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Making Enhanced CACs the Rule: A Proposed Amendment of the Foreign Sovereign Immunities Act

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Key Points

- The recent rise in sovereign debt litigation in the US Federal Court System is an unintended consequence of the US Foreign Sovereign Immunities Act of 1976 related to an unanticipated shift of the international sovereign debt market from a narrow loan market to a global bond market.
- Collective action clauses (CACs) — developed in 2003 and "enhanced" in 2014 — are, in theory, an effective contract-based tool to facilitate orderly debt restructurings and control the holdout creditor problem. However, compliance by countries is voluntary and may not be sustained.
- To assure sustained compliance and to reduce the future incidence of holdout creditor litigation, the US Foreign Sovereign Immunities Act should be amended to provide that only bonds with enhanced CACs will be subject to suit and enforcement in the US courts.

Introduction

The United States has two important interests at stake with respect to the restructuring of foreign sovereign debt issued into US markets. First, the United States has an interest in the orderly restructuring of foreign sovereign debt, to the benefit of both the sovereign debtor and US-based creditors. And second, the United States has an interest in the efficient use of its court system.

The first of these interests has been reflected in explicit US policy over the last 15 years: the US Treasury Department led the effort that resulted in the market's adoption of CACs in international sovereign bond contracts in 2003 and then coordinated their "enhancement" in 2014 ("enhanced CACs"). These clauses support orderly sovereign debt restructurings by providing, within bond contracts, a bankruptcy-like collective action mechanism.

The second interest — the efficient use of the US court system in sovereign debt litigation — has not been addressed as an independent matter. While the United States has offered amicus briefs with respect to numerous sovereign debt cases in recent years, it did *not* support an International Monetary Fund (IMF) 2002 initiative to establish an international, treaty-based Chapter 11 process for distressed sovereign borrowers. As a result, the law of the land with respect to sovereign debt remains the Foreign Sovereign Immunities Act of 1976,[1] which allows

1 See www.law.cornell.edu/uscode/text/28/part-IV/chapter-97.

About the Author

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both jurisdiction for suit and enforcement of claims against foreign sovereigns in US courts following a default.

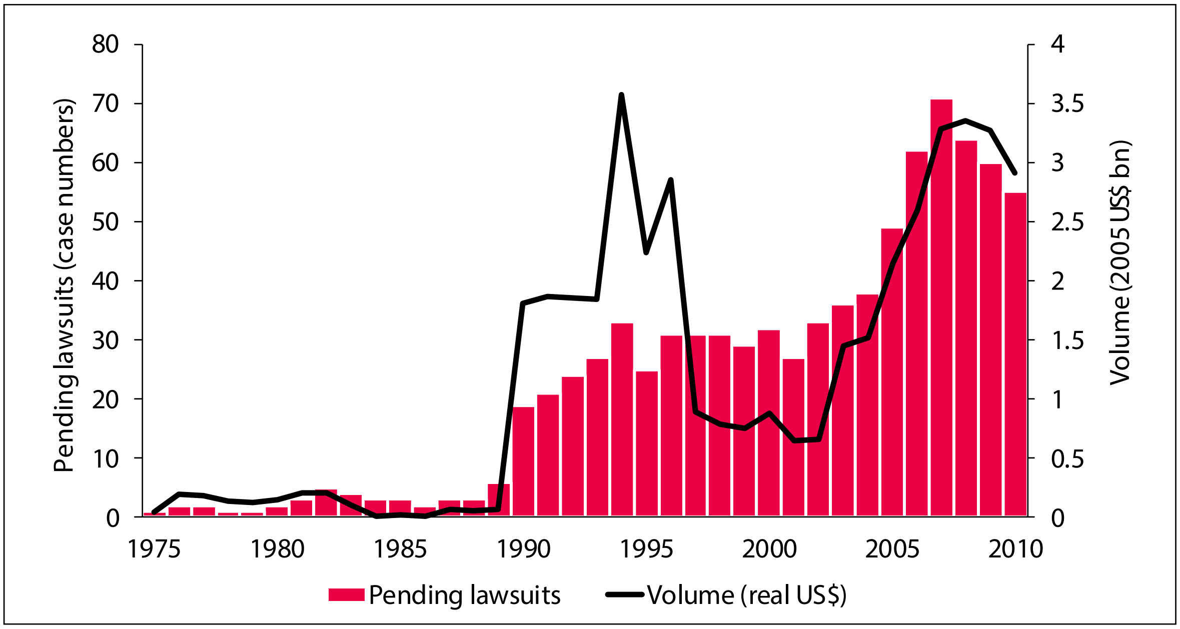
The idea of this policy brief is to suggest a minimalist change in the Foreign Sovereign Immunities Act to further both of these interests. It is proposed to "gate" access to US courts for sovereign debt law suits so that: the door is open for lawsuits and enforcement against sovereign defaulters when the relevant bonds contain enhanced CACs, but the door is shut with respect to bonds that do not contain enhanced CACs. This change is designed to incentivize the universal and sustained use of enhanced CACs while also substantially limiting the scope for holdout creditors to use the US Federal Court System as a tool in their investment strategies. Yet, it would not alter creditors' current enjoyed rights to sue or enforce with respect to bonds containing enhanced CACs, nor would it apply retroactively.

