What To Expect In The Coming Wave Of Sovereign Debt Litigation

Warnings about an impending sovereign debt crisis are growing louder.1 Low-income countries carrying high levels of debt, much of it denominated in U.S. dollars, are being squeezed by a stronger dollar and rising commodity prices.2 Middle-income countries, which now account for upwards of 90% of vulnerable sovereign debt, are also being squeezed.3 The coming sovereign defaults and restructurings is likely to generate a new wave of litigation—including over the validity of new bond provisions designed to minimize the likelihood of “holdout” creditors—and legislation aimed at curbing bondholder rights.

The pressures driving this crisis have been building for years.4 Many foreign states have avoided default thanks to low global interest rates5 and efforts by the international community to suspend debt payments and extend credit through “official sector” lenders like the International Monetary Fund (“IMF”).6 Even with these interventions, in 2020 alone, Ecuador, Lebanon, Belize, Suriname, Zambia, and Argentina defaulted.7 Belize defaulted again in 2021.8 Fueled by increased pandemic-related spending, government debt increased by 25% in low-income countries.9 And, whereas China had become a fertile alternative source of financing for state borrowers during the 2010s through its “Belt and Road” program,10 from the start of the pandemic China has been forced to focus on its own economic, health, and political troubles.11

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With pandemic-related payment suspensions ending, economic growth slowing, and the cost of borrowing increasing, more countries are expected to default. Ghana has teetered on the edge for months now, and dollar-denominated debt of fifteen countries is trading at distressed levels. The wave of defaults predicted several years ago was largely deferred, but it’s set to come crashing home in the coming year.

This alert provides an overview of the legal “landscape” ahead of the coming wave of defaults.

I. Testing The New Generation Of Collective Action Clauses (“CACs”) In Court

The next wave of sovereign default litigation will, for the first time, test the limits and bounds of CACs. CACs allow a defined super-majority of bondholders to consent to debt restructuring that is legally binding on all the holders of that issue, including any minority holdouts. CACs have been seen as the solution to holdout creditors using legal action to disrupt sovereign debt restructuring. Beginning in 2003, they became a typical feature in sovereign bonds governed by New York or English law. In 2012, Greece passed legislation that retroactively introduced CACs into its bonds, and then invoked the CACs to force holdouts to accept steep haircuts. Today, CACs are widely accepted as effective features of the international financial system. According to the IMF, almost all sovereign bonds issued since 2014 include some form of CAC.

CACs have continued to evolve. First generation CACs allowed a majority of bondholders within a single series to impose the terms of a restructuring on non-consenting holdouts in the same series. Second generation CACs created a mechanism by which voting can be aggregated across different bond series—allowing bondholders of one or more bonds to force bondholders in a different series into a restructuring if voting thresholds are met in each series, and as long as all of the affected series are governed by the same indenture.

The third generation of CACs included enhanced tools for forcing holdout bondholders into a restructuring through the votes of bondholders in other series. They allow for aggregated voting without any minimum voting thresholds for each series, and for individualized series voting. This feature has controversially allowed sovereigns to pursue the “Pacman” strategy in debt restructurings. Under this

17 Walker & Chong, supra note 15, at 1.
19 Id. at 22.
20 Id.
21 Id.
approach, which Argentina threatened to invoke in 2020, the sovereign would use multiple restructuring offers that garner a supermajority of individual bond series sequentially, and then offer a marginally better deal via the aggregated super-majority process to restructure all bonds.\textsuperscript{22} Such sequential bond offerings could, in effect, allow a foreign state to restructure all bonds with far less than the super-majority support required for aggregated voting, as every bondholder affected by the prior single-series restructurings would vote to approve the aggregated proposal.\textsuperscript{23} Ultimately, Argentina did not do this in 2020. But thanks to the CAC process, Argentina imposed worse financial terms on holdouts who did not tender their bonds.\textsuperscript{24}

