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Sovereign Exchange Offers in 2010

Sergio J. Galvis
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Since the early 1990s, emerging market sovereigns have relied on the international bond markets as an important source of foreign capital. Like other debtors, sovereign borrowers occasionally run into trouble. Their economies may stumble due to flawed policies and adverse conditions at home or abroad, or they may simply borrow more than they can afford to repay. When confronted with a liquidity crisis, sovereigns have sought to restructure their bond debt by asking investors to exchange their existing bonds for new bonds with more “realistic” payment terms. Amending their existing bonds has not been a practical alternative because such an amendment would require the unanimous consent of thousands of holders.¹

More recently, sovereign bonds issued under New York law have moved away from unanimous consent toward collective action clauses (“CACs”), which allow the bonds’ payment terms to be amended with majority bondholder consent. This trend will not diminish the role of sovereign exchange offers as the preferred means to restructure sovereign debt. Rather, the widespread use of CACs will make exchange offers increasingly effective as a tool for implementing broadly supported debt restructurings. At the same time, the case for a sovereign bankruptcy regime—as recently proposed by the International Monetary Fund—will seem even less compelling than it does today.²

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² Until recently, bonds issued under the laws of New York and certain other important jurisdictions required unanimous bondholder consent to amend their payment terms.

³ By the time Mexico added CACs to its international bonds in early 2003—paving the way for other sovereigns—the IMF’s proposal for a sovereign debt restructuring mechanism (SDRM) was visibly running out of steam. Today, the SDRM is chiefly remembered for its effectiveness in encouraging some reluctant investors to go along with CACs for fear of something much worse.
This essay is organized around four basic questions about exchange offers and the prospects for their future: When are exchange offers used? Why do they work? How are they changing? How will they work even better in five years?

I. WHEN ARE THEY USED?

Sovereign exchange offers are used in many different circumstances, not just when an issuer faces economic woe. There are at least three distinct purposes for exchange offers: liability management, reprofiling, and restructuring.

Until the late 1980s, emerging market sovereigns, particularly in Latin America, relied on bank loans to access foreign capital. In the early 1990s, many of these sovereigns experienced financial crises and, after protracted negotiations with creditors, their loans were converted into freely tradeable Brady bonds. Some Brady bonds required issuers to maintain collateral against payment of the bonds, which was expensive and tied up the sovereign’s capital. As economic conditions improved, and the international capital markets became more receptive to emerging market risk, countries began using exchange offers to swap Brady bonds for uncollateralized bonds. Since 1995, sovereigns have also used exchange offers to consolidate smaller series of bonds into larger series, extend the maturity profile of their external debt, and reduce their exposure to particular currencies. The effectiveness of exchange offers for liability management purposes is underscored by Mexico’s early retirement of its last Brady bonds in July 2003 following a number of exchange offers and bond repurchases.

There is another, less positive context in which emerging market sovereigns use exchange offers. A country in financial straits may resort to an exchange offer as a means to reprofile or restructure its external debt. Depending on the severity of the sovereign’s troubles, bondholders may be asked to exchange their existing bonds for new bonds with a longer maturity but no reduction in the principal or interest payable to holders—a so-called “reprofiling” of the issuer’s debt. This type of exchange offer is intended to give the sovereign some breathing room, and usually takes place before any default has occurred. Uruguay completed a successful reprofiling exchange offer in May 2001.

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3 Brady bonds are named after former US Treasury Secretary Nicholas Brady, who brokered the successful plan.

2003, and within five months was again able to tap the international bond markets to raise capital.⁵

In other cases, more time to pay is not enough. A country is forced to admit that its debt burden is unsustainable and approaches bondholders with a proposal to reduce the amount owed, or in other words, a haircut. Investors are a rational bunch, and will be persuaded to go along only to the extent they believe their alternatives are worse. An interesting dynamic develops between debtor and creditor in this context, which will be explored in Part II. For now, it is fair to say that bondholders have been “persuaded” in the past to agree to restructurings involving a substantial haircut. One example is Ecuador, which succeeded in reducing the amount owed under its international bonds by roughly 35 percent.⁶ And Argentina’s recent exchange offer involves a debt reduction that many investors would describe as a crew-cut.