This policy brief is developed in four parts. The first part ties the enactment of the Foreign Sovereign Immunities Act of 1976 to the recent rise in sovereign debt litigation and the follow-on development of CACs and their enhancement. The second part discusses current and future implementation and compliance issues with respect to the enhanced CAC policy approach. The third part presents the proposed amendment to the Foreign Sovereign Immunities Act and draws an analogy between its operation and that of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the law enacted in 2016 to help Puerto Rico restructure its debts. The fourth part seeks to address likely criticism of the proposal from both debtor and creditor proponents.

From the Foreign Sovereign Immunities Act to CACs

The rise of sovereign debt litigation in the United States and around the world over the last 20 years can be tied directly to the passage of the US Foreign Sovereign Immunities Act in 1976 and a similar law enacted by the United Kingdom two years later.

Figure 1: The Rise of Creditor Litigation (Case Numbers and Amounts)



Source: Schumacher, Tresbesch and Enderlein (2018).

The passage of the Foreign Sovereign Immunities Act was the first time that the United States put into statute the rules under which foreign countries could be sued in US courts. Up to about 1900, there were relatively few lawsuits involving foreign governments in domestic courts around the world because foreign governments were largely considered immune to suit. However, as global trade increased rapidly after 1900, commercial disputes with foreign sovereigns and state-owned trading companies multiplied, and the United States and European countries began to "restrict" foreign sovereign immunity so that it could only be used as a defence against suit with respect to acts of state (war, diplomacy, regulation) and not with respect to conventional commercial matters (failure to pay for or deliver goods after a sale). US policy shifted in this direction in 1952 with an administrative action, the delivery of a letter from Secretary of State Jack Tate to the US Attorney General and its publication in the State Department *Bulletin*; the "Tate Letter" stated that the United States would restrict foreign sovereign immunity in the case of commercial matters and that the State Department would advise the courts whether sovereign immunity should be granted on a case-by-case basis (US Department of State 1952, 984). US policy was subsequently concretized in statute with the enactment of the Foreign Sovereign Immunities Act in 1976, which defined in law the scope of foreign sovereign immunities and shifted the sole power to make determinations to the Federal Court System. Also, for the first time, the law provided specific enforcement rights to judgment creditors, which is an important consideration to any investor seeking to pursue a deliberate holdout strategy. This, in time, led to a material increase in sovereign debt litigation.

Figure 1 shows the rise of sovereign debt litigation in US and UK courts since the relevant laws were enacted. Here, a distinctive pattern is observed that may be readily explained: in the 1970s and 1980s, despite many defaults, there were few lawsuits because most sovereign debt was owned by international banks that would rarely sue their clients; in the 1990s, lawsuits began to rise as certain non-bank investors, with no long-term relationship with the sovereign borrowers, acquired loans and bonds in the secondary market and sought to sue governments if they were not paid; and, following Argentina's default on nearly US$100 billion of bonds in December 2001, the courts were flooded with Argentina-related lawsuits. Furthermore, a momentum factor was at play: successful legal manoeuvres in the courts by a small group of creditors encouraged others to follow the same path.

