January 2015

FINANCIAL MARKETS LAW COMMITTEE

SOVEREIGN DEBT – COLLECTIVE ACTION CLAUSES

Single-limb aggregated collective action clauses under English law

www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

WORKING GROUP[1]

Chair: Sir Robin Knowles CBE	Queen's Bench Division, High Court
Antony Beaves	Bank of England
Lachlan Burn	Linklaters LLP
Leland Goss	International Capital Market Association
Robert Gray	HSBC
Tolek Petch	Slaughter and May
Professor Rodrigo Olivares-Caminal	Queen Mary University of London
Stephen Roith	Sidley Austin LLP
Andrew Shutter	Cleary Gottlieb Steen & Hamilton LLP
Harriet Territt	Jones Day
Mark Trapnell	Freshfields Bruckhaus Deringer LLP
Philip Wood QC	Allen & Overy LLP
Deborah Zandstra	Clifford Chance LLP
Joanna Perkins	FMLC Chief Executive
Sherine El-Sayed	FMLC Project Secretary

[1] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

CONTENTS

1. EXECUTIVE SUMMARY

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the financial markets which might give rise to material risks, and to consider how such issues should be addressed.

1.2 Following a request from representatives of the International Monetary Fund ("IMF"), the FMLC prepared a short memorandum on the enforceability under English law of a single-limb "collective action clause" ("CAC"), with regards to the issuance of sovereign debt, in July 2014.[2] This paper expands on the interim findings set out in that memorandum.[3]

1.3 The view of the FMLC is that, fundamentally, suitably-worded single-limb CACs are enforceable under English law. Indeed, properly used, they can significantly reinforce legal certainty by promoting the swift resolution of issues arising from the restructuring of sovereign debt programmes.

2. INTRODUCTION

2.1 A CAC is a contractual collective voting mechanism used to facilitate restructurings of a bond issuer's debt obligations, including sovereign debt restructurings. Its provisions set out specific rules which govern the process by which changes to certain terms of bonds can be implemented. CACs have been used by sovereigns for many years.

2.2 Recent litigation concerning sovereign bonds—specifically the litigation against Argentina in the U.S. courts—is claimed to have increased the leverage of hold-out creditors.[4] Factors such as the possibility of preferential recovery outside a debt exchange, attempts to obtain a dominant position in a given bond series and reduced

---

[2] The International Monetary Fund ("IMF") published a staff paper entitled "*Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*" in August 2014. The paper refers to the work of the Financial Markets Law Committee ("the FMLC") on collective action clauses ("CACs") at p.29. The IMF's paper can be accessed here: http://www.imf.org/external/np/pp/eng/2014/090214.pdf.

[3] The FMLC also prepared a memorandum on the interpretation of *pari passu* clauses, discussed in the IMF's staff paper (*ibid.*): http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_memorandum_on_pari_passu_clauses.pdf.

[4] The U.S. Supreme Court refused to hear a petition to review a Second Circuit decision upholding injunctive relief: see *Republic of Argentina v NML Capital Ltd.*, No. 13-990. Also see decisions of courts below: *NML Capital, Ltd. v. Republic of Argentina.*, 699 F.3d 246 (2d Cir. 2012); *NML Capital, Ltd. v. Republic of Argentina.*, 727 F.3d 230 (2d Cir. 2013) and *NML Capital Ltd v Republic of Argentina.*, No. 08 Civ.6978 (S.D.N.Y. Nov. 21, 2012).

inclination on the part of creditors to participate in a consensual restructuring have increased the risk of coordination failure around restructuring.[5] Concerns in this regard have given new impetus to existing international efforts to strengthen contractual mechanisms which may facilitate orderly debt restructuring.[6]

2.3 Traditionally, many CACs operated on a series-by-series basis by seeking the agreement of a specified majority, or super-majority, of creditors in each series to the proposed restructuring. While these CACs have played a useful role in achieving high creditor participation in a number of past debt restructurings, they carry a considerable risk that the views of the majority will not be upheld because a minority—such as a creditor, or a group of creditors obtaining a "blocking position" in a particular series—will be able to undermine significantly the likelihood of the restructuring proposal being implemented successfully in a way which enables the sovereign to restore debt sustainability and market access.

