

# THE REPUBLIC OF CONGO'S DEBT RESTRUCTURING: ARE SOVEREIGN CREDITORS GETTING THEIR VOICE BACK?

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## I

### INTRODUCTION

In the 1970s, emerging-market sovereign governments went on a borrowing spree. They had little trouble finding commercial and official sources of loans. Commercial banks lent large sums of money to sovereigns under syndicated-loan agreements.<sup>1</sup> The 1980s brought a series of sovereign loan defaults. For roughly a decade, emerging-market borrowing and lending became static. In the 1990s, a solution emerged in the form of Brady bonds, named for the U.S. Treasury Secretary who helped promote the new technique, and sovereigns in default negotiated debt restructurings with London Club creditor committees constituted from the sovereign's syndicated lenders. These restructurings consisted of exchanging the nonperforming loan agreements for collateralized bonds that offered creditors the perceived liquidity benefits of being listed on an exchange and traded over the counter. In part, the negotiations related to these exchanges were possible because syndicated-loan structures allowed sovereigns to know who their creditors were. As a consequence, bank advisory committees (consisting often of the sovereign's largest creditors)<sup>2</sup> were easily organized. Under the syndicated-loan structure, agent banks, which had sometimes been selected based on historical associations with the sovereign debtor, often felt motivated by their agency status to assist in creating creditor-advisory committees and to assist in the debt-reconciliation process that served as a necessary component of a debt exchange. Although for some sovereigns, negotiating with bank advisory committees proved to be cumbersome, negotiated solutions were viewed by the creditor community as being a key first step in restoring good relations between struggling sovereign borrowers in need

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1. See LEX RIEFFEL, *RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY* 107 (Brookings Inst. 2003).

2. *Id.* at 106–08, 116–17.

of external investments and a market of lenders stung by past defaults and years of lost revenue.

But the switch from syndicated loans to Brady bonds did not insulate emerging-market borrowers from further civil and financial strife. Some countries that had restructured their debt in the early 1990s ran into a new series of civil or financial crises that resulted in new defaults on external debt. Such sovereign default on bonds raised a challenging question: Could a sovereign realistically negotiate a restructuring of its bonds?<sup>3</sup>

In prior decades, sovereign bonds had largely been spared from restructuring, in part because of their relatively small volume by comparison to syndicated loans and in part because bonds, by their nature, are more difficult to restructure.<sup>4</sup> Unlike syndicated loans, for which a sovereign could easily identify its bank creditors, sovereign bonds were held by diverse creditors dispersed throughout the world. Bonds are designed to be highly liquid and to be held beneficially through members of exchanges acting as intermediaries. This makes identification of, and communication with, beneficial holders much more challenging than with syndicated lenders. Emerging-market sovereign debtors began to realize that the technical difficulties with identifying bondholders, rather than being an obstacle to restructurings, might actually free these debtors from what they perceived as a cumbersome negotiation process.

With the help of the investment-banking industry (and, as suggested by some, with the blessing of the official sector),<sup>5</sup> some sovereigns turned to the “unilateral exchange offer.”<sup>6</sup> Disposing of negotiations with their creditors, sovereigns paid investment banks large fees to design new bonds that would appeal to the market while granting the sovereign the level of debt relief that it and the official sector—such as the International Monetary Fund (IMF), the World Bank, and the Paris Club creditors—felt was appropriate.<sup>7</sup> Sovereigns would then offer the new bonds to its creditors in exchange for the defaulted ones. Making a unilateral offer to the market is standard practice and not objectionable when a sovereign is issuing bonds for “new” money. But in the context of a restructuring, unilateral offers have the effect of preventing

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3. Features of New York-law-governed bonds, such as the unanimity rule for amending financial terms, were specifically designed to make restructuring difficult. In some Brady bonds, language was used to specify that such bonds would not be restructured, and these were efforts to make a sovereign think twice about defaulting on bonds.

4. RIEFFEL, *supra* note 1, at 264.

5. *See id.* at 263 (suggesting that the G-7 and the International Monetary Fund (IMF) liked the idea that unilateral exchange offers structured by investment banks could be considered voluntary market-based transactions, the outcome of which would be the responsibility of the private sector).

6. In 1999, Pakistan, Ukraine, and Ecuador restructured bonds through a unilateral exchange offer. The Ecuador unilateral exchange offer was of particular concern to the creditors for its aggressive use of “exit consents.”

7. For a description of the role of investment banks, called the “sell-side,” in opposition to the emerging-market investors, called the “buy-side,” see Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1628, 1634 (2006).

creditors from providing input on the terms of the exchange and the new instruments. Although sovereigns and the official sector could technically call participation in the offered exchange “voluntary,” it did not always seem that way to creditors. Bondholders rightly feared that, if they did not participate in the proposed exchange, even in exchanges they thought to be unfairly sovereign-friendly, they would be left as hold-outs with illiquid instruments that could be structurally degraded by “exit consents” as part of the exchange.<sup>8</sup>

In support of this departure from the London Club negotiations of past decades, some sovereigns and their advisors argued that negotiations with creditors had become impractical, not only because of the difficulties of identifying bondholders, but also because the nature of sovereign creditors had changed significantly from the days of syndicated loans. The bank advisory committees of the past represented a relatively homogeneous group of bank creditors, many of whom had long-standing commercial relationships with the debtor countries. By the nature of their activities and applicable regulatory schemes, it was thought that banks had similar enough objectives and incentives to be engaged as a corps. Negotiations with a representative committee, therefore, promised to attract like-minded banks to the restructuring. In contrast, sovereign creditors in the current market consist of a diverse group of institutions, including hedge funds, institutional investors, commercial banks, investment banks, and even individuals. Unlike traditional bank creditors, long-standing relationships with sovereigns are less likely to affect the investment or restructuring decisions of these other creditors, and because of the way bonds are held indirectly through clearing systems, bondholders are largely anonymous. Today, sovereign creditors are arguably as diverse in their investment strategies as they are in their applicable regulatory schemes. Sovereigns and their advisors have used these differences to argue that any creditors’ committee would be hopelessly lost in conflicting objectives and not really representative of the mass of creditors.<sup>9</sup> As a consequence, they argue that, in today’s market, creditors’ committees lack the promise of attracting other creditors to the restructuring. Similar arguments have been used regardless of whether the instruments to be restructured were old loan agreements or sovereign bonds.

For creditors, the absence of negotiations had at least two negative effects. First, creditors lost their place at the table that had allowed them to influence the financial terms of both the exchange transaction and the new securities that resulted therefrom. Second, creditors also lost their ability to have their legal

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8. An exit consent means consenting to an amendment to an existing contract as a condition for exchanging the debt represented by such contract for a new instrument. In short, the creditors amend the old contract on their way out the door to the new contract, leaving the old contract without some key provisions. For a description of how Ecuador used “exit consents” in connection with its 1999 exchange transaction, see Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, INT’L FIN. L. REV., Dec. 2000, at 17.

9. “Representative” is usually taken to mean that the committee should consist of creditors who, by the nature and size of their holdings, can be considered representative of the mass of all creditors.

advisors draft the documentation used for the exchange as well as the terms and conditions of the new bonds to be issued. This meant loss of control over the securities' legal terms.

Among the financial terms of concern to creditors are those affecting the net present value of the exchange transaction, calculated by reference to several factors, including the exchange ratio,<sup>10</sup> the existence and size of up-front cash payments, the amortization schedule, and the applicable interest rates. To state the obvious, creditors tend to prefer receiving as much cash as early as a sovereign is able to afford it. By contrast, sovereign debtors would rather defer payments as long as possible both to benefit from the time value of money and to satisfy the need for liquidity so as to escape the financial or civil crisis that led to its default in the first place. Negotiations allow the creditors' committee to test a sovereign's assumptions about its ability to pay. But creditors' concerns are not strictly financial. From the creditors' point of view, up-front cash payments not only have beneficial effects on the net present value of the exchange transaction, but also have symbolic value. They are often considered a "good-will" gesture from the sovereign, representing the sovereign's desire to return to good relations with market participants after years of default. The presence of a creditors' committee helps ensure that key financial terms are promoted in finding a negotiated balance between a sovereign's ability to pay and creditors' rights to preserve as much value as possible from the defaulted instrument in the exchange for the new instrument.<sup>11</sup>

Some would argue that emerging-market creditors do not regularly read legal provisions pertaining to a sovereign debt restructuring or new-money issuance. Perhaps creditors imagine that they have little to fear from such legal provisions. After all, such documentation is typically prepared by top law firms in accord with years of customary practice. Creditors' inattention to bond documentation probably remains largely the norm, but there have been some noteworthy exceptions to this general disregard. First was the attention in the creditor community given to the *pari passu* clause in the wake of *Elliott Associates, L.P. v. Republic of Peru*.<sup>12</sup> Another impetus for increased creditor

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10. The exchange ratio or calculation is used to determine how much of the new securities will be obtained in exchange for the debt in default. Negotiations address how much past-due interest will be taken into account for the exchange and how large the discount on principal will be on the defaulted debt.