Of greater concern that just the ultimate outcomes, when Argentina and Ecuador defaulted in 2020, they employed unprecedented strategies to manipulate the voting process. Both reserved the right to “re-designate” which series of bonds would be aggregated in the CAC vote.\textsuperscript{25} Doing so allowed the sovereigns to exclude any given series after tallying the votes, and thus manipulate the voting pool to ensure that the minimum voting thresholds were met on all individual series and in aggregate.\textsuperscript{26} This practice has been aptly described as a species of gerrymandering.\textsuperscript{27} CACs are meant to help overcome collective action problems, but, at their foundation, they are still a mechanism for bondholders to select a restructuring deal. They are not intended to allow bond issuers to retroactively engineer their preferred pool of voters to ensure a particular restructuring outcome.

Although it came to the brink of litigation in Spring 2020, the validity of the re-designation and the Pacman strategies remains untested in court.\textsuperscript{28} But bondholders should expect that these tactics will be tested in the coming years.

If so, there will be significant uncertainty around the validity of the redesignation and Pacman strategies. Under the Trust Indenture Act of 1939, which governs the distribution of debt securities in the United States, the use of collective action clauses for most (but not foreign sovereign) bonds has been banned.\textsuperscript{29} There is some (though arguably dated) authority that “[p]rovisions in bonds authorizing a specified majority in value of the bondholders to bind the minority to any change of their rights … are not enforceable” when exercised self-interestedly.\textsuperscript{30} The implied covenant of good faith and fair dealing may also bar manipulation of the CAC procedures.\textsuperscript{31}

These kinds of aggressive and norm-breaking uses of the newest generation of CACs illustrate just a few of the challenges and “maneuvering” that creditors may face in future sovereign debt restructurings. Newer strategies may arise. To take just one example, Ghana’s 2030 bonds include a new generation CAC, and there is some expectation that Ghana will deploy a voting and consent solicitation strategy aimed at forcing terms on

\textsuperscript{24} Holdout creditors did not receive deferred interest on their bonds and were saddled with less favorable maturity structure and creditor protections than their consenting counterparts. International Monetary Fund, \textit{supra} note 18, at 26-27.
\textsuperscript{25} International Monetary Fund, \textit{supra} note 18, at 25.
\textsuperscript{26} Walker & Chong, \textit{supra} note 15, at 2.
\textsuperscript{27} Id. at 3.
\textsuperscript{28} See, e.g., Benedict Mander & Colby Smith, \textit{Argentina debt restructuring talks close to collapsing}, Financial Times (June 18, 2020), https://www.ft.com/content/0ce01518-4b67-4a7d-b435-93386f7ea874.
\textsuperscript{30} 6A Fletcher Cyc. Corp. § 2767; see, e.g., Hacketstown Nat. Bank v. D.G. Yangtze Brewing Co., 74 F. 110, 113 (2d Cir. 1896) (holding, when addressing a similar collective action clause, that “every delegation of power implies that it will be honestly exercised”); Farmers’ Loan & Tr. Co. v. New York & N. Ry. Co., 44 N.E. 1043, 1048 (N.Y. 1896) (similar).
non-consenting bondholders. Ghana’s bond series is guaranteed by the World Bank, but restructuring under the CAC is likely to strip that protection from holders.

With so much money at stake, bondholders should expect sovereigns to take similarly aggressive interpretations of CACs in future.

II. Sovereign Efforts To Strip Bondholder Standing

Another issue already being litigated arises from attempts by sovereigns to severely restrict bondholders’ ability to sue. Typically, financial instruments like sovereign bonds are held centrally in a clearing system like Euroclear, Clearstream, or the Depository Trust & Clearing Corporation, which serves as a middleman to facilitate efficient market transactions. In this arrangement, the clearing system (or the “Holder”) is the registered owner of the bond, and the investor bondholder is the “beneficial owner.”