The trends in sovereign debt restructuring, including the rise of sovereign debt litigation, moved international policy makers to take action. In particular, Mexico's 1995 US$50 billion bailout to pay off short-term bondholders served as the proximate trigger for the following policy developments:

- In 1996, the Group of Ten (G10) released a study suggesting that CACs should be included in international sovereign bonds (G10 1996) to facilitate future restructurings.[2]
- In 2003, following Argentina's default and several preceding bond restructurings, the international sovereign bond new issue market generally adopted the use of "single-series" CACs that provide that all holders of an individual bond issue would be bound to a restructuring deal if a supermajority would agree to the terms (Gelpern and Gulati 2006; G10 2002).
- In 2014, following problems with both Greece and Argentina's debt restructurings, the sovereign debt market began to use much more powerful "enhanced" wording for CACs (Sobel 2016).[3] The distinction of these new clauses is that they provide that a single vote would have the power to bind all of a government's many series of bonds into a restructuring on the same terms, as further explained in Box 1.

Thus, over the last 40 years, a gradual evolutionary process has been at play: the enactment of the Foreign Sovereign Immunities Act in 1976 led 20 years later to a rise in sovereign debt litigation, which then, in turn, led another 20 years later to the development of enhanced CACs. It is an elegant story: a risk arose and then was closed, a full circle. It is tempting to have a warm glass of milk and go to sleep.

However, the natural beauty of this story belies the reality on the ground. Relatively few bonds today actually contain the enhanced CACs and, more importantly, the enhanced CAC approach has a significant weakness: compliance is voluntary and the choice to comply or not will arise each and every time a foreign country issues a new bond under US laws in the future. There is thus a concerning mismatch between the power of the Foreign Sovereign Immunities Act and the contractual solution: the act applies to all sovereign

Box 1: The Operation of Single Series and Enhanced CACs*

Consider the restructuring of the international debt of a government with US$60 billion of debt comprised of 30 different equally sized bonds (each of US$2 billion nominal).

Under the (2003-era) single-series CACs:

- The sovereign will make 30 separate offers, one for each series of outstanding bonds.
- Holders of each of the 30 series of bonds will vote whether to accept the proposal with respect to the bonds they hold, with activation of the CAC mechanism triggered if a 75 percent participation rate is achieved.
- A 75 percent success rate is required in 30 separate votes to achieve a perfect outcome for the restructuring.

Under the (2014-era) "enhanced" CACs:

- The sovereign will make one offer to all holders of all 30 series of bonds subject to the condition that all holders receive the same ("uniform") offer.
- A perfect result will be received if a 75 percent participation threshold is achieved in the single vote.

The advantage of the "enhanced" clauses was proven in Greece's debt restructuring of 2012 in which 53 series of Greek Domestic Government were 100 percent restructured through the action of an "enhanced" CAC inserted into Greek law in advance of the transaction, while 17 out of 35 of Greece's English bonds with single-series CACs failed to be fully restructured due to the action of holdout creditors.

Source: Zettelmeyer, Tresbech and Gulati (2013, 52, Table A4).

* The 2014 Standard International Capital Markets Association (ICMA) enhanced CACs provide the debtor with three different voting mechanisms to seek to carry out a debt restructuring: single-series voting, aggregated all-series voting (subject to uniform consideration) and a hybrid "two-limb" mechanism that has both aggregate and series voting conditions. They also allow the debtor to choose to pool outstanding bonds in sub-groups and offer them differentiated terms. However, the presumption of the discussion in this paper is that the single vote mechanism will most commonly be used in deep debt restructurings where the holdout risk is largest.

2 The initiative focused on the inclusion of these clauses in bonds documented under New York law since bonds issued under English law have long included such clauses (Buchheit and Gulati 2002).

3 An additional widely used strategy to enhance the collective action of creditors is the use of trust structures in the documentation of sovereign bonds, as explained in detail by the IMF (2017, 8).