11. The IMF recognizes the advantages of creditor input in a restructuring. In a Public Information Notice issued in 2002, its directors discussed the Fund's "lending into arrears" policy. Therein, the directors discuss the principles that a sovereign should follow in its good-faith negotiations with creditors: "the member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments." Public Information Notice (PIN), No. 02/107, Int'l Monetary Fund, (Sept. 24, 2002), available at <http://www.imf.org/external/np/sec/pn/2002/pn02107.htm>.

12. See *Elliott Assocs., L.P. v. Republic of Peru*, General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). In *Elliott*, the plaintiff was a holdout to the exchange of Peru's old external debts for Peru's new Brady bonds. Elliott was able to obtain a restraining order against Chase Manhattan (Peru's fiscal agent) and Euroclear (one of the clearing

attention to legal provisions was a speech given in November 2001 by Anne Krueger, First Deputy Managing Director of the IMF, proposing the creation of a Sovereign Debt Restructuring Mechanism (SDRM). The SDRM was intended to provide an orderly mechanism to restructure unsustainable sovereign debt.<sup>13</sup> Fearing loss of leverage and control, though, emerging-market creditors reacted with concern to the idea of a kind of “bankruptcy” procedure for sovereigns, and began looking for a contractual solution instead. Then, in December 2001, Argentina defaulted on over \$100 billion of external debt. This default quickly turned creditors’ attention to various types of legal provisions. Among the provisions to receive both official-sector and industry-association attention in the wake of the SDRM debate and the Argentine default were collective-action clauses.<sup>14</sup> As more and more creditors focused on legal terms, they grew concerned that “unilateral exchange offers” deprived them of negotiating provisions like the *pari passu* clause, collective-action clauses, the negative-pledge provision, the waiver of sovereign immunity, engagement clauses, and the enforcement mechanics.

After a series of restructurings in which creditors were either bypassed completely or slighted after initial overtures for dialogue,<sup>15</sup> the Republic of Congo (Brazzaville)<sup>16</sup> chose a different path, much to the relief of its creditors. At the time, it might have been more consistent with the practice to avoid a negotiation in the London Club style. By the time Congo (Brazzaville) was ready to restructure its debt, its creditors had transformed from bank syndicates to include hedge funds, institutional investors, investment funds, and fund managers. Taking advantage of a long-term relationship with BNP

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houses for the Brady bonds), preventing them from making payment on Peru’s Brady bonds on the basis of a questionable interpretation of the *pari passu* clause contained in Elliott’s contracts. For a discussion of the *pari passu* clause in sovereign debt instruments, see Rodrigo Olivares-Caminal, *Understanding the Pari Passu Clause in Sovereign Debt Instruments: A Complex Quest*, 43 INT’L LAW. 1217 (2009).

13. For a detailed description, see *Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism*, INT’L MONETARY FUND (Apr. 8, 2003), <http://www.imf.org/external/np/omd/2003/040803.htm>.

14. Gelpern & Gulati, *supra* note 7, at 1647 (“[C]reditors’ frustration with Argentina’s actions and with their own powerlessness ‘led the private international financial community to become much more willing to endorse some official reforms to make sovereign debt rescheduling more orderly, most notably through the use of . . . (CACs) in new international bond issues.’” (quoting Eric Helleiner, *The Strange Story of Bush and the Argentine Debt Crisis*, 26 THIRD WORLD Q. 951, 965 (2005))).

15. Deals done by Pakistan, Ukraine, and Ecuador, followed by the colossal default and exchange offer by Argentina, all used a unilateral technique rather than a negotiated solution. In Iraq and Belize, there was some contact between the sovereign and its creditors, but both cases left some creditors out in the cold and neither can be considered as a negotiated solution. In the case of Belize, the sovereign consulted with some of its important creditors and set up a website to provide information including that on possible instrument profiles. All were laudable initiatives, but Belize stopped short of negotiating with creditors, claiming it was not possible to constitute a “representative” committee.

16. The Republic of Congo (hereinafter Congo (Brazzaville)) is to be distinguished from the Democratic Republic of Congo, often referred to as Congo (Kinshasa).

Paribas,<sup>17</sup> Congo (Brazzaville) braved new territory: it brought together its traditional-relationship banks with a major investment-fund manager in a single committee.<sup>18</sup> The committee members were BNP Paribas, as chair; Société Générale; and Grantham, Mayo, Van Otterloo & Co. LLC (the Congo Creditors' Committee). Moreover, Congo (Brazzaville) agreed to pay for the expenses of the Congo Creditors' Committee and its legal advisors.<sup>19</sup> This set the stage for a negotiated restructuring in the London Club style. Congo (Brazzaville) then proceeded to communicate with the Congo Creditors' Committee on both the financial and legal terms of the restructuring, which eventually took the form of a debt exchange. These negotiations led to a financial deal that the Congo Creditors' Committee was pleased to endorse. With a participation rate of approximately ninety-two percent, the market seemed to share the Committee's enthusiasm. The transaction also produced documentation including negotiated legal provisions that seemed to stop some of the erosion of creditors' rights seen in some previous sovereign debt restructurings.

## II

### CONGO RESTRUCTURING

#### A. The Setting

A number of elements contributed to such a successful debt restructuring. Some relate to the various personalities and skills of the team members on both sides of the table. Having experienced, intelligent people around the negotiating table was key to allowing some of the innovations that appeared with the Congo (Brazzaville) transaction. As important as they sometimes were for the success of the transaction, discussion of those more-personal contributions will be reserved for the memoirs and tall tales of those involved. There was also a confluence of less-personal circumstances that allowed Congo

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17. As an agent under more than one syndicated credit agreement, BNP Paribas had, over the years of default, remained a point of contact between Congo (Brazzaville) and its creditors. BNP Paribas had taken the lead in calling for and negotiating debt acknowledgements from Congo (Brazzaville). Debt acknowledgements are used to toll the statute of limitations respecting unpaid payments of principal and interest, so that the long years of nonpayment do not result in the loss of the claim for payment.

18. An attempt was made in connection with the Russian debt crisis in 1998 to bring traditional banking creditors together with funds, but Russia and its advisors stopped short of actually including these different types of creditors on the same negotiating committee. The Republic of Côte d'Ivoire had been the first country to organize a "mixed" committee in 2001, but as civil strife continued, this sovereign and its creditors' committee did not have the chance to complete their discussions.

19. Argentina had refused to pay legal expenses when a group of its creditors organized themselves into a negotiating committee. The Global Committee of Argentina Bondholders (GCAB) was organized by a significant number of creditors of Argentina representing approximately \$34 billion of the roughly \$100 billion in default. GCAB's efforts to negotiate with Argentina, and to get its legal expenses paid by Argentina in the London Club tradition, went unsatisfied. The author represented GCAB in its attempts to negotiate with Argentina.

(Brazzaville) and the Congo Creditors' Committee to accomplish what they did.

## B. Congo (Brazzaville)

After the end of French colonial rule in 1960, Congo (Brazzaville) suffered through decades of civil unrest that caused significant damage to its economic and financial infrastructures. After a succession of military coups and the introduction of a Marxist-style economy, Congo (Brazzaville) transitioned to a multiparty democracy in 1992 and instituted financial and economic reforms to develop a more liberalized economy. Continued civil unrest throughout the 1990s and early 2000s delayed economic and financial reform and development. This civil unrest and lack of financial stability resulted in a host of financial problems, including Congo (Brazzaville)'s defaulting on its external debt beginning in 1985. By the end of 2004, nominal debt represented almost 200% of GDP, more than 230% of exports of goods and services, and close to 615% of the country's tax revenues—one of the highest such ratios in the world.<sup>20</sup>

An IMF analysis suggested that the traditional mechanisms of debt reduction (the so-called Naples Terms) would not be enough for Congo (Brazzaville) to reach the debt-sustainability thresholds set in connection with the Heavily Indebted Poor Countries (HIPC) Initiative. These considerations, combined with the performance of Congo (Brazzaville) under the Poverty Reduction and Growth Facility program, permitted the IMF and the World Bank, in March 2006, to approve the eligibility of Congo (Brazzaville) to the “decision point” under the HIPC Initiative. This point allowed Congo (Brazzaville) to qualify for alleviating the country's external-debt burden. Additional debt relief was granted to Congo (Brazzaville) by the Paris Club in April 2006.<sup>21</sup>

One typical condition of obtaining the debt relief granted by the Paris Club is the requirement for a sovereign like Congo (Brazzaville) to obtain “comparable” debt forgiveness from its other creditors. On June 29, 2007, Congo (Brazzaville) and the Congo Creditors' Committee reached an agreement in principle to restructure in excess of \$2 billion in commercial external debt. The restructuring agreement included the following main provisions:

1. The debt eligible for restructuring was the total amount of principal outstanding under the original debt agreements (mostly syndicated-loan agreements).
2. The eligible interest amounts for each original debt agreement were computed by multiplying the eligible debt by an interest coefficient (a

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20. Information Memorandum of the Republic of Congo, U.S. \$477,790,000, U.S. Dollar Notes Due 2029 11, 13, 14, 18–19 (Aug. 1, 2008), *available at* [http://data.cbonds.info/emissions/11061/Prospectus\\_Congo\\_2029.pdf](http://data.cbonds.info/emissions/11061/Prospectus_Congo_2029.pdf).

