

## Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds

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ABSTRACT: Emerging market sovereigns issue bonds in the international capital markets governed by a foreign legal regime such as the law of England or New York State. European sovereigns, however, have been able to issue bonds governed by the issuer's own law. In the event of a future financial crisis, this gives European sovereign issuers the ability to pass local legislation that will facilitate an eventual restructuring of their bonds -- the "local law advantage." Greece did this in 2012 as part of a restructuring of €206 billion of Greek Government bonds. The validity of the revisions to Greek law enacted in 2012 by the Greek Parliament has been upheld in multiple judicial challenges (in Greece, Germany, Austria and before the European Court of Human Rights), as well in a major ICSID arbitration. This raises the question of whether other European sovereigns enjoying the local law advantage over their bonds can, in an emergency, rely on the power of their own legislatures to amend local law in order to facilitate a future restructuring of those instruments.

KEYWORDS: *Sovereign Debt; Greek Restructuring; Local Law Advantage; Collective Action Clauses*

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## 1. THE LOCAL LAW ADVANTAGE

When emerging market sovereigns issue bonds in international capital markets, those bonds are governed by foreign law, normally the law of England or the State of New York. The reason is simple: allowing a sovereign bond to be governed by the sovereign's own law places the investor at the mercy of the local legislature. If the local law changes in a manner that impairs the performance of a local law bond or facilitates its restructuring, even judges in New York and England must respect that change.<sup>1</sup> We shall refer to this as the “local law advantage” that a sovereign enjoys over a bond governed by its own law. In contrast, a sovereign bond governed by a foreign law will be beyond the mischievous reach of the country's legislature. Sovereigns can (and occasionally do) attempt to pass laws – normally in the nature of capital controls – which purport to interfere with the performance of foreign currency-denominated bonds, but these enactments rarely provide the issuer with a legal defense to the performance of the instrument in a foreign court.<sup>2</sup>

Unlike their emerging market counterparts, European sovereigns have generally been able to issue bonds governed by their own laws. Investors seem to have more confidence that a developed country will not attempt to change its law in a manner that may injure holders of the sovereign's debt instruments.<sup>3</sup> To do so, the argument goes, would be suicidal for a country that must regularly refinance its debt from the capital markets with the support of foreign investors.

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<sup>2</sup> See New York City Bar, *Governing Law in Sovereign Debt—Lessons from the Greek Crisis and Argentina Dispute of 2012*, Committee on Foreign & Comparative Law, Feb. 2013, at page 7, summary point 3. <http://www2.nycbar.org/pdf/report/uploads/20072390-GoverningLawinSovereignDebt.pdf>.

<sup>3</sup> See Lee C. Buchheit & Elena S. Daly, *Contracts in a Time of Capital Controls*, 30 *Butterworths J. int'l banking and fin. law*, 489 (2015).

<sup>4</sup> Michael Bradley, Elisabeth de Fontenay, Irving Arturo de Lira Salvatierra & Mitu Gulati, *Pricing Sovereign Debt: Foreign versus Local Parameters*, 24 *Eur. Fin. Mgmt.* 261 (2018), <https://onlinelibrary.wiley.com/doi/full/10.1111/eufm.12161> (analyzing the pricing differential between sovereign bonds governed by local laws versus foreign laws).

## 2. GREECE 2012

When the Greek sovereign debt crisis erupted in the spring of 2010, the official sector (the EU and the IMF) elected to lend Greece the money needed to repay maturing Greek Government Bonds (hereinafter GGBs) in full and on time. A similar policy was later followed in the bailouts for Ireland, Portugal and Cyprus. The problem was that Greece's debt stock was obviously unsustainable. In the early morning of October 27, 2011, the official sector actors therefore careened from their prior position of forbidding Greece from restructuring *any* of its debt to a new position *commanding* Greece to restructure *all* of the GGBs left in the hands of private sector investors with at least a 50% principal haircut. Having decreed the result, however, the official sector did not confide the method by which that result was to be achieved. Greece was given five months to complete the debt restructuring or face default and a possible exit from the Eurozone.

For the prior two years, GGB holders saw Greece's official sector sponsors lend Greece the money needed to repay maturing GGBs. Senior public officials such as the President of the European Central Bank and his deputies issued regular assurances, stating that there never would be a sovereign debt restructuring in the Eurozone (which the market understandably heard as an assurance that all Eurozone sovereign bonds would be paid in full).<sup>4</sup> The market could thus literally smell the official sector's fear of bringing a messy Argentina-style debt crisis to the belly of Europe. In the face of this, a significant number of GGB holders would probably have called the official sector's bluff by declining to restructure their GGBs. After the tens of billions of euros already sunk in bailing out Greece, Ireland and Portugal, would the official sector really risk a collapse by allowing Greece to default on holdout GGBs? The question of the hour was therefore how to minimize the size of the anticipated holdout creditor population in a savage restructuring of GGBs.

