⁰ Also the norms concerning single-limb CACs can be subsumed under this category,⁴¹ since are meant to facilitate an orderly sovereign debt restructuring process, that pursues the collective interest of the financial stability of the monetary union.⁴²

³⁴ In connection with the proposal to transform the ESM into a proper EMF, it had been suggested to endow the EMF with the functions of a sovereign debt restructuring framework, see Sebastian Grund and Mikael Stenström, *A Sovereign Debt Restructuring Framework for the Euro Area* 42 Fordham Journal of International Law 795, 812 *et seq* (2019). This statutory approach is not a novelty in the landscape of sovereign debt restructuring and echoes the proposal by Anne Krueger to establish a Sovereign Debt Restructuring Mechanism within the framework of the IMF, see Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring* (Washington; IMF, 2002), available at <<https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf>>.

³⁵ *Supra*, para. 2.

³⁶ *Supra*, para. 4.

³⁷ Bénédicte Fauvarque-Cosson and Denis Mazeaud (eds.), *European Contract Law*, 103 (Münich; Sellier, 2008).

³⁸ Fauvarque-Cosson and Mazeaud, *supra* n. 37, 109.

³⁹ Art. 9(1) Regulation (EC) 593/2008 of the European Parliament and the Council of 7 June 2008 on the Law Applicable to Contractual Obligations (Rome I) [2008] OJ L 177/6.

⁴⁰ Andrea Bonomi, Art. 9 in Ulrich Magnus and Peter Mankowski (eds.), *European Commentaries on Private International Law. Vol. II: Rome I Regulation*, 599, 621 (Köln; Otto Schmidt, 2017).

⁴¹ Régis Bismuth, *L'émergence d'un "ordre public de la dette souveraine" pour et par le contrat d'emprunt souverain? Quelques réflexions inspirées par une actualité très mouvementée* 58 *Annuaire Français de Droit International* 489, 512-513 (2012).

⁴² Case C-370/12, *Thomas Pringle v. the Government of Ireland*, ECLI:EU:C:2012:756, para.135.

6. Single-Limb and Its Problems

The introduction of single-limb CACs into the terms of the loan is meant to facilitate the debt restructuring/reprofiling⁴³ of an ESM Member State requesting ESM stability support in the case of its debt burden being unsustainable and its capacity of repayment questionable (Art. 13(1)(b) ESM Revised Draft Treaty). Nevertheless, the impact of these clauses on the dynamic of sovereign bonded loans is Janus-headed. On the one hand, it avoids discrimination between creditors who are able to form a blocking minority and creditors who are not; on the other hand, it opens the door to possible abuses against minor holders.⁴⁴ In relation to this last point, it is worth considering that sovereign bonds are held by a wide range of subjects: commercial banks, investment banks, central banks, pension funds, mutual funds, hedge funds, vulture funds, and, least but not last, retail investors.⁴⁵ Needless to say, retail investors pursue investment goals that diverge from those of institutional investors and in case of restructuring they are less able to cover losses. Under single-limb CACs, where the voting threshold is calculated across all the series, they are unlikely to form a blocking minority, and their interests will be systematically subordinated to those of the major holders.

It is certainly true that, in the context of debt restructuring, it is necessary “to save the majority from the tyranny of the minority”,⁴⁶ but it is likewise essential to preserve the minority from the abusive conduct of the majority. In effect, although bondholders voting at meetings are not required to disregard their own interests,⁴⁷ the majority is expected to exercise its power in good faith for the benefit of the lenders as a whole and not in a malicious manner that is disadvantageous, discriminatory and oppressive to the interests of some of them.⁴⁸ This because community interest creates mutual obligations and entails the duty of acting in good faith in the interest of the associated.⁴⁹ However, it may be difficult to prove malicious conduct by the majority in court.