21. *Id.* at 13–14.

necessary simplification in light of the various interest rates applicable in the original debt agreements).

3. The exchange of principal and related eligible interest for twenty-two-year securities, amortized in thirty-four semi-annual installments growing from 1% in year five to 4% in year eighteen, with a fixed annual interest rate rising from 2.5% for the first year to 6.0% after the tenth year.

4. At closing, a first payment made on the securities equivalent to 5% of the nominal amount of the securities being issued.

### C. The Trend Towards Unilateral Exchange Offers

Beginning in 1999, some sovereigns initiated a significant departure from the previous practice of negotiating debt restructurings with their creditors. Faced with the need to restructure bonds, Pakistan, Ukraine, and Ecuador used the technique of a unilateral exchange offer.<sup>22</sup> Ecuador combined the unilateral exchange offer with an aggressive use of exit consents,<sup>23</sup> which turned the stomachs of even the most experienced sovereign creditors. For many creditors who had come to emerging-market investments through the old syndicated loans of the 1970s and 1980s, it seemed outrageous that a borrower could change “the deal” without the consent of the creditors. A unilateral exchange offer, when combined with aggressive exit consents, seems to achieve just that. Once the sovereign makes an exchange offer to the market, market participants are under pressure to move to the new bond or risk finding themselves holdouts in an illiquid instrument. When that illiquid instrument has also been amended by departing holders as part of their move to the new instrument, a holdout may be left with an instrument that is not only illiquid but that can also be very difficult to enforce.<sup>24</sup> With such powerful disincentives to hold out, creditors are left feeling as though a gun has been put to their heads to get them to participate in the proposed exchange offer.

Bonds were generally harder to restructure than syndicated loans in part because of the challenges of identifying bondholders. Rather than brave the challenge of identifying their bondholders and negotiating a restructuring,

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22. For a discussion of the G-7 policies that may have led to the need for such restructurings, see RIEFFEL, *supra* note 1, at 208–13. However, G-7 policies do not explain why the restructurings were accomplished through the technique of unilateral exchange offers.

23. See RIEFFEL, *supra* note 1, at 213. See also Buchheit, *supra* note 8, at 20.

24. For a discussion of Ecuador’s exit consents and its influence on investors’ attention to contractual provisions, see Anna Gelpern & Mitu Gulati, *Innovation after the Revolution: Foreign Sovereign Bond Contracts since 2003*, 4 CAP. MARKETS L.J. 85, 99–100 (2009). Some kinds of exit consents are a needed and appropriate technique to prevent holdout creditors from disrupting an exchange transaction. When the exchange has been negotiated with creditors, it is more appropriate to apply pressure on the stragglers to come to the deal accepted by the majority of bondholders. In contrast, aggressive exit consents used in non-negotiated deals attempt to strip old instruments of provisions needed for effective enforcement. It is this latter category that causes creditors the most concern.

sovereigns had found in the unilateral exchange offer a way to avoid negotiations with their creditors. This trend left emerging-market creditors feeling very uncomfortable about how sovereign defaults on bonds would be resolved in the future. When Argentina's debt crisis arose in 2001, creditors' fears about the trend seemed to be confirmed. And between Congo (Brazzaville) and the Congo Creditors' Committee, the trend was often discussed as something to avoid. Both sides were aware that if negotiations were to break down, a unilateral exchange offer like Argentina's would follow.

#### D. Argentina

In December 2001, Argentina defaulted on its external debt to the tune of over \$100 billion. In 2003, Argentina first announced a unilateral exchange offer proposing new bonds at a steep discount for its external debt in default. In June 2005, the Argentine government announced that it had completed the restructuring of 76% of its defaulted debt. When compared with other debt restructurings, 76% participation is a dismal outcome.<sup>25</sup> By some estimates, creditors who chose not to participate in Argentina's unilateral offer held more than \$20 billion of debt.<sup>26</sup> With so much defaulted debt untreated, Argentina has since faced lawsuits and arbitrations and has not been able to access new capital from the international markets.<sup>27</sup>

At the time of the default, Argentina's debt was widely held by a number of different types of creditors located throughout the world.<sup>28</sup> At some point after the default, Argentina was encouraged by one of its financial advisors to reach out to its creditors and create a handful of regional creditor committees.<sup>29</sup> Given the vast cultural differences and varied investment objectives that can exist when creditors range from Germany to Japan, regional committees might have made some sense. Eventually, however, Argentina decided to abandon the process. Interestingly, its attempts had the effect of alerting experienced creditors to the possibility of creating a global creditors' committee. If the sovereign was not going to do it, as had often been the case in the old London Club restructurings, then creditors would simply do it themselves.

One of the reasons Argentina's unilateral exchange offer was so distasteful to creditors was that these creditors succeeded in identifying and organizing

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25. Participation rates on other recent restructurings were all above 90%: Russia, 98%; Ecuador, 97%; Uruguay, 92%. Special Briefing: Argentina, Institute of International Finance (June 8, 2004) (on file with *Law and Contemporary Problems*).

26. Staff Note on Argentina, Institute of International Finance (June 15, 2005) (on file with *Law and Contemporary Problems*).

27. Instead, Argentina has issued a significant amount of local currency debt, often sold to governments in the region, primarily to Venezuela.

28. When the Argentine government launched its restructuring proposal, it covered 152 different bond issues, denominated in seven currencies, and under eight different governing laws. Staff Note, Institute of International Finance (Oct. 20, 2003) (on file with *Law and Contemporary Problems*).

29. Interview with one of Argentina's former financial advisors (June 13, 2008) (on file with author).

themselves into a representative creditor group for negotiation. The Global Committee of Argentina Bondholders (GCAB) represented approximately \$34 billion of the over \$100 billion in default. The creation of the GCAB eliminated one of the justifications some sovereign advisors had used for making a unilateral exchange offer: that bondholders were too difficult to identify and organize in a committee. The GCAB was also “representative” in that it had members from a number of different countries and its members held a significant portion of the defaulted debt. Yet, notwithstanding the GCAB’s numerous and concerted efforts to engage Argentina in a dialogue, Argentina largely shunned the GCAB and its other creditors to avoid negotiations.

Following on the heels of Ecuador’s unilateral exchange offer in 1999, the Argentine choice not to negotiate with its creditors, even after they had organized themselves for that purpose, had a great influence over the members of the Congo Creditors’ Committee, all of whom were either members of the GCAB or were intimately familiar with the GCAB’s valiant but vain attempts to engage Argentina and avoid a unilateral solution.

#### E. The Principles

Another important element to the context in which the Congo (Brazzaville) deal was struck was the “Principles.” In 2004, two large industry organizations—the Institute of International Finance and the International Primary Market Association—and a group of emerging-market creditors endorsed a market-based approach to sovereign debt crises and restructurings entitled “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets,” recognized simply as the Principles.<sup>30</sup> Following a Group of Twenty meeting in November 2004,<sup>31</sup> the group’s Finance Ministers and Central Bank Governors issued a press release that included the following paragraph:

We reaffirmed the importance of an international financial architecture that sets incentives for pursuing sustainable policies and prudent risk-taking. In this regard, we welcomed the results achieved between issuing countries and private-sector participants on ‘Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.’ Such principles, which we generally support, provide a good basis for strengthening crisis prevention and enhancing predictability of crisis management now, and as they further develop in future.<sup>32</sup>

With this broad endorsement, many market participants hoped that the Principles would serve as definitive counterpoints to the approach proposed in

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30. See *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets: Report on Implementation by the Principles Consultative Group*, INSTITUTE OF INTERNATIONAL FINANCE (2008), <http://www.iif.com/emp/principles/> [hereinafter *Principles*].

31. The governments represented at the meeting were Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union (represented by the Council presidency and the President of the European Central Bank).

32. Group of Twenty, Communiqué for the Meeting of Finance Ministers and Central Bank Governors, Berlin (Nov. 20–21, 2004) (on file with *Law and Contemporary Problems*).

the SDRM. The Principles are also consistent with some aspects of a 2002 report produced by the Group of Ten for more-efficient debt restructurings.<sup>33</sup> Both endorse greater communication between sovereign debtors and their creditors, for example, with the use of Collective Action Clauses (CACs).<sup>34</sup> But the Principles depart from the Group of Ten report to emphasize the benefits of negotiated solutions with creditors' committees.