Table 1: Evolution of Contractual Provisions of International Sovereign Bonds

	Pre-2003	2003–2014	2014–September 30, 2017	2024 Projected*	2034 Projected*
New issues under New York law	No CAC	Single-series CACs	Enhanced CACs	Enhanced CACs	Enhanced CACs
New issues under English law	Single-series CACs	Single-series CACs	Enhanced CACs	Enhanced CACs	Enhanced CACs
Aggregate stock of international bonds at the end of the period	Majority have no CACs	Most bonds have single-series CACs	27% have enhanced CACs 73% have single-series CACs	70% enhanced CACs 30% single-series CACs	85% enhanced CACs 15% single-series CACs

Source: Author's estimate using data from the IMF (IMF 2014, 33; 2017, 7).

* Analysis assumes: that 100 percent of all maturing debt is rolled into new bonds with the enhanced format; no net new issuance; and no liability management transactions to accelerate the changeover.

debt in the US courts while the enhanced CACs will operate only on bonds that include the specific clauses. Perhaps it is time for a cup of coffee before diving into the discussion of the scope of this problem and the proposed technical solution.

Implementation of Enhanced CACs

There is both good news and concerns to report about the implementation of enhanced CACs in international sovereign bonds since their adoption by the market four years ago.

The good news is that the IMF has calculated that about 90 percent of new international sovereign bonds issued since 2014 have included enhanced CACs and, as of end-September 2017, about 27 percent of outstanding stocks of bonds include them (which reflects roughly the amount of old debt refinanced in the intervening period).[4] Projecting the same trend, it is fair to anticipate that by 2024 about 70 percent of all bonds should include enhanced CACs and 85 percent by 2034, as detailed in Table 1. Implementation, so far, has been a success story and completion should be fairly rapid.

There is, however, a problem at hand. There is nothing in the enhanced CACs or in US law to force debtors to continue to use the clauses: compliance is voluntary. Any country can revert to issuing some or all of its bonds with single-series CACs (or even without CACs) at any point in the future. The problem is that even a little slippage — a few bond issues without the clauses — can destroy the essential speed and fairness provided by enhanced CACs, which derives primarily from the single voting process. Hence the interest in legal tools to mandate the sustained use of enhanced CACs.

Without a doubt, many will find this concern with compliance theoretical or even alarmist; since policy makers and the market went to great lengths to develop the new standards and compliance has been very good to date, it is unthinkable that countries will revert to prior contractual practices. Here are a few rocks to toss at the conventional wisdom: First, it is well known that debt contracts evolve over time, often with the ebbs and flow of global capital — nobody can be sure that in a tighter monetary environment, or after a particularly messy debt restructuring, creditors will not generally shift away from their support for enhanced CACs. Second, nobody can rule out a specific scenario in which a country first borrows US$50 billion from international markets at long tenors, low coupons and *with* enhanced CACs but then borrows another US$10 billion at short maturities, high coupons and

4 The new clauses can only be used by debtors after they have been inserted into the country's stock of debt, which is typically done gradually as countries issue new debt or refinance maturing debt. The international agreement on enhanced CACs in 2014 only provided draft standard language and thereby had no direct effect on outstanding contracts.

without enhanced CACs from new, more aggressive, investors when its economy is slipping toward crisis. Third, it is best not to underestimate the willingness of Wall Street banks to come up with reasons that individual new bonds should retain individual voting power — witness the proposed term sheet for GDP-indexed bonds (ICMA 2017, 7). In a word, it would be naïve to expect — without a strong incentive to do otherwise — that the same debtors that get into debt distress will not jumble up their debt portfolios with hard-to-restructure bonds on the path from normalcy to debt distress.

The problem with the wholly contract-based approach is that it is susceptible to break down exactly when and where it is most needed. Hence a change of US laws is suggested to make the use of enhanced CACs effectively mandatory. Therefore, it is proposed that if debtors want to borrow under the laws of the United States to gain the credibility and improved pricing generated by the superior enforcement rights offered by US courts, they should do so in a responsible fashion, by including enhanced CACs in their bond contracts.