Since 2015, some sovereign borrowers have incorporated language into bond indentures that arguably permits only the Holder to sue on bond obligations, stripping such rights from the beneficial owner. This is a stark departure from the well-accepted practice, under which the Holder either grants a proxy or otherwise conveys the right to sue to bondholders. Because it is unlikely that any clearing system would be willing to take legal action to enforce the bondholders’ rights, such provisions could strip bondholders of all enforcement rights.

These issues are being litigated in a case against Sri Lanka in the Southern District of New York. The plaintiff held almost $250 million in Sri Lankan bonds. When Sri Lanka defaulted in July 2022, the plaintiff sued to enforce the bond terms. Importantly, Sri Lanka’s bond indenture did not include language permitting the Holder to authorize beneficial owners of the bonds to sue. Sri Lanka moved to dismiss, in part on the grounds that the plaintiff had had “no right to proceed under the governing documents because it is not a registered owner of the Bonds,” and the bond indenture did not permit the Holder to proxy the right to sue to the bondholder. The plaintiff disputed that any of the indenture’s terms expressly prohibited bondholders from suing on the Holder’s behalf. The court has not decided the motion.

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33 See Mark Weidemaier, et al., “FUD and the Ghana 2030 Bond,” Financial Times (Nov. 29, 2022), https://www.ft.com/content/1a3fd1bf-72a7-475d-81f3-22bb68caea6 (“In short, the Ghana 2030 can be pooled for voting purposes with other foreign currency bonds that have the same aggregated CAC, or ‘provisions substantially in these terms.’ Then, if 75 per cent of the voting pool are in favor of a restructuring, the 2030 holders will be forced to take the same deal. And, because all bondholders must be offered the same deal, any restructuring proposal will almost certainly not benefit from a guarantee. Bye bye World Bank guarantee!”).


36 Id.

37 Defendant’s Memorandum of Law in Support of its Motion to Dismiss, Hamilton Reserve Bank LTD. v. Democratic Socialist Republic of Sri Lanka, Case No. 1:22-cv-05199, ECF No. 21, at 1 (S.D.N.Y. Nov. 4, 2022).

38 Id. at 1.

39 See, e.g., Plaintiff’s Memorandum of Law, supra note 35, at 1-2.
III. Litigation Challenging Legislation That Curbs Bondholder Rights

In prior sovereign debt crises, bondholders who refused to accept haircuts and blocked restructurings have received public opprobrium. Activists criticize so-called “vulture funds” for buying bonds at a discount and suing (or threatening to sue) debtor countries for the full amount of their debt obligations. Some scholars have argued that, because sovereign debt cannot be reorganized in bankruptcy, sovereign debt restructuring creates a unique collective action problem that incentivizes bondholders to hold out from a proposed restructuring in hope of securing a better deal down the road. Hearing these concerns, a handful of states in Europe, passed legislation restricting bondholder rights in sovereign restructurings. During the 2010s, the United Kingdom, Belgium, and France passed “anti-vulture” laws limiting the recovery rights of bondholders who purchased distressed sovereign debt at a discount. The U.K. legislation had a significant effect on sovereign debt markets because most sovereign debt not denominated in the debtor’s local currency is governed by either English or U.S. law.

New York may be next. Since 2021, members of New York’s state Senate and Assembly have proposed legislation that would significantly impinge on bondholder rights. One such law would create a mediated sovereign restructuring process, in which debtor states would be able to propose restructurings that a super-majority of bondholders could approve, while cutting out official sector lenders such as the IMF or the World Bank and weakening minority bondholders’ protections.