The essence of the Principles is best described in its own preface:

[T]he Principles outline a process for market-based restructuring based on negotiations between the borrowing country and its creditors that involve shared information, are conducted in good faith, and seek to achieve a fair outcome for all parties. Such a process maximizes the likelihood that market access will be restored as soon as possible under sustainable macroeconomic conditions.<sup>35</sup>

As part of promoting this market-based, negotiated restructuring, the Principles also encourage the use of creditor committees and CACs:

Structured, early negotiations with a creditor committee should take place when a default has occurred in order to ensure that the terms for amending existing debt contracts and/or a voluntary debt exchange are consistent with market realities and the restoration of growth and market access and take into account exiting CAC provisions.<sup>36</sup>

Drawing on the Principles, the Congo Creditors' Committee wished to see a negotiated solution with the use of CACs. By the time of the Congo (Brazzaville) transaction, CACs had become the trend for New York-law-governed indentures, and there was never much doubt that the Congo (Brazzaville) indenture would include them too. But the members of the Congo Creditors' Committee saw an opportunity for Congo (Brazzaville) to make its mark on sovereign debt history by agreeing to negotiate its restructuring with a creditors' committee. They used the Principles as a point of reference to demonstrate to Congo (Brazzaville) how sovereign debtors and creditors had come together to endorse and promote negotiated solutions over unilateral exchange offers. Congo (Brazzaville) responded favorably and will go down in sovereign debt history as the first negotiated debt restructuring conducted in conformity with the Principles in the wake of the reaction to the SDRM and the Argentine crisis.

### III

#### INNOVATIONS: THE PROCESS AND THE TRUST INDENTURE

Congo (Brazzaville)'s debt restructuring, being a product of negotiation, represents a compromise reached on financial and legal terms between Congo

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33. The countries in the Group of Ten are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. For the report, see GROUP OF TEN, REPORT OF THE G-10 WORKING GROUP ON CONTRACTUAL CLAUSES (Sept. 26, 2002), available at <http://www.bis.org/publ/gten08.pdf>.

34. CACs are discussed *infra* Part III.D.

35. See *Principles*, *supra* note 30, at 12.

36. *Id.* at 14.

(Brazzaville) and the Congo Creditors' Committee. The techniques and documents in the resulting transaction varied from those used in previous debt restructurings. The key variations are discussed below.

#### A. A Committee of Diverse Creditors

The bank advisory committees of the past represented a relatively homogeneous group of bank creditors, many of whom had long-standing commercial relationships with the debtor country. Congo (Brazzaville) had such a relationship with two banks, BNP Paribas and Société Générale. Both banks had lent money to Congo (Brazzaville) long before many other creditors had, most of whom had acquired Congo (Brazzaville) debt in the secondary market and had maintained good relations with Congo (Brazzaville) throughout the years of default. Building on these relationships, Congo (Brazzaville) sought out BNP Paribas to assist it with the reconciliation of its external debt in preparation for a restructuring, allowing BNP Paribas privileged contact with Congo (Brazzaville) and its advisors long before a restructuring was possible. BNP Paribas took advantage of this contact to encourage Congo (Brazzaville) to pursue a negotiated solution.<sup>37</sup> Congo (Brazzaville)'s decision to negotiate was made easier by its ability to identify its creditors. Congo (Brazzaville)'s debt had been incurred through loan agreements, which, in contrast to bond issuances, allowed Congo (Brazzaville) to identify those holding its debt. Building on its role as agent for a large number of the syndicated loan agreements, BNP Paribas worked with Congo (Brazzaville) to identify as many of Congo (Brazzaville)'s creditors as possible. Their joint efforts met with great success: all of Congo (Brazzaville)'s commercial creditors were identified before the restructuring was announced.

This facilitated Congo (Brazzaville)'s ability to pursue a negotiated solution. There was still the question, though, whether negotiations with a committee make sense when a sovereign's debt is held by a diverse group of institutions. Some of Congo (Brazzaville)'s advisors argued that differences in investment strategy and regulatory schemes among such creditors would leave any creditors' committee mired in conflicting objectives and not really representative of the mass of divergent creditor interests. Congo (Brazzaville) braved these considerations and invited Grantham, Mayo, Van Otterloo & Co. LLC to join Société Générale and BNP Paribas on the Congo Creditors' Committee. At the time Congo (Brazzaville) made this decision, no other sovereign had successfully negotiated and implemented a debt restructuring with a mixed committee. Congo (Brazzaville) deserves commendation for taking this initiative and following the tenets of the Principles.

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37. The Congo Creditors' Committee and its advisors were not generally privy to exchanges between the IMF and Congo (Brazzaville). It is possible, however, that the IMF also encouraged Congo (Brazzaville) to recognize and negotiate with a creditors' committee based on the IMF's criteria for good-faith negotiations in relation to its "lending into arrears" policy. See PIN, No. 02/107, *supra* note 11.

Throughout the negotiations, it became apparent that, despite differences among the creditors at large, having a committee that understood these differences was key to negotiating such a successful debt restructuring. The Committee itself showed no signs that divergent natures meant conflicting objectives. Differences of viewpoint were resolved in a timely and constructive way that allowed the Committee to present a united voice to Congo (Brazzaville). Congo (Brazzaville)'s debt restructuring is proof that a carefully selected committee consisting of banks and other market actors can contribute to the wide acceptance of a restructuring by the market at large.

### B. The Effects of Judgment Creditors

The longer a sovereign in default waits to either commence negotiations or present an offer to the market for resolving its payment arrears, the more likely a sovereign is to face litigation and its consequences. It was no different for Congo (Brazzaville). As an oil-producing country, Congo (Brazzaville) was potentially more susceptible to becoming a target of asset attachment than some other countries, making it all the more imperative that it act quickly to address its defaulted external debt. But with its devastating civil and financial stresses, it took Congo (Brazzaville) a number of years to reach the point of addressing its debt-restructuring needs.<sup>38</sup> Predictably, after so many years of default, some creditors had obtained judgments for nonpayment against Congo (Brazzaville) and were in a position to seize Congolese assets wherever they might appear. For the 2007 debt restructuring, one concern raised by the presence of judgment creditors was that they might attempt to attach the payment stream on the new instruments issued in the exchange or to otherwise disrupt the exchange transaction. This risk required the lawyers of both Congo (Brazzaville) and the Congo Creditors' Committee to pay special attention to structuring the exchange of old debt instruments for the new issuance. With this in mind, Congo (Brazzaville) requested that the Committee consider using a trust structure rather than the more-traditional fiscal agency structure.

### C. Trust Versus Fiscal Agency Structures

Generally speaking, sovereign issuances resulting from debt restructurings have traditionally used fiscal agency structures.<sup>39</sup> This structure entails the sovereign's appointing a fiscal agent to make payment on the bonds. As an agent of the sovereign, the fiscal agent does not represent or protect the bondholders and does not have responsibilities related to enforcing the bonds against the debtor. As payments on the bonds travel from the sovereign to its

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38. After defaulting in 1985, some initial discussions between Congo (Brazzaville) and some of its creditors occurred as early as 1986. In 1988, a consolidation and refinancing agreement was negotiated but never put into place. Multiple discussions took place again in 1994 only to be interrupted by civil war.

39. Lee C. Buchheit & Jeremiah S. Pam, *Uruguay's Innovations*, 19 J. INT'L BANKING L. REG. 28, 30 (2004).

fiscal agent on their way to bondholders, such payments are theoretically exposed to attachment risk by judgment creditors. This attachment risk occurs both at the time of the initial exchange of old debt for the new bonds if a cash payment is made, and at the time of the regularly scheduled principal and interest payments on the new bonds. To keep funds in the accounts of the sovereign's fiscal agent from being attached, fiscal agency agreements provide that funds received from the sovereign are to be held "in trust" for the bondholders. Whether this trust language would suffice to actually prevent attachment of the fiscal agent's payment accounts is, to my knowledge, untested.<sup>40</sup> With the risk of attachment in mind, sovereigns have begun embracing a structure that might seem, on its face, to be against a sovereign's interests. Trust structures are thought to solve the payment-attachment-risk problem because the trustee is a fiduciary of the bondholders rather than an agent of the sovereign. Thus, when payments from the sovereign arrive at the trustee's accounts, title has, in effect, already passed from the sovereign to the bondholders, making such amounts conceptually unattachable by judgment creditors. In light of Congo (Brazzaville)'s judgment-creditor risk, this feature made the trust structure appealing to Congo (Brazzaville), but it may not explain all of the reasons why Congo (Brazzaville) opted for a trust structure.

Although a trust structure protects the payment stream, it comes with features that a sovereign might consider potentially harmful to its interests. In the United States, the trust structure was designed to protect bondholders, not debtors. Before the Trust Indenture Act of 1939 (TIA), no law in the United States specifically provided protections to bondholders from what is generally referred to as the collective-action problem. In the wake of the market crash of 1929, Congress had grown concerned that bondholders were so widely dispersed, so challenged in their ability for concerted action, and so unmotivated to take individual action against a defaulting issuer that legislation was necessary to protect bondholders' interests.<sup>41</sup> In the hearings that preceded the enactment of the TIA, the Securities and Exchange Commission recommended that trustees "be transformed into active trustees with the obligation to exercise that degree of care and diligence which the law attaches to such high fiduciary position[s]."<sup>42</sup> In theory, an active trustee would mean that a fiduciary would facilitate action by bondholders or to even take action for bondholders if collective action proved ineffectual.