Proposed Amendment to the Foreign Sovereign Immunities Act

Here is the proposal: A "gate" should be added to the Foreign Sovereign Immunities Act so that only the holders of bonds that contain enhanced CACs will have the right to sue and enforce in the US Federal Court System; holders of other bonds — those without enhanced CACs — should not have the right to sue and enforce in US courts. This change should apply to all bonds issued under the laws of a US jurisdiction after the date of enactment and should not retroactively change the enforcement rights of bonds already outstanding.[5]

To illustrate how the proposed amendment would work it is useful to review the operation of the Foreign Sovereign Immunities Act. Box 2 shows that it works as a gauntlet, or a series of gates, that a creditor needs to run to collect from a debtor following a default.

The proposal here is to add a new gate to cut off sovereign debt litigation at the pass by adding in §1605 (or §1606) a provision that states "public debt obligations incurred by a foreign sovereign for general governmental purposes would be immune from the jurisdiction of the courts of the United States unless such obligations are governed by the law of a United States jurisdiction and contain qualifying collective action clauses."[6] Alternatively, or in addition, a gate could be added in §1609 (or §1610) that prevents enforcement actions unless the obligations contain qualifying CACs and/or only if a voluntary offer has failed.

The primary commercial effect of the proposed amendment would be to strongly incentivize international sovereign debt issuers to always issue bonds with enhanced CACs. Since this amendment would make bonds without enhanced CACs unenforceable, issuance of such bonds should be minimal and of marginal concern in future debt restructurings.

Additionally, the amendment should also condition debtor and creditor behaviour in future sovereign debt disputes. Once enhanced CACs cover most bonds, the onus would be on the parties to try to complete a voluntary restructuring of the debt (using the enhanced CACs) before bringing a sovereign debt dispute to the court. In this respect, the proposed amendment resembles PROMESA,[7] the law enacted in June 2016 to provide for the restructuring of Puerto Rico's debt. PROMESA requires that the debtor attempts an out-of-court voluntary restructuring of its debt using a collective voting provision (Title VI) before filing for adjustment of debt in an in-court process (Title III).

5 A retroactive change in creditor rights should be avoided because: it is awkward to change enforcement rights with respect to bonds issued by foreign countries after issuance; it is legally complicated to force a specific change of existing bond contracts on foreign countries; and without a specific emergency to justify such an action, creditor pushback would likely derail the legislation or eliminate such a provision.

6 The definitions of public debt and qualifying CACs would need some work. In particular, public debt of the central government should not cross vote with debt of instrumentalities and subdivisions. Also, secured debt (such as Brady bonds) and non-traded debt might not be immune to suit even if subject to separate voting provisions to give the country financing flexibility. Qualifying CACs would need to specify the availability of a single voting mechanism, as documented in the ICMA standard CAC language published in 2014, with a threshold no higher than 75 percent.

7 See http://oversightboard.pr.gov/documents/.

Box 2: The Operation of the Foreign Sovereign Immunities Act with Respect to Foreign Sovereign Debt

The Foreign Sovereign Immunities Act of 1976, including subsequent amendments (28 US Code Chapter 97 — Jurisdictional Immunities of Foreign States) is the sole basis for bringing suit against foreign sovereigns in the United States. The law has a number of parts as it covers a wide range of issues, including commercial transactions, torts, terrorism, maritime claims and foreign artwork being shown in the United States.

The operation of the code with respect to foreign debt claims is substantial, complex and evolving. However, from a high level, this portion of the US code can be viewed as series of gates, as follows.*

Gate No.	Task	Section	Applicable Rules
1	Find an exception to immunity to prove jurisdiction	§1605(a)	Sovereigns are not immune from suit for commercial activities with a US nexus, or if immunity has been waived. Sovereign (market) borrowing is considered a commercial matter and therefore not considered immune. Furthermore, waivers are typically included in bond contracts.
2	Serve process	§1608(a, b, c, d)	Service of process must be made according to specified procedures; the country has 60 days to respond.
3	Prove harm to obtain a judgment	§1608(e)	A judgment may be granted only after presentation of satisfactory evidence to the court.
4	Convince judge it is time to enforce	§1610(c)	A "reasonable" period of time must pass before enforcement orders may be granted.
5	Find, attach and execute against foreign state property within stated exceptions	§1610 and §1611	Subject to the operation of any waivers: · §1610(a) Property of the state may be attached if used for commercial activity of claim. · §1610(b) Property of an instrumentality may be attached. · §1611(a) Disbursements from international organizations may not be attached. · §1611(b) Property of foreign central banks for their own account may not be attached.