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<sup>4</sup> For analyses of these events, see Paul Blustein, *Laid Low: Inside the Crisis that Overwhelmed Europe and the IMF* (2016); see also Ashoka Mody, *EuroTragedy: A Drama in Nine Acts* (2018).

Greece enjoyed a significant local law advantage with respect to its bond indebtedness.<sup>5</sup> Approximately 93% of GGBs were governed by Greek law. To facilitate the debt restructuring, the Greek Parliament passed a law on February 23<sup>rd</sup>, 2012<sup>6</sup> that effectively homogenized the holders of Greek-law governed GGBs into a single class for purposes of voting on a debt restructuring. If holders of at least 50% in aggregate principal amount of the Greek law-governed GGBs voted either in favor or against the proposed amendment, and at least two-thirds of the principal amount voted to accept the terms of a debt restructuring, their decision would bind all other holders of those instruments. The law thus embodied the notion of supermajority creditor control of the process, very much along the lines of the class voting mechanism prescribed in domestic insolvency regimes for corporate debtors.

In choosing to retrofit a class voting mechanism on the holders of Greek law-governed GGBs, the Greek Parliament made a restrained use of its local law advantage. Parliament could, for example, have attempted to impose directly the financial terms of the restructuring by legislative fiat, rather than by allowing the affected creditors to vote on the measure. Such a thermonuclear use of the local law advantage would not have been supported by Greece's official sector sponsors. Moreover, the members of the Euro-area had already endorsed the use of a creditor class voting mechanism as a method for dealing with future sovereign debt crises in Europe.<sup>7</sup>

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<sup>5</sup> See Lee C. Buchheit & G. Mitu Gulati, *How to Restructure Greek Debt*, May 7, 2010 [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1603304](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304).

<sup>6</sup> Nomos (2012:4050) Κανόνες τροποποίησης τίτλων, εκδόσεως ή εγγυήσεως του Ελληνικού Δημοσίου με συμφωνία των Ομολογιούχων [Greek Bondholder Act], 2012.

<sup>7</sup> On November 28, 2010, the finance ministers of the larger European countries released a document bearing the caption 'Statement by the Eurogroup'. It contained the following paragraph:

In order to facilitate this process [the restructuring of the private sector indebtedness of an insolvent euro area Member State], standardized and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro-area government bonds starting in June 2013. Those CACs would be consistent with those common under UK and US law after the G10 report on CACs, including aggregation clauses allowing all debt securities issued by a Member State to be considered together in negotiations. This would enable the creditors to pass a qualified majority decision agreeing to a legally binding change to the terms of payment (standstill, extension of the maturity, interest-rate cut and/or haircut) in the event that the debtor is unable to pay.

It worked. The necessary supermajority of creditors approved the restructuring in March 2012 and accordingly there were no holdouts among the universe of Greek law-governed GGBs. Thirty-six series of GGBs were governed by English law, each with its own collective action clause. The required bondholder supermajority consent to join the restructuring was obtained for 17 of these series of English law GGBs. Holdout creditors had acquired blocking positions in the other series. Approximately 97% of the eligible debt stock was covered by the restructuring.<sup>8</sup>

Parliament's action was subsequently challenged in Greek, German and Austrian courts, as well as in a major arbitration commenced under one of Greece's bilateral investment treaties.<sup>9</sup> The action was also challenged in proceedings before the European Court of Human Rights.<sup>10</sup> None of these legal challenges prospered.<sup>11</sup>

### 3. EX POST FACTO LAWS AND SOVEREIGN DEBT WORKOUTS

The retroactive implementation of a class voting mechanism on the holders of Greek law-governed GGBs was not undertaken lightly. It represented perhaps the mildest possible use of Greece's local law advantage over the Greek law-governed debt stock consistent with the need to ensure that a transaction -- if broadly supported by a supermajority of similarly-situated creditors -- could not be undermined by a holdout minority. The Greek authorities and their official sector

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Eurogroup Ministers, *Statement by the Eurogroup* (Nov. 28, 2010). This statement was repeated verbatim in the Euro Summit, *Conclusions of the Heads of State or Government of the Euro Area of 11 March 2011* (Mar. 11, 2011). <http://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf>.

<sup>8</sup> See Jeromin Zettelmeyer, Christoph Trebesch & Mitu Gulati, *The Greek Debt Restructuring: An autopsy*, 28 *Econ. Pol'y* 513 (2013).

<sup>9</sup> For a discussion and thorough analysis of these legal challenges see, Sebastian Grund, *Enforcing Sovereign Debt in Court -- A Comparative Analysis of Litigation and Arbitration Following the Greek Debt Restructuring of 2012*, 1 *U. Vienna L. Rev.* 34 (2017).

<sup>10</sup> *Mamatas and others v. Greece* (application nos. 63066/14, 64297/14 and 66106/14), Eur. Ct. H.R. (2016). See European Court of Human Rights Press Release, *Judgements and Decisions of 21 July 2016*, ECHR 255(2016).