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40. Cf. *Elliott Assoc., L.P. v. Republic of Peru*, General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000) (discussing Elliott's success in getting a restraining order against Chase Manhattan, as fiscal agent for Peru's Brady bonds, on other grounds).

41. For a discussion of whether the Trust Indenture Act of 1939 actually remedied the collective-action problem, see Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1039 (2008).

42. SEC. & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI—TRUSTEES UNDER INDENTURES 110 (1936).

Practice has shown that the trust structure, when employed for sovereign issuances, may be more of an impediment to the exercise of bondholder enforcement rights than the Congress of 1939 intended for U.S. bondholders.<sup>43</sup> One reason for this in the sovereign context might be the absence of the prudent-man standard, a key trustee duty required by the TIA but inapplicable to sovereign trust indentures.<sup>44</sup> Whatever the reason for enforcement inefficiencies in trust structures, Congo (Brazzaville) and its advisors were aware of them. Furthermore, a trust structure offers another benefit to sovereigns: lodging enforcement powers in a trustee centralizes enforcement action, leaving the sovereign with one suit to defend rather than hundreds or thousands.

In contrast, fiscal agency structures largely leave enforcement provisions in the hands of individual creditors. Once a requisite number of bondholders—from a single bondholder to at least fifty percent of them—in a fiscal agency structure have accelerated the bonds, individual creditors are free to enforce the bonds individually. Individual enforcement rights provide creditors with flexibility and control over their own destinies. But such rights expose a sovereign to the possibility of having to defend multiple lawsuits. Moreover, sovereigns think that independent enforcement rights allow an individual bondholder to exert too much influence over any restructuring proposal that the sovereign might wish to offer its bondholders. And sovereigns fear that creditors in a fiscal agency structure will forego a proposed restructuring, which typically implies some debt forgiveness, opting instead to litigate for the full amount of their claims. The collective enforcement power vested in a trustee under the trust structure helps diminish the influence of any single creditor in the enforcement process, and, with rare exceptions, ensures that a sovereign will only have to defend a single lawsuit.

In summary, the use of the trust structure protects the interests of both the sovereign and the bondholders from judgment creditors wishing to disrupt the closing of the debt exchange or to attach the payment streams associated with the new bonds. The Creditors' Committee recognized this advantage as a partial justification for using a trust structure. Yet such advantages did not fully outweigh the enforcement disadvantages of the trust structure in the mind of the Congo Creditors' Committee. To get over that hump, the Congo Creditors' Committee negotiated a compromise that helped justify accepting Congo (Brazzaville)'s request for a trust structure: it introduced an “engagement

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43. See Schwarcz & Sergi, *supra* note 41, at 1039 (arguing that even with the additional standards of care imposed on trustees by the TIA, “indenture trustees do not always live up to their ‘efficient centralized enforcement’ function contemplated by the TIA, especially post-default when enforcement is most critical”). Sovereign issuances are not subject to the requirements of the TIA, *see infra* note 55, and contain even fewer trustee duties than TIA-qualified indentures.

44. For a discussion of the “prudent man standard” in relation to sovereign issuances, see G. Mitu Gulati & Lee C. Buchheit, *The Coroner's Inquest*, INT'L FIN. L. REV., Sept. 2009, at 22.

clause” into the indenture and made changes to the enforcement mechanism of the indenture to curb recent degradations in creditor rights.

#### D. Majority Modifications

Prior to Mexico’s bond issuance in 2003, trust indentures governed by New York law featured provisions that did not allow the key financial terms and conditions of the indenture to be modified without the consent of each bondholder. This constraint meant that restructuring a New York–law bond issuance would have to be done by a debt exchange. In contrast, English–law–governed trust indentures allowed modification of the financial terms by a supermajority of bondholders, known as Collective Action Clauses or CACs. CACs allow a sovereign to conduct a debt restructuring through contract modification rather than through an exchange offer, providing additional flexibility for a sovereign in crisis. But the key benefit to contract modification through CACs is the effect they have as a deterrent to hold-outs. Once the amendments to the financial terms are agreed upon by the relevant supermajority, the amendments’ terms apply to all holders of the bonds, whether they consented to them or not. So minority holders cannot hold the successful completion of the restructuring hostage. As an increasing number of sovereign bonds move to CACs in trust structures, the difficulties some sovereigns faced in the past from holdouts and litigating creditors should be significantly diminished. By the time of the Congo (Brazzaville) transaction, CACs had become standard in New York–law sovereign trust indentures.<sup>45</sup> As a market-based contractual solution to facilitate orderly sovereign debt restructurings, CACs enjoy wide support from industry organizations, multilateral institutions, and emerging market debtors as an alternative to the SDRM.<sup>46</sup>

It was evident, therefore, that CACs would be included in the Congo (Brazzaville) trust indenture. The only real question was which form of clauses would be used and at what level the supermajority would be set. Several different versions of CACs had been circulating at the time. In drafting the trust indenture, the Congo Creditors’ Committee and its advisors drew from model clauses proposed by industry organizations. As the first and only CACs negotiated between an issuer and a creditors’ committee, the CACs departed slightly from the model clauses.<sup>47</sup>

One negotiated point was the level of supermajority required to approve the amendment of the key financial terms and other key provisions. The Congo Creditors’ Committee initially proposed a three-tiered approach to indenture

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45. Lee C. Buchheit, *Supermajority Control Wins Out*, INT’L FIN. L. REV., Apr. 2007, at 21.

46. For an excellent discussion of the way CACs were introduced into New York–law–governed indentures, see Gelpern & Gulati, *supra* note 7.

47. Some discussions on documentation usually occur between the issuer and the investment banks it employs to assist with a “new” money issuance, but such discussions cannot be considered a negotiation for creditors’ interests.

modifications, distinguishing among (1) minor modifications at an approval rate of two-thirds, (2) important financial modifications at an approval rate of eighty-five percent, and (3) modifications of legal provisions affecting the ability to enforce the indenture at an approval rate of one hundred percent.<sup>48</sup> In the Committee's collective mind, there was an important reason to distinguish between the second and third tiers: Amending financial provisions should be done only from a truly dominant position, and seventy-five percent was thought to be too low. The reason for the third tier is more complex. After all, if seventy-five to eighty-five percent of the creditors are willing to modify the financial provisions to grant debt relief to a sovereign, why should some legal provisions require one hundred percent of the bondholders? To relieve a debt crisis with a favorable restructuring of the financial terms, there should be no need for the sovereign to modify the governing-law clause, its waiver of immunities, or the jurisdictions in which it can be sued. These and other "enforcement-related" provisions are simply irrelevant to resolving a financial crisis. Creditors might therefore fear that any sovereign proposal to amend such provisions was really an effort to insulate the sovereign from contract enforcement. In addition, CACs were conceived to allow the orderly amendment of bond terms in the case of a debt crisis. Yet there is nothing to ensure that a sovereign in a debt crisis will actually use the CACs to amend the bonds. Instead, the sovereign could choose to revert to an older technique: a unilateral exchange offer. In such a case, the old bonds would be exchanged for new ones rather than be amended. If such an exchange offer were to include exit consents, key legal provisions permitting the enforcement of the old bonds could be removed or their effectiveness compromised. The concession to a CAC without a unanimous component was thought by the Congo Creditors' Committee to make such a CAC easier to use, and to encourage its use over a unilateral exchange offer.

With this in mind along with the weight of most precedents and other elements of compromise in the overall negotiations, the Committee agreed to adopt Congo (Brazzaville)'s preference for a two-tiered system, with both the financial terms and the enforcement-related provisions modifiable with the approval of seventy-five percent of the principal amount of the bonds.

#### E. The Engagement Clause: A Creditors' Committee

The unilateral exchange offers of Pakistan, Ukraine, Ecuador, and Argentina cast a long shadow. From that shadow, the Congo Creditors' Committee wished to promote negotiated solutions, building on tenets of the

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48. The approach was inspired to some extent by model CACs issued by a number of industry groups: the Emerging Markets Creditors Association, the former Emerging Markets Trade Association, the Institute of International Finance, the International Primary Market Association, the International Securities Market Association, the Securities Industry Association, and the Bond Market Association. *Model Collective Action Clauses for Sovereign Bonds*, INT'L CAPITAL MKT. ASS'N (Jan. 31, 2003), <http://icma.org/ICMAGroup/files/6f/6f64b60e-2926-42e3-b757-27696ec7661d.PDF>.

Principles.<sup>49</sup> Creditor committees with expenses paid by the debtor had been a key feature of London Club restructurings in the 1980s and '90s. Organizing a means of allowing bondholders to negotiate with a sovereign in circumstances of distress became a negotiating priority for the Congo Creditors' Committee. It argued to Congo (Brazzaville) that such a committee could be contractually introduced into the trust structure and that Congo (Brazzaville) should agree to pay the reasonable expenses of that bondholders' committee.