II. WHY DO THEY WORK?

Sovereign exchange offers are not only common, they also have an enviable track record. During various crises in emerging markets in the last five years, every attempt by a sovereign issuer to restructure its existing bonds through an exchange offer was successful: Pakistan, Ukraine, Ecuador, Russia and Uruguay were each able to effect new payment terms for approximately 90 percent of their bonds.⁷ And Argentina is on the verge of completing the largest and most complex exchange offer in history, involving 152 distinct series of bonds representing over 80 billion dollars of debt.⁸

Before exploring the reasons for this success, it is important to acknowledge that there are other, perhaps more important factors that determine whether and when a government is able to restructure its external debt. First, the country must be prepared both politically and economically to

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⁵ See Carlos Stenari, Lessons from Uruguay’s Aggregation Clauses (Jan 2005) (unpublished manuscript on file with authors).


⁷ For a discussion of these exchange offers and a current overview of issues relating to sovereign debt restructurings, see Nouriel Roubini and Brad Setser, Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies 119–180 (Inst for Intl Econ 2004).

address its obligations to foreign investors in a serious way. Second, the sovereign’s proposal must be perceived by a critical mass of investors as fair and equitable in light of its repayment capabilities and its treatment of other creditors. An exchange offer is most likely to yield satisfactory results when these two conditions are present.

Explanations for the effectiveness of sovereign exchange offers tend to focus on a distressed issuer’s willingness to resort to pressure tactics, including threats of nonpayment and exit consents. The threat of nonpayment is powerful in the case of a sovereign because, unlike a corporate debtor whose assets can be liquidated to satisfy its creditors’ claims, government issuers are effectively “judgment-proof.” Collecting a judgment against a sovereign is very difficult because its assets at home and abroad are usually shielded by immunity. Consequently, bondholders trying to decide whether to accept new bonds (which the sovereign has promised to pay) in exchange for existing bonds (which the sovereign has promised not to pay) reject the offer at the risk of an even greater loss.

Some exchange offers involve the use of exit consents as a further means to increase bondholder participation. When this device is used, investors who wish to participate in the exchange offer are required to consent to adverse changes to the existing bonds’ non-payment terms before receiving new bonds. Holders feel pressure to accept the sovereign’s offer for fear of being left behind with bonds that have been adversely modified.

Threats of nonpayment and exit consents deserve a share of the credit for the success of exchange offers. But there are other, more positive factors at play as well.

First, the liquidity of the secondary market for most sovereign bonds provides valuable information to issuers and their advisors as they craft a proposal for an exchange offer. In a liquid market, investors are able to enter and exit the bonds at different price points, reflecting their assessment of the issuer’s prospects. These price signals help the sovereign identify the parameters of a deal likely to gain widespread acceptance in the market. The success of an exchange offer is bound to be greatest where the net present value of the terms

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9 Obtaining a judgment against a sovereign issuer also limits the bondholder’s options by restricting its ability to sell the bonds in the market or participate in a subsequent exchange offer.

10 These amendments usually involve the removal or modification of important nonpayment terms, such as the waiver of sovereign immunity, submission to New York courts and choice of governing law. Standard New York bond documentation does not expressly require the issuer to obtain unanimous consent to make changes to these nonpayment terms.

11 The importance of exit consents relative to other factors is sometimes exaggerated. Notably, Argentina has foregone the use of exit consents in its current exchange offer.

of the exchange represent a premium over the market price of the existing bonds, allowing short-term investors to exit their investment with a trading profit.

Second, exchange offers give sovereigns and their advisors flexibility to craft terms that address the various objectives of a diverse investor base. Issuers usually sound out the market in advance of a proposal and, with the assistance of experienced financial and legal advisors, design a menu that gives as many bondholders as possible an option they can live with. For example, if a significant number of bondholders are intent on preserving the principal amount of their bonds, the sovereign may offer investors an option to exchange their existing bonds on a par-for-par basis for new bonds with a longer maturity or a lower coupon. This flexibility is also evident in the system of carrots-and-sticks sovereigns have used in past exchange offers. Sticks were discussed earlier. Carrots often take the form of "sweeteners," which can include anything from straight-out cash payments to investors accepting the issuer's offer, to interest step-up provisions rewarding holders of new bonds with a higher return if the country's economy recovers in the future.