In order to safeguard minorities under single-limb CACs, some form of protection is envisageable. First, the exchange offer must be uniformly applicable to all creditors. This implies that the holders of all affected series are invited to exchange, convert, or substitute their debt securities on the same terms for the same new instrument or a new instrument from an identical menu of instruments.⁵⁰ Second, similar bonds

⁴³ When a restructuring takes place without a default is called “reprofiling”, Rodrigo Olivares-Caminal, *Transnational Aspects of Sovereign Debt Restructuring* in Rodrigo Olivares-Caminal et al (eds.) *Debt Restructuring*, 415-416 (Oxford: OUP, Oxford 2011).

⁴⁴ Gelpert et al., *supra* n. 29, at 120.

⁴⁵ Jill E. Fisch and Caroline M. Gentile, *Vultures or Vanguard? The Role of Litigation in Sovereign Debt Restructuring* 53 Emory Law Journal 1043, 1070-1072 (2004).

⁴⁶ Sir Francis B. Palmer, *Company Precedents*, 271 (London; Stevens & Sons, 1881).

⁴⁷ Philip R. Wood, *International Loans, Bonds, Guarantees, Legal Opinions*, 303 (London; Sweet & Maxwell, 2007).

⁴⁸ *Redwood Master Fund Ltd and Others v TD Bank Europe Ltd and Others* [2002] EWCH 270 Ch. and *Assénagon Asset Management SA v Irish Bank Corporation Ltd* [2012] EWCH 2090 Ch.

⁴⁹ *Hackettstown National Bank v. D.G. Yuengling Browning Co*, 74 Fed. 110, 112 (2nd Cir 1896).

⁵⁰ ICMA Standard Aggregated CACs, *supra* n. 30, at point (c)(v).

– e.g. bonds denominated in the same currency or having zero coupon – can be placed in the same voting pool by sub-aggregation. Under this scheme, each sub-aggregated group is entitled to vote according its own interest, but cannot block the operation unless it coagulates a blocking minority of over 25 per cent of the whole outstanding debt.⁵¹ This mechanism of sub-aggregation was not acknowledged in the ICMA Standard Aggregated CACs, but may taken into account by the EU Economic and Financial Committee in drafting the single limb CACs under the ESM mandate.

7. Drafting Protective Provisions

The machinery above described does not seem sufficient to provide an effective safeguard in favour of minor bondholders who are fated to be bound by the decisions of the major ones. This calls for the insertion of protective clauses in the single-limb CACs. However, the operation of these clauses presupposes to identify which bondholders deserve such protection. To this purpose, some criteria may come into play.

A first criterion may consist of drawing a line between those holders who have purchased bonds on the markets in normal times and those holders who have purchased them when their price was far below the face value. In other words, holders should not receive preferential treatment when they indulge in speculative manoeuvres. This point is well highlighted in *Accorinti*,⁵² where the Court of Justice of the European Union (CJEU) was asked to rule on the application filed by certain Italian holders of Greek bonds for compensation of damages suffered following a decision of the European Central Bank under which Greek bonds were declared temporarily ineligible for the Eurosystem. In its line of reasoning, the court held that any purchase of sovereign bonds by investors entails certain risks as market fluctuations reflect the creditworthiness of the issuer.⁵³ This was particularly true in relation to those applicants who had purchased the bonds over the peak of the Greek financial crisis.⁵⁴ However, notwithstanding the finding that not all the applicants were involved in speculative purchases, the court concluded that all of them must have been aware that trading in Greek bonds occurred in volatile markets and was characterised by hazards and risks involving loss in their face value.⁵⁵ This point came also into play in *Nausicaa*,⁵⁶ where the CJEU restated the rule that any investment in sovereign bonds

⁵¹ Gelpert et al., *supra* n. 29, at 131-132.

⁵² Case T-79/13 *Accorinti and Others v. European Central Bank*, ECLI:EU:T:2015:756.

⁵³ In other words, lending to a foreign country remains an “act of faith”, Herbert Feis, *Europe the World's Banker 1870–1914*, 102 (New Haven; Yale University Press, 1930).

⁵⁴ *Accorinti*, *supra* n. 52, at para. 82.