<sup>11</sup> See Sebastian Grund, *Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe*, 12 *Cap. Mkts L. J.*, 253, 273 (2017) ("Five years after Greece implemented the biggest sovereign debt restructuring in history, European courts and international tribunals have finally vindicated its legal decision.").

partners were acutely aware that passing any law with retroactive effect, often referred to as an *ex post facto* law, is generally undesirable.

The Greek Parliament's decision was subsequently validated as a matter of Greek and European law. This raises the question of why other European sovereigns – whose debt is wholly or principally governed by the sovereign's own law – cannot follow the Greek precedent should circumstances ever require a restructuring of their bonds? Is anything else needed, over and above the local law advantage enjoyed by most Euro-area sovereigns, to facilitate an orderly restructuring of sovereign debt in Europe? In effect, does the Greek precedent obviate the need for any other measures to facilitate future sovereign debt restructurings in Europe?<sup>12</sup>

Our view is that any use of the local law advantage by a European sovereign should only be considered as a last resort and, even then, only if a crisis erupts before an orderly debt restructuring mechanism can be put in place. Our reasons are:

1) *Ex post facto* laws are disfavored in all legal regimes for the obvious reason that they erode the fundamental premise that contracts will be enforced as written.

2) Any public suggestion that members of the Euro-area expect to rely on *ex post facto* laws as the principal tool to facilitate future sovereign debt restructurings could restrict European sovereigns from borrowing under their own laws. Investors should logically begin insisting on the use of a foreign law for

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<sup>12</sup> This question has come up recently in the context of proposals for Euro area sovereigns to switch from the type of CACs that were adopted in January 2013 to a more restructuring friendly version. The 2013 version required approvals both from creditors in each individual bond and on an aggregated basis across the bonds for modifications to payment terms to be binding on all the bondholders. The proposed 2018 version would allow for binding modifications to occur so long as a single aggregated approval threshold was met across all the bonds with these CACs. These two types of CACs are sometimes referred to as “dual limbed” and “single limbed”. See Antonia E. Stolper & Sean Dougherty, *Collective Action Clauses: How the Argentina Litigation Changed the Sovereign Debt Markets*, 12 *Cap. Mkts. L. J.* 239 (2017). As of this writing, the proposals to move to the latter form of CACs have been fiercely resisted by a subset of countries concerned about negative market reactions. See Jan Strupczewski, *EU Leaders to Boost Bailout Fund Role, But Duck Talks on Deposit Insurance*, Reuters (June 26, 2018).

European sovereign bonds<sup>13</sup> or they might begin charging a basis point penalty for the continued use of local law.<sup>14</sup>

3) It is true that Greece survived the legal challenges to its 2012 legislative retrofit of a class voting mechanism on the local law debt stock. A common theme in those decisions is, however, a perception that Greece acted with considerable restraint and under absolute necessity. That same latitude may not be shown if the member state concerned had the opportunity to put in place a forward-looking mechanism to ensure an orderly debt restructuring but simply neglected to do so.<sup>15</sup>

4) Each member State will have its own constitutional constraints on the ability of the government to interfere with private property. The Greek Constitution, for example, provides that no one shall be deprived of property “except for public benefit” (Article 17), subject to the power of the State “to consolidate social peace and protect the general interest” (Article 106). Not every constitution may offer similar flexibility.

5) Since 2013, all European sovereign bonds have incorporated an aggregated CAC (that is, a contractual provision that mimics, with certain exceptions, the class voting mechanism of corporate insolvency regimes). If a crisis were to occur during the next decade or so, however, only a portion of the bonds of the afflicted sovereign will contain such clauses. In such a situation, what would be the relationship between bonds *with* CACs and those *without* CACs? There are two options. The local legislature could pass a law

- retrofitting a new class voting mechanism over the entire debt stock (effectively ignoring the presence of CACs in some of the bonds), or

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<sup>13</sup> Following the action of the Greek Parliament in February 2012, for example, the Hellenic Republic has been forced to designate English law as the governing law of its international bond issues.

<sup>14</sup> For empirical illustrations of this dynamic, see Marcus Chamon, Julian Schumacher & Christoph Trebesch, *Foreign Law Bonds: Can They Reduce Sovereign Borrowing Costs* (ECB Working Paper No. 2162, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3200256](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3200256).

<sup>15</sup> For a prior discussion of this question, see also Lee C. Buchheit & Mitu Gulati, *Sovereign Debt Restructuring in Europe*, 9 *Global Pol’y* (Special Issue) 65 (2018), <https://onlinelibrary.wiley.com/doi/abs/10.1111/1758-5899.12531>.

- imposing a class voting regime only on the bonds that do *not* contain CACs (relying on the CACs in the bonds containing the clauses to facilitate the restructuring of those series).

In either case, were the retrofit voting mechanism to be more liberal (in terms, for example, of the voting thresholds required to approve a debt restructuring) than the corresponding features of the contractual CACs, this might forfeit judicial sympathy in a future legal challenge by an aggrieved bondholder.