

## EU publishes mandatory Collective Action Clause for use in eurozone sovereign bonds from 1 January 2013

### 1 Overview

In February 2012, eurozone member states signed a modified version of the Treaty Establishing the European Stability Mechanism. Amongst other things, this treaty provides for the mandatory inclusion of standardised and identical Collective Action Clauses (“**CACs**”) in all new eurozone sovereign bonds from 1 January 2013. A sub-committee of the Economic and Financial Committee on EU Sovereign Debt Markets (the “**Committee**”) developed the terms of this mandatory collective action clause which was published on 26 March 2012 (the “**Model CAC**”). As a result, from 1 January 2013, eurozone sovereigns will be obliged to include the Model CAC in bonds with a maturity of greater than one year, irrespective of their governing law. The Model CAC will apply to both international and domestic issues, regardless of whether the security is listed, traded or privately placed<sup>1</sup>.

The sovereign bond market is familiar with CACs. In 2004, following the G-10 recommendations, the International Capital Market Association produced a recommended CAC (the “**ICMA CAC**”) for use in sovereign bonds governed by English law. Sovereign bonds governed by English law commonly include CACs. However, most EU sovereigns do not include CACs, at least in their domestic issues. The sovereign debt crisis across Europe has now brought CACs back on the agenda.

In this note we look at the terms of the Model CAC and how they differ in a number of respects from the ICMA CAC. One of the significant differences is that the Model CAC provides that modifications may be made either to a single series or to more than one series of bonds (a “**cross-series modification**”).

Eurozone sovereign bonds issued prior to 1 January 2013 will not be affected by the Model CAC unless such bonds themselves contain provisions that allow for their modification on a cross-series basis. As at 26 March 2012, the

<sup>1</sup> Eurozone sovereigns will be able to tap existing securities issuances which do not include the Model CAC up to a limited percentage of all bonds issued by that Member State in that year. For example, in 2013, a Member State will be able to tap 45 per cent of all bonds issued. The percentages decrease on a sliding scale every year so that, for example, a Member State will only be able to tap 10 per cent by 2022.

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Committee were not aware of any eurozone sovereign bonds containing such provisions, other than the English law governed bonds issued by Greece in February 2012 as part of its private debt restructuring. Those bonds contain aggregation provisions similar to those in the Model CAC. It may be however, that some sovereigns choose to include the Model CAC provisions (or similar provisions) in the terms of debt issued in advance of 1 January 2013.<sup>2</sup>

## 2 What are CACs?

CACs are contractual provisions that:

- (i) facilitate an issuer approaching bondholders with a proposal to modify key terms of the relevant bond;
- (ii) enable a majority of those bondholders to agree to the proposed modifications; and
- (iii) (where the requisite majority has so agreed) provide that the modifications are binding on all bondholders.

The purpose of CACs is to aid the process of restructuring outstanding bonds - they help avoid disruption from minority bondholders (or hold out creditors) who do not agree to the restructuring proposals. Some CACs also enable a majority of bondholders to prevent a minority from accelerating the bonds following a default. Therefore in the context of a sovereign financial crisis, the CAC is a tool which could facilitate a relatively quick and orderly bond restructuring.

## 3 Key terms of the Model CAC

### 3.1 Two tiered test

The Model CAC provides for a two tiered test to be met before modifications can bind all bondholders.

First, approval must be given at a quorate meeting before a modification can be validly accepted. What constitutes a quorate meeting depends on the importance of the terms proposed to be amended. For example, where an important term (or “**reserved matter**”) is to be considered at a meeting, at least 66⅔% of the principal amount of all bonds outstanding must be represented at that meeting. Where a less important term (or “non reserved matter”) is to be considered at a meeting, at least 50% of the principal amount of all bonds outstanding must be represented at that meeting before it is considered quorate.

Secondly, once a quorum has been achieved, a specified percentage of those bondholders in attendance must vote in favour of the amendments. Again, the threshold will vary depending on the type of modification proposed. For example, for a modification of a reserved matter to be binding on a single series of bondholders, at least 75% by principal amount of bondholders

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<sup>2</sup> The Republic of Slovakia included provisions based on the Model CACs in the terms of its USD issuance in May 2012.

represented at a quorate meeting (see above) must vote in favour of the proposals.

As an alternative, the Model CAC also provides for amendments to be approved by written resolution instead of convening a meeting. Different thresholds apply in respect of written resolutions. See section 3.3 below.

## 3.2 Types of modification

The Model CAC distinguishes between three types of modification. Quorum and approval thresholds applicable will vary depending on the type of modification.

### 3.2.1 *Reserved matter modification:*

A reserved matter modification involves a change to the bond's most important terms and conditions. The reserved matters in the Model CAC include the following:

- > A reduction in any amount payable on a bond. (This is supposed to catch any reduction in principal, interest or additional amounts that may be payable on the bond.)
- > Changes in the dates on which amounts are payable and other changes that may impact the amounts received by bondholders.
- > Modification of the issuer's obligation to make payments.
- > The release of any guarantee or changes in collateral.

A meeting to approve a reserved matter modification requires at least 66 $\frac{2}{3}$ % by principal amount of bondholders to be present in order to reach a quorum. This is the case even if the resolution is to be passed at an adjourned meeting. Once quorate, the level of approval required depends on whether the proposed modifications are to apply in respect of a single series or are intended to apply cross-series.

For modifications to a **single series** of bonds, the resolution must be approved by 75% by principal amount of all bonds represented at a quorate meeting.