Third, the unilateral nature of exchange offers reduces the likelihood that the sovereign and its investors will get bogged down in endless negotiations. While the success of a restructuring may depend on how effectively the issuer gauges market sentiment and persuades investors that its proposal is reasonable, the terms of the exchange offer are set by the issuer in consultation with its financial advisors. In the end, investors are presented with a carefully crafted take-it-or-leave-it proposition.13

III. HOW ARE THEY CHANGING?

Advocates of a recent IMF proposal to establish a Chapter 11-type bankruptcy process for sovereign debtors focused their arguments on two principal concerns about the current framework for debt restructurings. First, due to the presence of thousands of bondholders among the sovereign's creditors, it is simply not practicable for an issuer to engage in a collective dialogue with its creditors during a liquidity crisis. Second, for the same reason, it is impossible for an issuer to obtain unanimous consent to restructure its payment obligations. Consequently, a vulture fund or other so-called rogue

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13 This is the flipside of the concern that the absence of creditor coordination makes it difficult for a sovereign and its bondholders to negotiate and reach an agreed proposal. For a recent and insightful discussion of the interaction between the issuer and its bondholders, and among the bondholders themselves, see Nouriel Roubini and Brad Setser, The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions, and the Argentine Episode, 1 J of Restructuring Fin 173 (2004).
investor could acquire a small percentage of bonds in the open market and sabotage a proposal that a large majority of bondholders are prepared to accept.  

After a spirited debate, the IMF’s proposal ran out of steam in the face of opposition from investors, issuers and, eventually, the US Treasury. However, many opponents of the IMF’s proposal conceded that improvements to the existing framework would be desirable. A number of G-10 officials (led by the US Treasury), creditor associations, and lawyers perceived an opportunity to improve the status quo by introducing CACs into sovereign bonds issued under New York law. CACs mitigate the holdout problem by allowing a qualified majority of bondholders to amend a bond’s payment terms, substantially reducing the risk that a few holdouts in one series of bonds could forestall a restructuring proposal.

Mexico added CACs to the terms of its bonds issued under New York law in early 2003, and since then almost every emerging market sovereign issuing international bonds has followed Mexico’s example. A partial list includes Uruguay, Brazil, Belize, South Africa, Indonesia, Colombia, Panama, Chile, Venezuela, and Hungary. In a recent study, the Bank of England noted that 80 percent of sovereign bonds issued in the international bond markets in 2004 (through September) contained CACs. The penetration of CACs is both wide and increasingly deep. Critics of CACs argued that the clauses would take too long to make their way into a sovereign’s bond inventory because they could only be incorporated prospectively in new bonds. However, as noted at the time, emerging market countries frequently consolidate or otherwise swap out their existing bonds through exchange offers, providing opportunities to phase in CACs more quickly. For example, Brazil first adopted CACs in April 2003, and had

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14 During this debate, advocates of the IMF’s proposal were unable to persuade key participants that agreement was any easier to reach when an issuer had to negotiate with syndicates of bank lenders. See Roubini and Setser, Bailouts or Bail-ins? at 12 (describing as a “myth” the suggestion that “[r]estructurings were easy and orderly in the bank-dominated 1980s”) (cited in note 7).


17 See Galvis, 6 Intl Fin at 153 (cited in note 12).
incorporated the clauses in more than one-third of its outstanding international bonds by December 2004.\textsuperscript{18}

IV. HOW WILL THEY WORK EVEN BETTER IN 2010?

As mentioned earlier, the success of an exchange offer depends largely on the market's perception of the fairness of the issuer's proposal. However, the rules of play can also make a difference in helping a motivated issuer reach its goal. Those rules are likely to be different in 2010, as most emerging market countries will have incorporated CACs into their international bonds. The following discussion highlights some of the ways in which exchange offers may play out differently—and more smoothly—in five years.

