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Restructuring of sovereign bonds and the legal position of non-assenting creditors using the examples of Argentine, Greek and German Bonds

1. Government Bonds - important part of sovereign capital raising

The issuance of government bonds is rising steadily. According to the IMF, USD 140 trillion in sovereign bonds are now issued worldwide every year. The number is constantly growing. After taxes, the issuance of bonds is the most important financing instrument of governments worldwide.

2. Bond Structure

a. Credit relationship

Government bonds are debts of a country that are securitised in bonds. All government bonds are based on a credit relationship. The debtor receives money and promises to repay it at a certain time, plus interest.

b. Securitisation by means of securities

This credit relationship is securitised. Government bonds are usually issued as bearer bonds. This means that the creditor's position can change by transferring the bond. The debtor does not find out about this. Most government bonds are freely traded on the capital markets.

c. Bearer Instrument

i. Legitimation of the creditor

The holder of the bond is considered the holder of the underlying claim. This special feature facilitates the circulation of bearer bonds.

ii. Liberation - Double payment exclusion

In addition, there is another special feature: The debtor pays the holder of a bearer bond with discharging effect. He therefore does not have to fear that a third party will make a claim on him again for the same debt.

3. Sovereign debt restructuring - reasons and frequency

Sovereign as debtors default on interest payments - just like private individuals - or cannot pay their debts from government bonds at all in the long term. Unlike private individuals, the debtor cannot become insolvent. This makes government bonds attractive, but also vulnerable. What happens if the debtor can no longer pay, i.e. cannot either pay the interest or even make the repayment at maturity? The only way out is debt restructuring, which follows a certain practice with government bonds. Debt restructuring has two sides. The debtor wants to reduce his debt burden, the creditors, obviously, do not. In the following, we will focus on the creditor perspective.

a. Preemptive debt rescheduling

Sovereign debt can be rescheduled before or after default. Preventive debt restructuring usually involves less harsh cuts for creditors and is completed more quickly.

b. Debt restructuring following default (Post-default restructuring)

2/3 of all debt restructurings start only after the default. Since 1950, according to IMF data (IMF Papers 2020), there have been about 500 different sovereign debt restructurings, involving about 100 countries. Debt restructuring is usually preceded by talks with creditor representatives or the Club of Paris.

Afterwards, the debtor makes an offer to change the bond conditions after negotiations. The changes always mean a deterioration of the bond conditions. The changes concern the interest rate, the currency, the payment terms and - this

is the main thing - the repayment amount. The reduction of the actual claim amount is also called a "haircut". A reduced claim takes the place of the previous claim. The amount of the haircut varies considerably in debt rescheduling. Of course, it depends on the debtor's ability to pay. The larger the haircut, the less likely it is to be accepted.

The debtor then makes an offer to all creditors to change the terms of the bond with certain deadlines. Often the offers are tied to a certain quorum. The bonds are exchanged after a debt restructuring has been accepted. The old bonds are replaced by new bonds with the new conditions.

4. Offer to amend the contract - no compulsion to accept

a. Freedom of rejection

The contractual terms of government bonds are basically fixed. They cannot be changed unilaterally by the debtor. A debt restructuring therefore requires the consent of the creditors. The higher the approval rate of the creditors, the better for the debtor. 100% consent is the ideal case, but is rarely achieved. In principle, creditors who do not agree to a debt restructuring offer (holdout or non-assenting bondholders) retain their original claims.

b. Incentives for a debt rescheduling

There are only a limited number of tools to achieve a debt restructuring with as many creditors as possible, which is desirable from the debtor's point of view.

i. CAC

The most effective means of obtaining broad consent is through so-called collective action clauses. According to such clauses, a majority of creditors also decides on the consent to rescheduling for a minority that is not willing to reschedule. The clauses serve the debtor. They have become part of the terms and conditions of most government bonds since around the 1990s. The quorum that decides on the liability varies, but is usually not less than 75% of all creditors. CACs cannot be subsequently imposed on creditors.

If a majority of creditors has accepted a debt restructuring offer from a debtor on the basis of a collective action clause, there is no longer any possibility for the offside creditors to pursue the original terms. They must accept the deterioration.

ii. Exclusion from litigation

Creditors unwilling to reschedule make debt restructuring more difficult. The mere possibility of enforcing the original conditions lowers the acceptance of debt restructuring offers.