The idea of introducing an engagement clause that provided for a bondholders' committee was not new. After 2004, a small number of sovereign issuers gave bondholders the option of organizing a committee for purposes of facilitating a debt restructuring.<sup>50</sup> The Congo (Brazzaville) trust indenture provides that, after an "Event of Default," holders of at least fifty percent of principal amount of the bonds (those held by the Republic itself and certain governmental entities are excluded from the calculation) can name a committee of bondholders to facilitate a solution. This feature may be similar to other engagement clauses, but as a result of the parties' divergent considerations, the engagement clause resulting from the negotiations between Congo (Brazzaville) and the Congo Creditors' Committee also had a few unusual features.

For the Congolese delegation, the idea of negotiating with a committee of bondholders was not completely unpalatable. After all, Congo (Brazzaville) had already decided to favor a negotiated solution for its debt restructuring. But for Congo (Brazzaville), the idea of building a committee into a trust indenture had some limitations. As the negotiations progressed, it became clear that the Congolese delegation had some concerns about the need for flexibility in addressing its debt management. It also had some concerns that negotiations with a committee would be meaningful only if the committee were perceived to be "representative"—that is, representative by the nature and amount of holdings of the mass of bondholders. With these considerations in mind, Congo (Brazzaville) did not want to be constrained to negotiate with a creditors' committee of whose composition it could not be certain. That resulted in a provision that did not require Congo (Brazzaville) to recognize the committee organized by the bondholders. This left open the possibility that the creditors would organize a committee but would nonetheless be unable to engage with Congo (Brazzaville). If, on the other hand, Congo (Brazzaville) chose to recognize the committee, it would pay the reasonable expenses of such committee. A form of recognition acknowledgment was attached to the trust indenture to be employed by Congo (Brazzaville) for such purpose.

For the Congo Creditors' Committee, the idea that a future bondholders' committee might be properly organized but not recognized by Congo

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49. See *Principles*, *supra* note 30, at 14.

50. See Gelpern & Gulati, *supra* note 24, at 96 (describing issuances by Hungary, Latvia, Macedonia, Serbia, Slovakia, Abu Dhabi, and Sweden).

(Brazzaville) was not pleasing. Likewise, having expenses reimbursed only if Congo (Brazzaville) chose to recognize the future bondholders' committee was a disappointment. The Committee nonetheless got comfortable with the provision because of some practical considerations that Congo (Brazzaville) would have to face if a bondholders' committee were actually constituted. If the future default were to occur at a time when Congo (Brazzaville) needed financial assistance from the IMF, Congo (Brazzaville) would likely face the need to engage in good-faith negotiations with its commercial creditors as a condition to getting such financial assistance.<sup>51</sup> It would be hard for Congo (Brazzaville) to argue that it is acting in good faith with respect to its commercial creditors if it failed to recognize a bondholders' committee organized by the majority of bondholders in accordance with the Congo (Brazzaville) trust indenture. In a Public Information Notice issued in 2002, the IMF stated,

In cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good faith negotiations with this committee, though the unique characteristics of each case would also be considered.<sup>52</sup>

This "good faith" criteria connected to the IMF's "lending into arrears" policy would likely make it difficult for Congo (Brazzaville) to refuse to recognize a properly formed bondholders' committee.

Moreover, if Congo (Brazzaville) were to shun a bondholders' committee appointed in accordance with the indenture by bondholders representing a majority of the bonds, Congo (Brazzaville) would likely even find it difficult to garner support for a unilateral exchange offer. With such a committee already organized, bondholder opposition to a unilateral approach would be easier and quicker to initiate and pursue. With these considerations in mind, the Congo Creditors' Committee thought it better to have an unusual engagement clause than to have none at all.

#### F. The Enforcement Mechanism

The TIA was enacted in part to protect bondholders in crises by appointing a professional trustee to represent them. One of the key bondholder

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51. In 1999, the IMF amended its policy regarding "lending into arrears." Generally speaking, the IMF will not provide additional financial assistance to a sovereign that is in default under external commercial or bond debt. However, "[t]he 1999 policy specified that Fund lending into sovereign arrears to external private creditors can be granted in circumstances in which: (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors." PIN, No. 02/107, *supra* note 11.

52. *Id.* The PIN also points out that the directors "emphasized that in assessing whether the member is making good faith efforts to negotiate, judgments would continue to be required in a number of important areas. These include a consideration of the complexity of the restructuring case, the extent to which a creditor committee is sufficiently representative, and whether a reasonable period has elapsed to allow for the formation of a representative committee." *Id.*

protections required by Section 316(b) of the TIA is the right of a bondholder to sue an issuer for unpaid amounts of principal and interest. That right is often contractually expressed in language similar to the following:

[E]ach Holder of Debt Securities shall have the right, which is absolute and unconditional, to receive payment of the principal of and interest on (including Additional Amounts) its Debt Security on the stated interest payment or principal payment date expressed in such Debt Security . . . and to institute suit for the enforcement of any such payment and such right shall not be impaired without the consent of such Holder.<sup>53</sup>

This unconditional individual enforcement right exists side-by-side with the collective-enforcement approach that is structurally built into such indentures. Specifically, TIA-qualified indentures provide a general rule that, after a default by the debtor, the trustee is empowered to enforce the trust indenture and the related securities against the debtor for the collective benefit of all holders of such securities. From the bondholders' point of view, centralized enforcement authority provides cost savings (and a professional whose duty is to protect the interests of bondholders and to facilitate enforcement). From the debtor's point of view, having a single lawsuit over unpaid amounts is more efficient than defending itself against myriad suits from individual creditors. Yet, notwithstanding these collective powers, individual bondholders were given the flexibility to take matters into their own hands in the case of unpaid principal or interest. Creditors view this flexibility as an asset, especially when the difficulties of identifying, and coordinating with, other bondholders prevent the trustee from taking quick action. Quick action is often further hindered because trustees usually have the right to refuse to act until indemnified and instructed by the bondholders. When bondholders are difficult to contact and organize, this process can take some time.

The TIA does not, however, apply to indentures for the issuance of sovereign bonds.<sup>54</sup> Still, for sovereign indentures governed by New York law, the TIA and the New York practice based upon it appear to have set the standard.<sup>55</sup> Such was the case for the unconditional enforcement right.

However, in 2005, following the devastation caused by Hurricane Ivan, Grenada restructured its sovereign debt by exchanging nonperforming instruments with a series of New York-law-governed bonds in which the unconditional enforcement right had disappeared. How could such an important staple of New York indentures be dropped, especially in the context of a debt restructuring? As between the sovereign and its creditors, the dynamics of a sovereign debt restructuring differ from those of a new-money issuance. In the first case, creditors have not been receiving payments on old instruments, usually for years on end. Theoretically, this provides leverage for

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53. Trust Indenture between the Republic of Iraq, as Issuer and JP Morgan Chase Bank, as Trustee, § 4.6 (Nov. 16, 2005) (on file with *Law and Contemporary Problems*).

54. Trust Indenture Act of 1939, § 304(a)(6), 15 U.S.C. § 77ddd(a)(6) (2006).

55. For further insight on why this might be the case, see Lee C. Buchheit & Elizabeth Karpinski, *Grenada's Innovations*, 21 J. INT'L BANKING REG. 227 (2006).

creditors to demand more of a sovereign in the context of a restructuring. In contrast, in a new-money issuance, a sovereign is free to propose whatever terms it wishes, and its only concern is to choose terms that are market-friendly enough to attract investors. Given these differences, one might expect that any innovations detrimental to creditors' rights would be more likely to appear in a new-money issuance than in a restructuring. Grenada defied this expectation.

Given that discussions between Grenada and its creditors took place, one would have expected creditors to resist the disappearance of the unconditional enforcement right. Yet, although some creditors of Grenada were represented by counsel, once the parties had agreed upon the financial terms of the restructuring, Grenada, its advisors, and the investment bank it had hired prepared the documentation for the issuance without meaningful scrutiny of the documentation by the creditors' lawyers.<sup>56</sup> Without the presence of creditor-side counsel in the preparation of the documentation, Grenada and its advisors were able to eliminate the unconditional enforcement right from its indenture, making it the first trust indenture governed by New York law not to feature one.<sup>57</sup> When, a few months later, Belize issued a series of New York-law-governed bonds on substantially the same legal terms,<sup>58</sup> it appeared that a key creditor right might be lost forever.

Grenada and its advisors may have had good intentions in eliminating the unconditional enforcement right. Sovereign debtors in need of a debt restructuring are routinely concerned about giving power to individual creditors who could disrupt such restructuring. Using the derogatory term of vulture funds, sovereign issuers fear a rare but potentially costly kind of creditor—one that purchases a claim against the sovereign at a discount with the intent of using aggressive tactics against the sovereign to obtain payment of the full face value of the claim. Such behavior can also be distasteful to other creditors. If negotiations with a sovereign debtor are underway and showing promise, most creditors will not want to see an individual creditor get one hundred percent when most are willing to accord a discount to a sovereign issuer in distress. The unconditional enforcement right was a potential weapon for holdout creditors, whether “vulture” or not.<sup>59</sup> The trouble with the loss of the enforcement right for creditors generally is that it was also a potential way

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56. *See id.* at 229 (stating that institutions holding claims expressed their preferences to Grenada's advisors).