Source: www.law.cornell.edu/uscode/text/28/part-IV/chapter-97.

* Exceptions to immunity are required because the law is structured to provide immunity from suit and enforcement unless an enumerated exception applies. §1604 states that sovereigns are immune from suit unless an exception applies and §1609 states that sovereigns are immune from attachment and execution unless an exception applies.

Discussion

It is natural to expect that any proposal to change the law of sovereign debt will be subject to scrutiny and criticism from various quarters.

The greatest challenge, of course, will be inertia — creditors will say "the law has worked pretty well since 1976, let's not bother." They will also worry about the risk of opening Pandora's box, although it is hoped that this paper has adequately highlighted the risks associated with the current state of affairs.

On the other hand, debtor proponents may find this proposal "too narrow": it would only address bonds and tradeable loans issued under US laws and not debt issued under foreign laws or in other formats; it would not (without other document changes) limit the right of creditors to sue or seek satisfaction in non-US courts following a default;[8] it does not include other features of corporate bankruptcy such as access to a stay on creditor litigation and debtor-in-possession (DIP) funding; and it does not introduce an arbitrator to help forge a deal (as suggested in some proposals). The following is offered in response to these criticisms:

- the residual risk from not capturing non-US law bonds and non-bond debt and from the possibility that non-US courts will seek to enforce on New York law bonds is too small and of such a limited potential impact that a more complicated, international solution is not justified;
- the litigation stay and DIP funding aspects of corporate bankruptcy are unnecessary in the sovereign context because countries can stop paying their bonds with relative impunity, and the IMF or bilateral lenders can provide emergency funding;
- there is no natural source of unbiased arbitrators to stand between debtors and creditors in such a dispute; and
- formal court-based debt restructurings are very expensive and take way too long — witness PROMESA, which is on track to generate over US$1 billion in professional fees while there have been no significant transactional results in the two years since its enactment (Commonwealth of Puerto Rico 2018, 24).

Conclusions

It is proposed that the US Congress move to amend the US Foreign Sovereign Immunities Act of 1976 to "gate" access so only bonds that include enhanced CACs will be eligible for creditor lawsuits in the US Federal Court System.

The effect of the change would be to cement current best practice in sovereign debt contracts — the use of enhanced CACs — and thereby increase the chance of orderly sovereign debt restructurings in the future. It would also materially lower the incidence of sovereign debt litigation in the US Federal Court System.

The proposed amendment would generate a minimal change in the text of the act — probably one operative line plus two definitions. It would not change debtor or creditor rights relative to current market practice — if you own enhanced CAC bonds you would retain the same enforcement rights you currently enjoy. Also, the amendment, as proposed, would only apply on a prospective basis and would not alter the rights of holders of any existing debt instruments.

Conceptually, the proposed change in law is driven by two factors: the rise of holdout litigation since the enactment of the Foreign Sovereign Immunities Act of 1976; and the compliance risks associated with a purely contract-based approach.

Of course, as a new proposal, the objective of this policy brief is to stimulate a debate among market participants and international policy makers, rather than to promote a near-term change of US laws. However, it also might be used to generate some discussion in Europe. First, as the second-largest jurisdiction for international sovereign bonds, the United Kingdom should consider a similar amendment to English law. Second, the euro area might look to a similar strategy to promote the switchover of euro area government bond contracts from two-limb CACs to the enhanced format, as recently proposed by Germany and France (Strupczewski 2018).

8 This is known as "forum shopping."

Author's Note

A friend suggested that sovereigns should not be subject to suit in US courts and that the Foreign Sovereign Immunities Act should be repealed. To this I responded perhaps it should be repealed and replaced — or amended — to keep the parts that work. Hence this paper.

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