Some countries are therefore trying to prevent or at least complicate holdout processes with their national laws. Special holdout creditor rules have been established in the UK, Belgium and France, which are intended to make at least the secondary acquisition of rescheduled bonds for the purpose of enforcing the original terms after a debt restructuring considerably more difficult. They do not just apply to own domestic bonds; they are intended to make it more difficult to pursue claims arising from foreign issues in the courts in the three countries. The regulations are relatively new. There are considerable doubts about the enforceability of these legal regulations.

On the other hand, the legislator has an easier time changing conditions that are subject to its own law. Domestic issues of a sovereign bond that are subject to own law can be changed by intervention. The effects are limited to domestic tranches, because no legal system has yet accepted a change with foreign effect.

c. Deferment vis-à-vis creditors not willing to reschedule debt

Given the few possibilities to force a debt restructuring, the debtor must at least achieve a postponement of the holdouts. This is usually achieved with payment prohibitions or a de facto refusal to pay. Following the rescheduling, practically only the rescheduled creditors are paid.

In the country of the debtor, such lawsuits usually do not have much success.

Abroad, however, things usually look different.

Interestingly, the number of lawsuits by holdouts has increased significantly over the last 50 years. While between 1970 and 1980 there were only 2 lawsuits by holdouts on the terms that were not rescheduled, between 2000 and 2010 there were as many as 83 lawsuits, and this despite the fact that the number of reschedulings is actually declining. 58 % ended with a settlement out of court. Only 8.9% of all pending holdout cases were unsuccessful (Trebesch, Institute for World Economy Kiel 2021).

5. Debt restructuring of Argentine bonds and the redemption upon the original terms

Let's move on to the practical side of the theory. With the help of three exemplary cases, we will now learn more about what non-assenting bondholders have been able to achieve. The successful cases are not mentioned much in the daily press.

a. Push by non-rescheduling creditors

The most spectacular case of the success of holdouts is the so-called Argentina case. Argentina had rescheduled several large government bonds in the early 2000s. The annuities were extended considerably and the payments were cut to about one third.

Several groups of investors rejected the debt restructuring and demanded that Argentina pay the original debt. Among other things, a ship of the Argentine navy was seized for this purpose. Even more decisive was the pressure exerted by the creditors on the assets in favour of the rescheduling creditors. In New York, they seized the amounts that Argentina wanted to pay to the assenting bondholders. The holdouts demanded equal treatment with the rescheduling creditors on the basis of the pari passu clause of the bond terms.

b. Argentina's Defence - State Emergency

Argentina justified its refusal to pay the holdouts with a state of emergency. German courts up to the German Federal Supreme Court ruled in favour of the

investors, not the Argentine government. The state of emergency on which the debtor based its refusal to pay was not evident and, moreover, was not a reason to refuse payment from a government bond. The German courts ordered Argentina to pay. Italian courts ruled similarly.

c. Pari passu and application for attachment by an absent creditor

Most of the pressure came via the seizure in New York in the case. The meaning of pari passu clauses is something like this: All creditors of a bond must be treated equally in decisive matters. As a rule, a new issue without equalisation of current bonds is excluded. Peri passu clauses, in effect, prohibit discrimination against remote creditors. The New York court followed the holdout creditors , not the Argentine government, which sought to have the seizure lifted.

d. Judicial assessment

The decision was upheld on appeal. The dispute went relatively quickly to the US Supreme Court, which also rejected Argentina's appeal at the last instance. As a result, Argentina was practically cut off from the capital market. The debt restructuring, which had long since been completed, was also still in jeopardy for certain reasons that we cannot go into here.

e. Result - New issue

The Argentine government then issued a new bond from which it paid the holdouts, who in the end were able to enforce 100% of the original terms. The Houldout creditors raised about USD 8.0 billion.