57. *Id.* at 230–31; *see also* Trust Indenture between Grenada, as Issuer and JP Morgan Chase Bank, as Trustee, §§ 4.5–4.6 (Oct. 28, 2005) (on file with *Law and Contemporary Problems*).

58. *Compare* Trust Indenture between Belize, as Issuer and the Bank of New York, as Trustee, §§ 4.5–4.6 (Feb. 20, 2007) (on file with *Law and Contemporary Problems*), *with* Trust Indenture between the Republic of Iraq and JP Morgan Chase Bank, *supra* note 53, §§ 4.5–4.7, *and with* Trust Indenture between Grenada and JP Morgan Chase Bank, *supra* note 57, §§ 4.5–4.6.

59. The unconditional enforcement right may be considered by some to pose a conceptual problem as well. It may seem incompatible with the incorporation of CACs in New York-law-governed trust indentures in as much as it would allow an individual creditor to potentially preempt collective action. I believe that there is a reliable and appropriate way to allow an unconditional enforcement right without preempting collective action, but that is a subject for another article.

for legitimate enforcement of a contract in breach. To compensate for its loss, the Congo Creditors' Committee felt strongly that the collective-enforcement structure needed reinforcement. It thought that if the trustee or another creditor could truly be relied upon for enforcement when negotiations were not an option, then the loss of the unconditional enforcement right might be overcome.

In the absence of the unconditional enforcement right, creditors still have two tools for enforcement. Foremost is the trustee. With enforcement powers vested in a trustee, bondholders must indemnify the trustee against its potential costs and losses in order for the trustee to initiate enforcement proceedings against a defaulting sovereign. In practice, however, this simple principle is not always as effective as one might hope.<sup>60</sup> It often takes months to negotiate such indemnification. Once there is agreement on indemnification, the mechanics of getting proper instructions from bondholders in connection with such enforcement proceedings also bring delays and inefficiencies—thus the importance of the unconditional enforcement right, which was unburdened by such complications.

There is a second tool for enforcement if the trustee fails in its duties. TIA-qualified indentures and New York-law-based sovereign indentures typically provide that if the trustee mechanism breaks down in certain ways, creditors are not stuck in a collective-enforcement structure. If, notwithstanding indemnification, the trustee fails to initiate enforcement proceedings and certain other conditions are met, creditors regain an individual right to sue—that is, a conditional enforcement right. One might think that creditors would be satisfied with having this safety net if the collective structure were to fail. But in the Grenada and Belize indentures, the conditional enforcement right was burdened by other conditions that diminished its value significantly in comparison to the unconditional enforcement right. The language used in the Grenada indenture reads as follows:

No Holder of any Debt Securities of any Series shall have any right by virtue of or by availing itself of any provision of this Indenture or of the Debt Securities of such Series to institute any suit, action or proceeding in equity or at law upon or under or with respect to this Indenture or of the Debt Securities, or for any other remedy hereunder or under the Debt Securities, unless (a) such Holder previously shall have given to the Trustee written notice of default and of the continuance thereof with respect to such Series of Debt Securities, (b) the Holders of not less than 25% in aggregate principal amount Outstanding of Debt Securities of such Series shall have made specific written request to the Trustee to institute such action, suit or proceeding in its own name as Trustee hereunder and shall have provided to the Trustee such reasonable indemnity as it may require against the costs, expenses and liabilities to be incurred therein or thereby and (c) the Trustee for 60 days after its receipt of such notice, request and provision of indemnity shall have failed to institute any such action, suit or proceeding and no direction inconsistent with such written request shall have been given to the Trustee pursuant to Section 4.7, *it being understood and intended, and being expressly covenanted by every Holder of Debt Securities of a Series with every other Holder of Debt Securities of such Series and the*

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60. See Schwarcz & Sergi, *supra* note 41, at 1039.

*Trustee, that no one or more Holders shall have any right in any manner whatever by virtue or by availing itself of any provision of this Indenture or of the Debt Securities to affect, disturb or prejudice the rights of any other Holder of Debt Securities of such Series or to obtain priority over or preference to any other such Holder, or to enforce any right under this Indenture or under the Debt Securities of such Series, except in the manner herein provided and for the equal, ratable and common benefit of all Holders of Debt Securities of such Series.*<sup>61</sup>

Apart from the hurdles to enforcement found in this provision, it is worth pointing out that creditors of a sovereign debtor face a significant extra-contractual deterrent: collection is not easy. Even with an enforceable judgment, creditors may have great difficulty seizing any sovereign assets, for such assets generally benefit from sovereign immunity. Although there are typical exceptions to such immunity for assets used in commercial, as opposed to official, capacities, if a sovereign is well advised by counsel, the universe of seizable sovereign assets can be very, very small.

This extra-contractual deterrent to bringing a suit against a sovereign is exacerbated in Grenada's and Belize's formulations of the conditional enforcement right because they contain the sharing clause emphasized in the Grenada indenture agreement above. The agreement's language is vague as to what right holders would actually get back if the trustee failed to act. Is it a right to sue for the amount of one's own claim against the sovereign or a right to sue for the amount of all holders' claims, as the trustee would have done?<sup>62</sup> The distinction is significant whenever indentures contain a sharing clause. In the Grenada and Belize indentures, no right can be exercised by an individual bondholder, "except in the manner . . . provided [in the Securities] and for the equal, ratable and common benefit of all Holders" of the Securities.<sup>63</sup> If the conditional enforcement right were interpreted to mean that a holder could sue only for the amount of its own claim, then the sharing clause would represent an almost insurmountable deterrent to suit. With recovery already being unsure and costly, a holder would be able to recover only an amount equal to its claim, which would then have to be shared with all other holders. When attachable resources are limited, this sharing provides some assurance to other creditors that they will get some portion of the available assets. But the quoted language provides no comfort that a prosecuting holder will be able to recover its costs of litigation and collection before sharing the recovery with everyone else. If the prosecuting holder could not recover those costs, one creditor would be paying the costs of recovery for all creditors. In short, the sharing clause may mean that an individual bondholder might exhaust its legal recourse without getting full recovery either for itself or for the other creditors.

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61. Trust Indenture between Grenada and JP Morgan Chase Bank, *supra* note 57, § 4.5 (emphasis added).

62. Indentures typically provide expressly that the trustee is authorized to sue for every bondholder's claim. No similar authorization is typically provided for a bondholder in connection with the conditional individual right to sue. I believe that without such an express authorization, a bondholder would be limited to making its own claim.

63. Trust Indenture between Grenada and JP Morgan Chase Bank, *supra* note 57, § 4.5.

In the face of the loss of the unconditional enforcement right and the sharing clause imposed on the conditional enforcement right, the Congo Creditors' Committee determined that some balance and clarity needed to be reintroduced into sovereign bond documentation. In the Committee's collective mind, once there is an Event of Default and the requisite number of bondholders decides to take legal action, there should be no deterrents to such action hidden in the language of the trust-enforcement mechanism.

Consequently, one of the key innovations of the Congo (Brazzaville) trust indenture relates to the way the indenture can be enforced. As with previous trust indentures, the Congo (Brazzaville) indenture vests the trustee with enforcement powers for the collective benefit of all bondholders. The differences lie in what happens if the trustee does not act. If the trustee is indemnified by creditors and does not act, or if the creditors have offered a reasonable indemnity that the trustee has not accepted, a conditional individual right to sue is provided. This conditional enforcement right, though, looks different from that in other indentures. Rather than allow an individual creditor to sue only for its own claim and then force that creditor to share the proceeds with all the others, the Congo (Brazzaville) indenture in effect replaces the trustee with one of the creditors. If the conditions are met, any individual creditor has the right to sue for the entire claim of all creditors. It would have to share the proceeds, but it would be sharing from a much larger pot, and only after its own costs of enforcement have been reimbursed. The language from the Congo (Brazzaville) trust indenture is as follows:

(a) No Holder of any Securities shall have any right by virtue of or by availing itself of any provision of this Indenture or the Securities to institute any suit, action or proceeding in equity or at law upon or under or with respect to this Indenture or the Securities, or for any other remedy hereunder or under the Securities, unless all of the following conditions are satisfied (the "Conditions for Enforcement Without Trustee"): (i) the Trustee has received one or more Acceleration Requests and one or more Enforcement Requests from, in each case, Holders representing in the aggregate at least 25% of the Outstanding Principal Amount, (ii) such Holder has made an Acceleration Request and an Enforcement Request, (iii) either (x) the Trustee has failed to bring a claim or to institute an action, suit or proceeding within 60 days following the signing of an Indemnification Agreement, or (y) such Holder has attempted in good faith to conclude an Indemnification Agreement with the Trustee, but no such agreement was reached within 60 days following the Enforcement Request and the Holder pleads in an Enforcement Without Trustee (as defined below) that the Indemnification Agreement proposed by, or acceptable to, such Holder during such 60-day period was reasonable, provided that the Republic shall be entitled to oppose such Enforcement Without Trustee by such Holder if the reasonableness of such Indemnity Agreement is not sufficiently established by such Holder, and (iv) a rescission of the relevant Acceleration Request was not made by the Holders of a Majority of the Outstanding Principal Amount.