⁵⁵ In the view of the court, speculative purchases may also be referred to those bondholders who had purchased the instruments well before the burst of the financial crisis because of the high indebtedness and deficit of the debtor State, *Accorinti*, *supra* n. 52, at para. 121.

⁵⁶ Case T-749/15, *Nausicaa Anadyomène SAS and Banque d'Ecompte v. European Central Bank*, ECLI:EU:T:2017:21.

bears the risk of a sovereign default, irrespective of the goals pursued by the investors.⁵⁷

A second criterion may consist of drawing a line between physical persons and legal persons or, in other words, between retail investors and institutional investors. This point was raised before the European Court of Human Rights (ECtHR) in *Mamatatas*⁵⁸ by some holders of Greek bonds who voted against the 2012 exchange offer but resulted bound by its terms because of the operation of the CACs introduced by Greece just before the launch of the offer.⁵⁹ The ECtHR highlighted that one of the conditions to which institutional investors subordinated their participation in the debt reprofiling was the extension of the exchange offer to all the holders.⁶⁰ On these grounds, the court justified the decision of the Greek government not to make a distinction between different typologies of holders. Other justifications were related to the operation of the exchange offer, such as the difficulty in identifying the physical persons, the necessity to arrange the operation rapidly, and the risk that masses of bonds would pass from institutional investors to physical persons with the consequential reduction of the debt falling in restructuring.⁶¹ However, the most pregnant argument against a differential treatment between retail investors and institutional investors lay in the fact that there might be physical persons who had purchased a considerable number of bonds and legal persons who had bought lesser amounts of bonds.⁶²

To overcome these problems, a reasonable and objective criterion may consist of putting a threshold below which bonds are exempted from reduction, regardless the quality of the holders. In this context, a useful benchmark is constituted by the second Argentine debt restructuring (2010), where a “par option limit per holder” exchange offer was arranged in favour of holders of bonds not exceeding the ceiling of USD 50,000.⁶³ Although this ceiling formally applied to all types of investor, it was clearly meant to safeguard minor holders.

With this in mind, it would be reasonable to insert an exemption ceiling of this kind in the single-limb CACs the EU Economic and Financial Committee is required to prepare by 2022. Under this clause, bonds below a certain threshold held by single holders across all the series affected by single-limb CACs would be exempted from debt reduction. This exemption may assume two forms: either a *tout-court* exemption, where bonds under the ceiling are simply not covered by the exchange offer and, thereby, not affected by the operation of single-limb CACs; or a par limit exchange

⁵⁷ *Nausicaa*, *supra* n. 56, at para. 115.

⁵⁸ ECtHR, *Affaire Mamatas et Autres c. Grèce*, arrêt du 21 juillet 2017, at <[https://hudoc.echr.coe.int/eng#{"itemid":\["001-164969"\]}](https://hudoc.echr.coe.int/eng#{)>.

⁵⁹ *Supra*, para. 4.

⁶⁰ *Mamatatas*, *supra* n. 58, at para. 118.

⁶¹ *Mamatatas*, *supra* n. 58, at paras. 136, 138, 139.

⁶² In this context, the court rejected the submission of the applicants that the threshold of 100,000 euros could reasonably draw a line between different categories of bondholders, *Mamatatas*, *supra* n. 58, at para. 137.

⁶³ <https://www.argentina.gob.ar/sites/default/files/us_prospectus_version_ingles_30042010.pdf>.

offer arranged along the same lines as the 2010 Argentine debt restructuring. These two options involve different legal consequences. Under the first, the original terms of the loan would survive and, in case of default, the *pari passu* clause could be used against the exchange bondholders. Moreover, the exempted bonds would be disenfranchised from the calculation of meeting and voting quorum in the restructuring process. Under the second, the old bonds would be exchanged for the new ones and the terms of the loan would be amended accordingly; further, the recipients of a par limit exchange offer would be allowed to vote, and this may facilitate reaching the quorum. This tips the scales in favour of the second option.⁶⁴