More recently, activists are pressuring legislators to revise New York’s “champerty” defense—the traditional, common law prohibition on “maintaining a suit in return for a financial interest in the outcome.” Champerty has not been a significant bar to bondholders in New York, largely due to a 2004 statute creating a safe harbor defense where the creditor paid at least $500,000 in the aggregate for its holdings of the issuer’s debt. In 2022, a New York state senator introduced a bill that would eliminate champerty’s safe

42 The United Kingdom pioneered this approach with its Debt Relief (Developing Countries) Act of 2010, which forced bondholders to accept debt reduction deals brokered by the IMF’s and the World Bank’s Heavily Indebted Poor Countries Initiative (“HIPC”). Debt Relief (Developing Countries) Act 2010, c. 22 §§ 3-4.
43 Belgium enacted legislation in 2015 that, subject to very limited exceptions, immunized sovereign property, including bank accounts from execution by creditors who purchased the debt at a steep discount. Code Judiciaire/Gerechtelijk Wetboek art. 1412 (Belg.), http://www.etaamb.be/fr/loi-du-23-aout-2015_n2015009459.html.
44 In 2016, France passed legislation limiting bondholders’ rights to execute on sovereign property if they bought the debt while it was in default and forcing bondholders to accept sovereign restructurings struck by a super-majority of other creditors. Loi Sapin 2, Law No, 2016-1691 of December 9, 2016, on transparency, the fight against corruption and the modernization of economic life.
49 N.Y. Judiciary Law § 489(2); see also, e.g., Elliott Assocs., L.P. v. Banco de la Nación, 194 F.3d 363, 381 (2d Cir. 1999).
harbor defense for sovereign bondholders. The bill also specified that champertous intent can be established from (1) a bondholder’s “history of acquiring claims at significant discounts,” (2) the bondholder’s history of declining to agree to prior restructurings, and (3) any other “facts or circumstances as a court may find relevant.” This legislation, were it to be enacted and survive legal challenges, would subject sovereign bondholders to broad discovery into their investments, and any lawsuit brought by a bondholder that previously bought debt at a discount or refused to participate in a restructuring would be deemed presumptively champertous. This would have a significant chilling effect on investment in distressed sovereign debt and the New York sovereign capital markets.

We expect so-called “anti-vulture” legislation to be the subject of litigation in the coming wave of sovereign defaults. Most sovereign debt is governed by New York law, and thus a significant number of cases enforcing sovereign bonds are brought in New York courts. Laws that change the terms of sovereign bonds retroactively can be challenged as unconstitutional impairments of contracts. The U.S. Supreme Court has, for example, stated that it is unconstitutional for Congress to impair national debt obligations. Thus, efforts in New York’s and elsewhere to impair foreign sovereign bonds are not guaranteed to succeed. State legislation, like New York’s proposal, that targets sovereign debt bonds is also arguably preempted by national foreign affairs powers. Facial neutrality regulations that apply to all creditors, even if motivated by sovereign restructurings, are generally more likely to pass constitutional muster. Even so, courts may curb state legislation enacted with the intention of infringing on foreign policy. Courts concerned with maintaining “New York’s status as one of the foremost commercial centers in the world” might be especially disinclined to sustain such measures.

In sum, the next round of sovereign debt defaults is likely to include litigation in which the sovereigns will test the bounds of CACs, novel indenture terms, and possibly the constitutionality of new legislation designed to impair bondholder rights.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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50 Assembly Bill A9317, Relates to claims against certain obligors (N.Y. Feb. 23, 2022).
51 Id. § 1(4) (capitalization altered).
53 Eight of nine Justices in Perry v. United States, 294 U.S. 330 (1935), held that it was unconstitutional for Congress to abrogate the “gold clause” in government-backed Liberty Bonds (and thus repay creditors in devalued currency). See id. at 353-54. Although the Perry majority held that the plaintiff lacked standing to challenge this law, the Supreme Court has since reaffirmed that a Congress can, by contract with private parties, incur obligations on the part of the United States that future Congresses must adhere to. See, e.g., Maine Cnty. Health Options v. United States, 140 S. Ct. 1308, 1319 (2020).
56 See, e.g., Garamendi, 539 U.S. at 426.
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