2.4 International efforts to find a solution to the hold-out creditor problem and facilitate restructurings prior to a sovereign's default and to encourage more private sector involvement earlier in a country's debt crisis have focused on clauses which provide aggregation in voting mechanisms. The single-limb aggregated voting mechanism aggregates votes across multiple series of bonds to determine whether the requisite voting threshold had been met and the proposed change or action approved.[7] A key feature of the single-limb aggregation is to remove the need to obtain majority support at the level of each individual series affected.

2.5 While the case for single-limb CACs has been put forward by many organisations of standing and repute, including the IMF, some lawyers and commentators have questioned whether the single-limb aggregated voting mechanism may be subject to legal risk. Single-limb CACs may result in one or more series being bound by a majority of creditors across the entire debt stock of an issuer, raising—for some—issues of democracy and fairness. It is against this background that the FMLC was asked to examine the English courts' likely approach to single-limb collective action clauses in

---

5 See IMF paper *op. cit*, p.15 to 16, para. 23.

6 See IMF paper *op. cit.*, "*Strengthening Collective Action Clauses*" section from p.15 to 30.

7 The International Capital Market Association published a standard model CAC in August 2014: http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-August-2014.pdf. Three options were provided, in particular, the option to modify multiple series of notes with single-limb voting.

circumstances where a majority decision purports to be contractually binding on a dissenting minority.

3. GENERAL APPROACH UNDER ENGLISH LAW

3.1 English courts have traditionally demonstrated respect for the terms of commercial agreements reached between parties at arm's length and are unwilling, as a rule, to interfere, particularly where the parties are commercially sophisticated.[8]

3.2 As a general proposition, English courts will recognise and give effect to a contractual term which allows a majority of creditors to alter the terms of the agreement governing the debt at a future point, provided the bond contains the CAC from the outset so that it forms part of the contractual rights and obligations acquired by subscribers and subsequent purchasers of the bond.[9] Thus, where it is clear at the outset of a deal—in this case, at the issue of the bond—that should a restructuring be proposed, a CAC may be applied, the courts can, as a rule, be expected to uphold both the clause and the exercise of the collective power to achieve that result.

3.3 Moreover, the mere fact that a decision would cause varying treatment of different groups will not invalidate the decision. English courts have stated that "*[b]y signing up at the outset, each lender submits to the decision of the majority lenders at important forks in the road.*"[10]

3.4 In the recent case of *Azevedo v Imcopa Importaçao, Exportaçao e Industria de Oleos Lida*,[11] the Court of Appeal upheld a majority resolution varying the terms of notes in such a way as to obtain the benefit, for the majority, of a promise by the issuer to pay a fee to those voting in favour of the resolution. Necessarily, the resolution disadvantaged the minority who voted against it but the key, as far as the Court of Appeal was concerned,

---

8 *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland Plc* [2011] 1 Lloyd's Rep. 123 at [314], [2010] EWHC 1392 (Comm). See also *Springwell Navigation Corp v JP Morgan Chase Bank* [2010] 2 C.L.C. 705 at [183], [2010] EWCA Civ 1221, per Aikens L.J.; *Michael Duthie Wilson v MF Global UK Ltd* [2011] EWHC 138 (QB); *Bank Leumi (UK) Plc v Wachner* [2011] 1 C.L.C. 454, [2011] EWHC 656 (Comm); and *Standard Chartered Bank v Ceylon Petroleum Corp* [2011] EWHC 1785 (Comm) at [507]-[525].

9 *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] 3 W.L.R. 521, [2011] UKSC 38 especially Lord Collins S.C.J. at [74]-[79], [103]-[104]. Alternatively, the bond may contain a CAC at the outset pursuant to which a later CAC is introduced as a term of the bond.

10 See *Redwood Master Fund, Ltd and Others v TD Bank Europe Limited and Others* [2002] EWHC 2703 (Ch), [2012] EWHC 2090 (Ch) [98].

11 [2014] 1 BCLC 72, [2013] EWCA Civ 364.

was that the payment was available in principle to all noteholders (subject to their vote) and the basis of the payment was made clear up front.

4. LEGAL RISK FACTORS

4.1 The general proposition stated above is, however, traditionally subject to certain limitations.

4.2 Different language has on occasion been used to describe the situations in which exceptions to the fundamental position may arise, including oppression and bad faith. The types of behaviour considered to fall within these categories include "negative inducement" and "coercion of a minority".[12] In this paper the terms "oppression" and "bad faith" are used interchangeably.

4.3 The situations in which concepts of this nature and seriousness are genuinely applicable will tend to be rare. The threshold is high. Furthermore, the situations are relevant to all types of CACs, not single-limb CACs in particular.