A. NEUTRALIZATION OF HOLDOUTS: MAJORITY AMENDMENT CLAUSES

The defining feature of CACs is the majority amendment clause, which permits holders representing 75 percent in principal amount of outstanding bonds (or another stated percentage) to amend basic payment terms such as payment dates, amounts due, interest rates, and currency of payment.\textsuperscript{19}

A sovereign issuer conducting an exchange offer in 2010 will be able to invoke this clause to restructure bonds that are not tendered voluntarily, thereby "neutralizing" holdouts. Specifically, the issuer would seek to amend the payment terms of its existing bonds to match those of its new bonds by requiring tendering bondholders to consent to the amendment as a condition of participating in the exchange offer. Assuming consents are received from bondholders representing 75 percent of principal, nontendering bondholders and tendering bondholders would end up with identical bonds.\textsuperscript{20} This result would demonstrate the issuer's commitment to fairness, while the high level of


\textsuperscript{19} For sovereign bonds issued under New York law, a market consensus has formed around an approval threshold of 75 percent of outstanding principal for amendments to payment terms. The influential International Primary Market Association recently issued standard form CACs for sovereign bonds issued under English law that follow the New York threshold. See International Primary Market Association, Standard Collective Action Clauses (CACs) for the Terms and Conditions of Sovereign Notes, (Oct 2004), available online at \texttt{<http://www.ipma.org.uk/pdfs/CACs\%20Clauses\%20Section\%20VII\%20\&\%20Oct\%202004.pdf>} (visited Mar 3, 2005).

\textsuperscript{20} However, nontendering bondholders may not receive any sweetener offered by the issuer to tendering bondholders, and will not have had a choice as to which series of new bonds the existing bonds are effectively "swapped" for. Uruguay's recent bonds address the second issue ex ante by prohibiting amendments that result in terms less favorable than those of any new bonds issued in connection with a simultaneous exchange offer.
bondholder participation would prove the market’s acceptance of the exchange offer.\(^\text{21}\)

**B. Fewer Blocking Positions: Collective Acceleration Clauses**

In addition to a majority amendment clause, most CACs include a provision restricting an individual bondholder’s right to accelerate the principal due at maturity following an event of default. This provision typically requires the consent of holders representing at least 25 percent of principal to accelerate the maturity date, and authorizes holders representing 50 percent of principal to rescind a previously declared acceleration for the entire series. Without acceleration, holdouts are limited to suing an issuer for regularly scheduled payments after their due date instead of the full principal, which is less likely to justify the expense of litigation.

With similar thresholds under majority amendment and acceleration clauses, holdouts will need to acquire at least 25 percent of principal to establish a blocking position from which to interfere with an exchange offer. As a result, this strategy may prove expensive in some cases. Even where the bonds trade at a discount to par, acquiring a blocking position would require a substantial investment of capital unless the series targeted by the holdout is very small (and thus insignificant). Vulture funds may not always be keen to put that much

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\(^{21}\) The sovereign could further evidence market acceptance by announcing a minimum level of bondholder participation in the exchange offer, below which the issuer would admit defeat and the transaction would not move forward. Ideally, the minimum condition would be set at the same level as the issuer’s majority amendment clause, although the former is usually based on the participation rate of bondholders in the exchange offer as a whole while the latter is typically based on the participation rate of bondholders of individual series.
capital at risk given the well-known difficulty of collecting judgments against sovereigns.