6. Greek bond rescheduling

The largest debt restructuring in recent times involved Greek government bonds to the tune of almost Euro 200 billion (2011 - 2018). It was not just one or two foreign bonds, but a whole series of government bonds.

a. Prohibition of unequal treatment of creditors

Foreign law, mostly US or UK law, applied to some 10% of Greek government bonds. The majority also had CAC clauses that facilitated debt restructuring. For some bonds, however, the quorum for debt restructuring was not reached. Greece therefore paid the full price for this part of its bonds. The offside creditors realise about USD 6.4 billion from the foreign tranches.

b. National legal regulations for domestic bonds

Greek law applied to most of the government bonds, which proved to be an advantage for the debtor. The Greek legislator was able to order a haircut. This possibility led to a cut of about 50 % for a considerable part of the Greek bonds.

c. Prohibition of unilateral amendment of the terms of the contract

The treatment of the Greek government bonds shows impressively that even in a dramatic situation, bondholders cannot be forced to change the terms of the bonds by any legally permitted means.

7. Unpaid German sovereign bonds

The rescheduling of the Argentinean and Greek bonds is more or less completed. The cases are therefore only of historical interest. Open, on the other hand, and perhaps surprising to some, are some overdue German government bonds.

a. German gold dollar bonds, especially Dawes and Young Bonds

The German government issued two large government bonds in 1924 and 1930 respectively, bearing the names of the US Treasury Secretaries from that period. Both were the brains behind relatively complex plans involving the issuance of two dollar bonds. Both bonds are gold-backed. This means that the repayment is linked to the development of the gold price. This should help to prevent a decline in value.

b. Securities Trust - Trustee: Bank for International Settlements (BIS) in Basel

Both bonds do not form a simple creditor-debtor relationship. In the interest of the

bondholders, the Bank for International Settlements was founded in Basel. It administers a sinking fund and is to distribute the amounts from it between the creditors. The office of the bank continues for both bonds. In addition, the trustee has the task of administering and, if necessary, using the collateral provided by the German government for the two bonds.

Both bonds are probably the most famous bonds of the XX. century. Almost everyone who deals with government bonds knows their names. It is also completely clear and undisputed that a considerable part of these two bonds is unpaid.

c. Debt rescheduling as a result of the London Debt Agreement 1953

The debtor paid interest on both bonds only sporadically shortly after the issue. During WW II, there was a complete default. After the war ended, the bonds remained unpaid. In 1953, the debtor offered the bondholders a debt rescheduling on the basis of an international agreement negotiated for years, the London Debt Agreement (LDA). On the basis of this Treaty Germany offered a rescheduling in the way described above. There is no question that the rescheduling was voluntary. Each creditor was free not to vote for the rescheduling. At the time, both the German and US governments emphasized that maintaining the original position - i.e. no decision to reschedule the debt - was not associated with disadvantages for the bondholders. The debtor paid the rescheduled bonds. The holdouts remain unpaid.

d. Deferment of the creditors not wishing to reschedule their debts

The claims arising from the bonds have been deferred indefinitely for those bond holders not opting for debt rescheduling.

e. New due date

The deferral in the course of the debt restructuring changed the maturity in relation to the holdouts. The maturity has been postponed indefinitely. Some bondholders are therefore now trying to redeem their unpaid bonds.

f. Hurdles to redemption - change in bond terms?

The German government is still paying the bonds, or rather, it is not rejecting the payment outright. However, it is trying to force the bondholders to pay the rescheduled amount. This would be tantamount to a forced debt restructuring with long-distance effect. Unlike Argentina and Greece, which paid in full the holdouts that were not willing to reschedule, the debtor is trying to obtain better terms for itself in this case. Even more seriously, however, the debtor is also trying to make payment conditional on a so-called Validation Law. She demands proof of origin for the bonds. This, in turn, clearly collides with the bearer bonds principle. Also for the two German government bonds, the debtor cannot subsequently change the bond conditions, with the result that the redemption depends on circumstances that cannot be seen from the bond itself. If this were allowed, any debtor could simply invent conditions on the occasion of a debt restructuring that would practically rule out payment.

8. Outlook

The three examples show how diverse the circumstances of rescheduling government bonds are. The principle applies, however, that a debtor cannot change the bond conditions of its own accord against the will of the bondholder. Debt restructuring is, of course, characterised by different interests. The debtor often has a fundamental need to reduce its debt. The creditor insists on compliance with the agreed terms. Balancing these opposing interests is not easy. However, compliance with a contract is not only a high good in private law, but is also significant in the relationship between states as debtors. Government bonds will only be able to retain their importance as a significant means of financing if - as shown here - the debtors fulfil their obligations and do not thwart claims by unforeseeable legal means or even by abusing the power as legislators that is only theirs.