8. The Covid-19 Impact

The single-limb CACs may play a crucial role in relation to the effects of the Covid-19 crisis. Since late winter 2020, the globe has been affected by a pandemic virus which has confined at home one third of the world's population with a reduced income or none. This scenario has triggered an unprecedented decline in the world economy capable of originating social and political unrest. In response to this, many governments have provided grants, loans and guarantees to enterprises and households. These interventions involve huge financial commitments that, in times of falling revenues, can scarcely be found in national budgets. To secure the necessary resources Governments have systematically resorted to financial markets by issuing bonded loans. However, the regular access to financial markets depends on the debt sustainability and capacity of repayment of the issuer. An economic recession of the present magnitude questions these two requirements.

To support Member States, the EU institutions have progressively arranged a number of measures. A first set of measures was based on a coordinated strategy that includes flexibility on fiscal rules and state aid, targeted use of the EU budgetary resources and the purchase of bonds of private and public entities on non-standard terms under the Pandemic Emergency Purchase Programme arranged by the European Central Bank.⁶⁵ Further, at its meeting of 9th April 2020, the Eurogroup envisaged additional measures hinging on four pillars.⁶⁶ First, a new facility arranged by the ESM – the Pandemic Crisis Support facility – that allows Euro countries to draw funds, provided that these are used to support domestic financing of direct and indirect healthcare, cure and prevention related to the COVID-19 crisis. Second, a new instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) – proposed and managed by the European Commission – to provide financial

⁶⁴ Mauro Megliani, *The ESM Reform: More than Meets the Eye?* 34 Butterworths Journal of International Banking and Financial Law 628 (2019).

⁶⁵ Decision (EU) 2020/440 of the ECB of 24 March 2020 on a Temporary Pandemic Emergency Purchase Programme (ECB/2020/17) [2020] OJ L 91/1.

⁶⁶ <<https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/>>.

assistance in the form of loans on favourable terms to Member States aimed at protecting work and jobs. Third, a new fund established by the European Investment Bank – the Pan-European Guarantee Fund – with the purpose of financing business in Member States, particularly small and medium enterprises, including national promotional banks and institutions. Fourth, a Recovery Fund providing resources through the EU budget to programmes designed to support the economy consistently with European priorities and ensuring EU solidarity with the most affected Member States.

On 23rd April 2020, the European Council endorsed the measures proposed by the Eurogroup relating to States (ESM), workers (Commission) and business (EIB), amounting to a package worth 540 billion euros.⁶⁷ In addition, it agreed on the establishment of the Recovery Fund and mandated the European Commission to work on this objective. On 27th May 2020, the European Commission presented an ambitious plan capable of mobilising 750 billion euros from bonds issued by a Recovery Instrument (Next Generation EU), with further resources worth 1,100 billion euros from the EU budget (Multiannual Financial Framework).⁶⁸ In this context, the European Commission has proposed the creation of a Recovery and Resilience Facility (RRF)⁶⁹ under which Member States are allowed to draw resources in the form of loans or grants.⁷⁰

The combination of bonded loans and loans contracted under the ESM/EU facilities has the effect of inflating sovereign indebtedness at a level which may question the debt sustainability and capacity for repayment of the issuer. For Euro countries, this problem may specifically come into play when ESM stability support is sought (Art. 13(1)(b), ESM Revised Treaty). For all EU countries, Art. 126(2) TFEU imposes avoiding excessive debt and deficit. In this context, it is to be emphasized that the revised Stability and Growth Pact contains a general escape clause that permits, in periods of severe economic recession, to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not impair fiscal sustainability in the medium term.⁷¹ The European Commission proposed to apply this clause

⁶⁷ <<https://www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/>>.

⁶⁸ COM(2020) 442 final.

⁶⁹ Proposal for a Regulation of the European Parliament and the Council establishing a Recovery and Resilience facility, COM(2020) 408 final.

⁷⁰ The European Council of 17-21 July 2020 agreed to a RRF worth 672.5 billion euros, of which 360 billion euros in loans and 312.5 billion euros in grants, <<https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf>>.