4.4 In *Redwood Master Fund, Ltd and Others v TD Bank Europe Limited and Others*[13] the court held that

> *by signing up at the outset, each lender submits to the decision of the majority of lenders at important forks in the road… Power to modify the terms on which debentures in a company are secured is not uncommon in practice… [but] the power given must be exercised for the purpose of benefitting the class as a whole, and not merely individual members only.*[14]

4.5 This approach stresses the importance of exercising the power for the purpose of benefitting the class as a whole and the delineation of the creditor "class" is therefore likely to be a question of some significance in this context.[15]

---

12 See *Assenagon Asset Management S.A. v Irish Bank Resolution Incorporation Limited (formerly Anglo Irish Bank Corporation Limited)* [2012] WLR(D) 243, [2012] EWHC 2090 (Ch), [82] to [83].

13 *Op. cit*.

14 *British American Nickel Corporation Limited and Others v M.J. O'Brien Limited* [1927] A.C. 369, 371 per Viscount Haldane, cited in *Redwood op. cit*, at [82]. See also *Greenhalgh v Arderne Cinemas Ltd* [1950] 2 All ER 1120.

15 The FMLC takes the view that this question is beyond the scope of this paper but notes that there has been widespread market acceptance of single limb CACs and that this may be, in part, because creditors are willing—commercially, at least—to view all bondholders across the entire debt stock of an issuer as being "all in it together".

4.6 Oppression must be proven by demonstrating that the exercise of power by the majority was exercised with the motivation of malice to

> *[…] damage or oppress the interests of the minority adversely affected by it … since that… will clearly amount to the commission of fraud on the minority, which is… obviously outside the scope and purpose of the power.*[16]

That the minority suffers a disadvantage will not in itself invalidate a resolution passed by the majority. The court will rather consider whether a motivation of malice, oppression, fraud etc. on the part of the majority has been proved.[17] Bad faith may be presumed (where it is not proven directly) if no reasonable person in similar circumstances could have made the same decision.[18] Whilst powers may be drafted to provide for substantial discretion to those who exercise them, it is well established under English law that they must be exercised in good faith. As previously mentioned, where an oppressive motivation or intent is identified, it is unlikely that a decision will be upheld by the English courts; however, the threshold for demonstrating this is high.

4.7 Particular care and judgment are required if, for example, the situation will involve the use of incentives to vote or discretion is to be accorded to a particular party. One case in which the court found that an abuse of power had taken place, invalidating the resolution passed by majority noteholders, is *Assenagon Asset Management S.A. v Irish Bank Resolution Incorporation Limited (formerly Anglo Irish Bank Corporation Limited)*.[19] In that case, Briggs J concluded that it would be unlawful for the majority to facilitate the coercion of a minority by means of a negative inducement constituted by the passing of a resolution, that introduced an issuer call option with a negligible strike price, in the context of an exit consent arrangement (i.e. an arrangement intended to change the

---

16 See judgment in *Redwood op. cit*., at [105].

17 In *Redwood op. cit.*, the court held that there was no evidence to suggest that the majority were motivated by bad faith. Analysis as to whether the power had been exercised *bona fide* and for the purpose for which it was conferred was undertaken by the court. As these conditions were satisfied, a disadvantage suffered by the minority would not lead to an interpretation that the power had been improperly exercised by the majority.

18 In *Redwood op. cit.*, the court noted that what might have constituted bad faith would be improving one's position at the expense of a minority class of lenders or being motivated by "*vindictiveness or malice towards the claimants and other… lenders*". The judge noted, at [93], that it was not suggested that the contractual provision under consideration should be regarded as:

> *[…] conferring on the majority an unfettered power to act arbitrarily, capriciously or oppressively and [they] fully accept that the power is impliedly subject to certain restrictions in the manner of its exercise.*

19 *Op. cit*.

terms of the existing debt by combining the exchange of the old notes for new notes accompanied by a noteholders' resolution to decrease the value of the old notes). Briggs J found that the resolution's only function was "*the intimidation of a potential minority, based upon fear of any individual member of the class that […] he (or it) will be left out in the cold*".[20] This coercive element was regarded as oppressive by the court.