C. LESS LITIGATION AND FREE RIDING: COLLECTIVE LITIGATION CLAUSES

Beyond measures that reduce a holdout’s incentive to sue the issuer, an outright ban on litigation by individual bondholders is also possible. One approach to this model involves migration from a fiscal agency structure to a trustee structure, as Uruguay has done and Argentina now proposes to do.\(^2\) Under a typical trust indenture, no bondholder is permitted to sue the issuer unless holders representing 25 percent of principal have requested the trustee to commence litigation and the trustee has failed to act on this request for 60 days. It is worth noting that similar provisions could be used under an existing fiscal agency structure if a sovereign was not inclined to move to a trustee structure.\(^3\)

Collective litigation clauses preclude individual holdouts from using litigation as a tactic to disrupt an exchange offer or “free riding” on other creditors’ debt forgiveness by suing for the full amount. A ban on litigation can prove invaluable while a sovereign develops and implements a broadly acceptable restructuring proposal. Notably, Uruguay and Argentina have limited the effectiveness of this device somewhat by including an exception for suits brought by individual bondholders to collect past due amounts (but not accelerated principal).\(^4\) Subject to market acceptance, this exception could be omitted by a sovereign to further reduce the risk of disruptive litigation.

D. REDUCED VULNERABILITY OF SMALLER SERIES: AGGREGATED VOTING

Uruguay’s bonds allow it to amend payment terms across multiple series of bonds with the consent of holders representing 66\(\frac{2}{3}\) percent of principal of each series (as opposed to 75 percent) if the same amendment is approved by at least 85 percent of principal of all affected series. Argentina has included a similar provision in the bonds offered in its recent exchange offer.

\(^2\) Traditionally, sovereigns have used fiscal agents instead of trustees under their international bonds. Fiscal agents are mere payment agents of the issuer, while trustees act as a fiduciary of bondholders.

\(^3\) For example, the fiscal agency agreement or the terms of the bonds themselves could provide that no holder is permitted to sue the issuer unless holders representing 25 percent of principal have consented in writing to such a lawsuit.

\(^4\) This exception is specifically required to be included in corporate bonds offered publicly in the United States under the US Trust Indenture Act of 1939, but is not required in sovereign bonds.
Lowering the per-series threshold needed to amend the bonds’ payment terms reduces the risk that a holdout will circumvent CACs by acquiring a blocking position in a smaller series of bonds. For example, under Uruguay’s CACs, holdouts would need to own 33⅓ percent of principal of an individual series (or 15 percent of principal of all series) to block a restructuring proposal. One article notes that, had Uruguay’s existing bonds contained the same majority amendment and aggregated voting clauses as its new bonds, its exchange offer in 2003 would have succeeded in restructuring 95.9 percent of its existing bonds instead of 88.9 percent.25

While aggregated voting can be helpful in some circumstances, it is worth making two observations. First, raising the bar from 25 percent to 33⅓ percent is unlikely to make a significant difference unless the issuer has one or more small series of bonds in which a potential holdout would be able and willing to purchase even a 25 percent stake. As noted above, in recent years, sovereign issuers have tended to issue fewer, larger series of bonds in order to satisfy investors’ preference for liquidity, sometimes “re-opening” an existing series to increase the size instead of issuing a new series.

Second, aggregated voting is not the same as aggregation. Uruguay’s innovation is a conditional reduction of the approval threshold for amendments to individual series of bonds from 75 percent to 66⅔ percent. By analogy to corporate bankruptcy law, true aggregation would occur if bondholders (along with other creditors) were arranged for negotiating and voting purposes into classes with common interests based on the substantive characteristics of their credit.26 The rules for class divisions would need to be established ex ante, possibly in a master debt agreement incorporated into all of the sovereign’s medium and long term indebtedness regardless of form or governing law. It would take time to establish sensible divisions, but possibilities include separating bondholders and other creditors based on the remaining time to maturity of their competing claims.

V. CONCLUSION

Sovereign debt workouts usually arise in the face of economic distress, and a comprehensive debt restructuring will inevitably involve considerable time and effort. When the country’s government is ready to face its creditors, however, exchange offers are a useful tool that mitigates many of the concerns raised by commentators about the prospects for orderly debt restructurings. Their track

26 See Galvis, 6 Intl Fin at 154 (cited in note 12).
record since emerging market countries began using them more than ten years ago tends to contradict claims that the “financial architecture” for restructurings is fundamentally flawed. Moreover, with the spread of CACs, the outlook for successful exchange offers in 2010 looks even more promising.