⁷¹ The clause was introduced as part of the “Six-Pack” reform of the Stability and Growth Pact in 2011, in the wake of the global economic and financial crisis. In detail, the clause is set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 (as amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies, OJ [2011] L 306/12) and in Articles 3(5) and 5(2) of Regulation (EC) 1467/97 (as amended by Council Regulation (EU) No 1177/2011 of 8 November 2011 amending

in relation to the Covid-19 crisis⁷² and the Ecofin endorsed this proposal.⁷³ What it is to bear in mind, though, is that the suspension of the fiscal and budgetary rules is just temporary and, once the economic conditions will improve, deficit and debt should be progressively reduced. In this case, an orderly debt restructuring is a means to relieve the debt burden and single-limb CACs would facilitate this process. However, it is necessary to highlight that the insertion of this clause in the sovereign bonds of Euro countries depends on the still on-going ESM Treaty amending process. Also, it would not operate in relation to previous bond issues where a blocking minority could still be formed. Nevertheless, all EU countries may pre-empt this impasse in two ways. First, they are free to incorporate single-limb CACs in the terms of new bonded loans irrespective of the outcome of the ESM Treaty reform. Second, just like Greece in 2012, they can amend the terms of bonded loans previously issued under domestic law and, thus, insert retroactively single-limb CACs.

All this picture makes it all the more necessary to insert in single-limb CACs a protective clause meant to safeguard the interests of minor bondholders. This could be done both at the EU Economic and Financial Committee level, in drafting the single-limb CACs, and at the ICMA level, in amending the Standard Aggregated CACs for the Terms and Conditions of Sovereign Notes. However, national governments may pre-empt these institutions and arranging single-limb CACs containing protective clauses.

9. Conclusion

In December 2019, the European Council, in the form of the Euro Summit, was expected to approve the amendments to the ESM Treaty. One of the most controversial issues was debt sustainability and repayment capacity as a precondition for a Member State to receive stability support. When this precondition is not met, a debt restructuring/reprofiling is to be arranged. To facilitate this process, the ESM Revised Draft Treaty stipulates that single-limb CACs shall apply to all new Euro area government securities, with maturity above one year, issued on or after 1st January 2022, irrespective of the governing law, the currency in which they are denominated, or the method of issuance. This picture presents some advantages, as under this clause vulture funds are unlikely to form a blocking minority and impede the amendments to the terms of the loan. It also presents some disadvantages, as minor bondholders would be bound by the decisions of major bondholders. In this context, the sticking point is that minor holders are less able to cover losses than major holders. To solve

Regulation (EC) No 1467/97 on Speeding up and Clarifying the Implementation of the Excessive Deficit Procedure, OJ [2011] L 306/33).

⁷² Communication from the Commission to the Council on the Activation of the General Escape Clause of the Stability and Growth Pact, COM(2020) 123 final.

⁷³ <<https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/>>.

this problem, the drafting of the single-limb CACs should provide some kind of safe harbour in favour of small investors. In this context, some criteria may come into play to identify these investors. A first criterion could be to distinguish between those who speculate and those who do not. This, however, may be inconsistent with the market risk involved in any transaction on financial instruments. A another criterion could be to distinguish between institutional investors and physical persons. This, in turn, does not consider that there may be institutional investors holding a small number of bonds and physical investors holding a large number. A workable solution can then be borrowed from the second Argentine debt exchange offer, where bonds below a certain threshold were exchanged at par. This is an objective criterion that can ensure some protection to small investors and help reach the voting quorum.

The single-limb CACs may play a fundamental role in managing the growing indebtedness deriving from the Covid-19 crisis. An overindebtedness is permitted under the escape clause of the Stability and Growth Pact. However, this is a temporary waiver that will progressively expire in connection with the economic recovery and the end of the pandemic. After that, debt must be reduced to a sustainable level and this might occur under a restructuring process facilitated by single-limb CACs. This scenario urges the insertion of a protective clause in favour of minor bondholders.