(b) In the event that all of the Conditions for Enforcement Without Trustee have been fulfilled for a given Holder, that Holder shall be entitled to pursue any type of recourse available to it under this Indenture, the Securities and applicable law (an "Enforcement Without Trustee") under the following conditions: (i) such Holder shall undertake the Enforcement Without Trustee on behalf of all Holders, (ii) such Holder shall be diligent in pursuing the Enforcement Without Trustee, (iii) such Holder shall employ the services of a law firm that is internationally respected for its

handling of complex financial lawsuits governed by New York law, (iv) such Holder shall not settle the claim unless it has the consent of Holders of at least 75% of the Outstanding Principal Amount, (v) the Holders of at least 50% of the Outstanding Principal Amount may, to the extent permitted by applicable law, (x) replace the plaintiff in such action by another Holder, provided that doing so does not materially interfere with the ongoing lawsuit, (y) designate one or several other Holders to lead such action without changing the identity of the plaintiff or (z) require that the management of the Enforcement Without Trustee be shared by the plaintiff with one or several other Holders, and (vi) any sum recovered by such Holder in the context of the Enforcement Without Trustee, including any sum arising from any settlement or any other type of resolution between such Holder and the Republic following the commencement of an Enforcement Without Trustee, shall be for the joint benefit of all Holders (other than the Republic or any Governmental Entity) and shall be turned over to the Trustee so that it may be shared among the Holders in proportion to their respective shares of the outstanding principal amount, after deduction of the amounts necessary to reimburse such Holder for its reasonable costs and expenses incurred in pursuing the Enforcement Without Trustee; it being understood and intended, and being expressly covenanted by every Holder with every other Holder and the Trustee, that no one or more Holders shall have any right in any manner whatever by virtue or by availing itself of any provision of this Indenture or of the Securities to affect, disturb or prejudice the rights of any other Holder of Securities or to obtain priority over or preference to any other such Holder, or to enforce any right under this Indenture or under the Securities, except in the manner herein provided and for the equal, ratable and common benefit of all Holders. For the protection and enforcement of this Section, each and every Holder and the Trustee shall be entitled to such relief as can be given either at law or in equity.

(c) With respect to an Enforcement Without Trustee, provided that all of the conditions set forth in Sections 4.9(a) and (b) are fulfilled for a given Holder, (i) such Holder shall be entitled and empowered to institute any action or proceedings at law or in equity for the collection of the sums due and unpaid by the Republic, and may prosecute any such action or proceedings to judgment or final decree, and may enforce any such judgment or final decree against the Republic and collect in the manner provided by law out of the property of the Republic, wherever situated, the monies adjudged or decreed to be payable, subject to the provisions of Section 9.7(d), (ii) all rights of action and of asserting claims under this Indenture or the Securities may be enforced by such Holder without the possession of any Securities or the production thereof on any trial or other proceedings relative thereto, and any such action or proceedings instituted by the Holder shall be brought in its own name, on behalf of all Holders, (iii) such Holder shall be entitled to obtain from the Trustee, to the extent that additional copies are available to the Trustee, an original counterpart of this Indenture, including any and all amendments hereof, and (iv) in any proceedings brought by such Holder (and also any proceedings involving the interpretation of any provision of this Indenture to which the Holder shall be a party) with respect to the Securities, the Holder shall be held to represent all the Holders, and it shall not be necessary to make any such Holders parties to any such proceedings.<sup>64</sup>

As a practical matter, the “Enforcement Without Trustee” provisions may mean that the first creditor to the courthouse will largely control the litigation against Congo (Brazzaville).<sup>65</sup> In addition, if this creditor actually manages to

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64. Trust Indenture between the Republic of Congo, as Issuer and HSBC Bank U.S.A., N.A., as Trustee, § 4.9 (Nov. 15, 2007) (on file with *Law and Contemporary Problems*).

65. As indicated in clause (b) of the quoted language, the indenture provides a number of provisions that will allow the majority of the bondholders to join, or take control of, such litigation as

receive payment on its judgment either from Congo (Brazzaville) or by seizing sovereign assets, then it is required to share such proceeds with all other creditors after deducting all the costs of litigation and collection. The hope is that the disincentive to legal proceedings that sharing clauses present in other indentures will be dissipated by the assurance that the prosecuting bondholder will get its costs back first. Bondholders' ability to sue for the entire amount of the collective claim will help justify the costs of suit and collection. If the collective-enforcement mechanism does not work in the hands of the trustee, the hope is that it will work in the hands of a motivated individual bondholder.

As an innovation, the Congo (Brazzaville) enforcement mechanism is still untested and not without some potential dysfunction. The first to the courthouse might be a rogue creditor—one that intends to manipulate the enforcement procedure for its own benefit rather than for the majority of bondholders. If negotiations are underway with other bondholders, they might have to organize to displace the rogue creditor to keep its suit from derailing such negotiations. Moreover, the majority controls over a prosecuting bondholder provided in the Congo (Brazzaville) indenture are complex and must be coordinated with the procedural rules of the jurisdiction in which the judicial proceedings are brought. Time will tell whether the Congo (Brazzaville) enforcement mechanism is needed and, if so, whether it will provide the creditors with an efficient and reliable means of obtaining payment.

#### IV

#### CONCLUSION

Before Congo (Brazzaville) agreed to officially recognize the Congo Creditors' Committee, it would have been hard to overestimate how concerned its members were about the trend toward unilateral exchange offers as a technique for restructuring sovereign debt. The Committee members were not the only ones. Industry groups, with which the committee members were in regular contact, were equally concerned. The Congo (Brazzaville) transaction represented a ray of sunshine cutting through the shadow cast by the cases of Ecuador and Argentina. Congo (Brazzaville)'s embrace of creditor negotiations of both the financial and legal terms puts it in line with the creditor negotiations of the financial terms in the Grenada transaction and the creditor consultations on the financial terms in the Belize transactions. Perhaps future resolutions to some of the pending sovereign crises will tell whether the Ecuador–Argentina trend has in fact been supplanted by a new, more creditor-friendly trend towards negotiated solutions.

The Congo Creditors' Committee hopes innovations in the Congo (Brazzaville) Engagement Clause will foster a negotiated solution for any future crisis that Congo (Brazzaville) may face. Congo (Brazzaville)'s creditors

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they may feel necessary. But the inertia associated with getting a majority of creditors to act together will likely provide a prosecuting bondholder with a fair amount of leeway to pursue the litigation.

would have to overcome some challenges, though, before the Engagement Clause would have its desired effect. First, after a default by Congo (Brazzaville), a majority of its bondholders would have to overcome the inherent difficulties of identifying one another. Then they would have to find a way to communicate with one another efficiently enough to organize the identification and approval of institutions willing and qualified to participate on a negotiating committee. This task might be all the more difficult should Congo (Brazzaville) exercise its right not to recognize such a committee. In such a case, the committee members would have no assurance that their expenses for acting on the committee would be reimbursed by Congo (Brazzaville). Congo (Brazzaville) might have the right to refuse recognition of a committee, but it would also face some practical challenges as a result of such refusal. Overall, the Congo Creditors' Committee felt it had advanced creditors' rights by including their ability to organize a committee to engage Congo (Brazzaville) during a crisis. Should negotiations not prove possible, Congo (Brazzaville)'s bondholders would still have the option of enforcement.

The innovations in the Enforcement Mechanism of the Congo (Brazzaville) Indenture may be the most striking feature of the Congo (Brazzaville) transaction. I am aware of no other indenture that attempts to replace the trustee with a bondholder to represent all other bondholders in default situations in which the trustee fails to act. The checks and balances provided to the majority of bondholders under the Congo (Brazzaville) Enforcement Mechanism over the bondholder that takes the trustee's place may prove too cumbersome to be effective for the majority or may even disrupt or delay the litigation itself. But the mechanism has its advantages. One is that it gives creditors the incentive to take responsibility for the enforcement of their own rights. It achieves this by (1) encouraging a creditor to replace the trustee to gain control over the litigation, subject to majority oversight, (2) ensuring that the litigating creditor can make a claim for the entire amount of the bond issuance, and (3) allowing the litigating creditor to collect its costs and expenses before sharing any recovery with its fellow bondholders. All hope that the Congo (Brazzaville) enforcement mechanism will never be needed; but, if it is, creditors hope that it will be an efficient and reliable means of obtaining payment.

Whether or not the innovations and techniques employed in the Congo (Brazzaville) transaction will endure remains to be seen. But even if the Congo (Brazzaville) transaction is not duplicated by another sovereign, it is sure to further the ongoing discussions regarding more-efficient sovereign debt restructurings. It may well prove to be an important step in an evolution towards a more equitable and balanced trust structure for sovereign issuances that will discourage holdouts while ensuring bondholders a more effective and efficient means of engaging the sovereign and, if necessary, enforcing contractual obligations against it.