4.8 The extent to which this case has survived the subsequent Court of Appeal case of *Azevedo* is unclear. Lord Justice Lloyd in giving the Court of Appeal's judgment made no effort to compare the two cases, saying only that *Assenagon* "*is too far away from the present case on the facts to be of any particular assistance*".[21] What is clear, however, is that the facts of *Assenagon* were unusual in that the disparity in value available to consenting and dissenting voters was very marked indeed, more than is usually to be observed in restructurings of this kind. What is also clear is that, following *Azevedo*, under English law, consent payments offered to creditors in exchange for their votes to amend the terms of their bonds are valid if they are openly disclosed and offered to all those in a similar position and on an equal basis prior to the actual solicitation of the votes.[22]

4.9 Acting in good faith and with the benefit of objective advice has a high value in the context under discussion. Experience suggests that attention to transparency of knowledge and information, and a willingness to explain approaches and decisions,[23] can materially help avoid the risk of the language of "oppression" or "bad faith" being unduly invoked by a party.

5. VALIDITY OF SINGLE-LIMB CACS

5.1 The analysis above is relevant to all types of CACs, not single-limb CACs in particular. A single-limb CAC should not, therefore, be regarded by its very nature as being of questionable validity or enforceability.

---

20 *Op. cit.* at [84].

21 See judgment in *Azevedo*, *op. cit*. at [37].

22 See judgment in *Azevedo op. cit*.

23 The International Institute of Finance produced non-binding guidance entitled *Principles for Stable Capital Flows and Fair Debt Restructuring,* endorsed by the G20 in 2004. The guidelines are intended, *inter alia*, to enhance transparency, dialogue or information sharing between investors and creditors and effective crisis resolution through, for instance, *bona fide* negotiations for fair debt restructuring. The latest report on the implementation of the principles was published in October 2014: https://www.iif.com/file/6573/download?token=sVzJwuyF.

5.2 The exercise of the power conferred by the clause will be affected if there is oppression, bad faith or insufficient disclosure, as with all types of CAC. The advantages of transparency of knowledge and information and a willingness to explain approaches and decisions apply, as with all types of CAC.

5.3 It is the view of the FMLC that, absent clear examples of conduct that could be said to amount to oppression, bad faith or non-disclosure in the exercise of the power conferred by the clause, an English court would likely take the view, particularly with respect to sophisticated lenders and investors, that the outcome for which the clause is primarily designed namely, the implementation by collective action of compromise between sovereigns and creditors in the event of a debt restructuring, should be upheld by the court. It is an outcome that every creditor accepted from the outset and from which every creditor has the potential to benefit.[24]

6. CONCLUSION

6.1 The view of the FMLC is that suitably worded single-limb CACs are, subject to the caveats mentioned above, enforceable under English law.

6.2 Single-limb CACs significantly reinforce legal certainty by eliminating some of the problems which can occur in respect of hold-out creditors and by promoting the swift resolution of disputes arising in the context of sovereign debt restructuring.

6.3 Oppression, bad faith or insufficient disclosure in the exercise of the powers will lead to vulnerability with all types of CAC, including single-limb CACs, but experience suggests that these situations will tend to be rare.

[24] "*Accepted from the outset*" that is, provided the bond contains the CAC (or the CAC pursuant to which that CAC is introduced as a term of the bond) when issued so that it forms part of the contractual rights acquired by subscribers and subsequent purchasers of the bond.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS*

Lord Walker (Chairman)

David Greenwald (Deputy-Chairman)

Andrew Bagley, Goldman Sachs International

Charles Barter, Bridgepoint

Sir William Blair

Hubert de Vauplane, Kramer Levin Naftalis & Frankel LLP

Simon Dodds, Deutsche Bank AG

Michael Duncan, Allen & Overy LLP

Simon Firth, Linklaters LLP

Bradley J Gans, Citigroup

Kate Gibbons, Clifford Chance LLP

Richard Gray, HSBC Bank plc

Wim Hautekiet, Bank of New York Mellon SA/NV

Mark Kalderon, Freshfields Bruckhaus Deringer LLP

Sir Robin Knowles CBE

Piers Le Marchant, JPMorgan Chase Bank, N.A.

Sean Martin, Financial Conduct Authority

Jon May, Marshall Wace LLP

Sean McGovern, Lloyd's of London

Chris Newby, AIG

Graham Nicholson, Bank of England

Stephen Parker, HM Treasury

Sanjev Warna-kula-suriya, Slaughter and May

Geoffrey Yeowart, Hogan Lovells International LLP

Chief Executive: Joanna Perkins

* Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.