For modifications **across a number of series** of bonds, the resolution must be approved by 75% by principal amount of bondholders (aggregate) represented at a quorate meeting plus 66 $\frac{2}{3}$ % by principal amount of bondholders of each individual series represented at a quorate meeting.

### 3.2.2 *Non reserved matter modification*

This involves changing the less important terms of a bond and requires a lower level of bondholder consent. Non reserved matters are (broadly) anything that is not a reserved matter. A meeting to approve a modification to a non-reserved matter requires at least 50% by principal amount of bondholders to be present at the meeting. For an adjourned meeting, only 25% by principal amount need be present. Once quorate, the resolution must

be approved by at least 50% by principal amount of all bonds represented at the meeting.

### **3.2.3 Cross-series modification**

The issuer may make proposals to modify terms across a range of series of bonds. However, this is subject to the condition that every modification proposed must be available to be accepted by every holder of an affected bond.

If the quorum and threshold requirements mentioned in paragraph 3.2.1<sup>3</sup> above are met, the modifications will apply to all of the series subject to the proposal.

A feature of the cross series modification provisions is that if an issuer has 10 series of bonds outstanding and wishes to modify a term of each of those series of bonds, it may do so by resolution at a quorate meeting of the bondholders in aggregate, and quorate meetings of each individual series. If, however, the holders of series 1 to 9 agree to the modification, but there are insufficient agreeable holders in series 10 to meet the relevant approval threshold, the issuer may implement the modifications in relation to those series whose modification would have been approved if the cross-series modification had initially been proposed only in respect of series 1 to 9. This can only be done, however, where investors were informed at the outset of the circumstances in which this could happen.

### **3.3 Written resolutions**

The Model CAC also provides for written resolutions. In this case, 66⅔% by principal amount approval is required for a reserved matter modification in respect of a single series of bonds. Non-reserved matter modifications in respect of a single series of bonds must be approved by holders of 50% of the principal amount of all outstanding bonds.

For a cross-series modification, approval by holders of 66⅔% of the principal amount of all outstanding bonds (aggregate) plus 50% of the principal amount of all outstanding bonds of each series is necessary.

**For ease of reference, the relevant quorum requirements and thresholds under the Model CAC are summarised in Appendix 1 below.**

### **3.4 Procedural rules**

The Model CAC provides for procedural matters including mandatory rules on how bondholder meetings should be held. This is intended to ensure that the CAC operates in the same manner and with the same legal effect in all euro area Member States. However issuers may adopt supplementary rules that are consistent with the obligatory rules included in the Model CAC – e.g. the issuer may specify the documentary evidence required to vote at such a meeting.

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<sup>3</sup> The Model CAC does not contemplate cross-series modifications in respect of non reserved matter modifications.

In addition, eurozone sovereign issuers will be required to appoint a calculation agent to determine whether a proposed modification has been validly approved under the terms of the CAC. This is likely to be the same entity that performs the function of fiscal or paying agent on the bonds. The CAC contains provisions detailing what information from the issuer the calculation agent may rely on for this purpose.

The Model CAC also provides special treatment for zero-coupon and index linked bonds. These provisions set out rules for calculating the principal amount of such instruments (without which the holders might have preferential voting rights as compared to the holder of an interest-bearing bond). There are also transparency rules, requiring appropriate publications of modifications with sufficient notice periods.

### 3.5 Disenfranchisement

Consistent with traditional market practice, the Model CAC disenfranchises government bonds held by the issuer or by any of its ministries, departments or agencies. So an issuer's holdings of its own bonds, and the bonds held by other governmental bodies are therefore treated as not outstanding for purposes of voting or quorum. Essentially, this is a "top down" test that is designed to stop the issuer or those it controls from voting. It is intended to give the "genuine" investor a measure of comfort that the majority that may bind him will be comprised only of "genuine" investors. Where, however, a government-controlled entity has autonomy of decision and is required by applicable law to act independently of any instruction given by an issuer, then that entity's holdings of government securities will not be disenfranchised. The Model CAC therefore includes a number of carve outs that expressly exempt companies having autonomy of decision from the otherwise applicable disenfranchisement of their holdings.

Certain market participants have argued that, in the context of an issue by a eurozone sovereign, the question is more complex. Given that the Euro is both the domestic currency of the issuer and an international currency, if a failure by bondholders to agree to the proposal put to them might result in a threat to the currency itself, other holders (e.g. eurozone states or institutions which are wholly outside the issuer's control) will be inclined to vote in favour. Equally, if the result of a rejection of the proposal put to bondholders might be a collapse in market confidence in the Euro, some holders may favour their larger economic interests over their interests as bondholders and vote in favour of the proposal. Therefore in the context of a eurozone sovereign issue there will always be a risk that there will be bondholders whose interests are focused on matters other than their investment and who are not subject to the control of the issuer. So the typical "top down" disenfranchisement provision may be less effective to protect investors in eurozone sovereign bonds. In this respect, the Eurozone CAC is unlike similar provisions in other sovereign bonds.

However, for political and other reasons, it would likely be unacceptable to include a provision which covered this risk. The Committee took the view that disenfranchising an investor is a "*serious step with important legal*

*consequences and that neither an investor's motives nor the predictability of its vote for or against constitutes adequate grounds for disenfranchising that investor*<sup>4</sup>. Provided that the holder is acting in its own interest (whether those interests be its larger economic interests rather than its interests as a holder of the relevant bonds), the Committee has taken the view that it should be enfranchised. It is therefore important that investors are made aware of the scope of the disenfranchisement provisions in this context.

#### 4 Comparison with the ICMA CAC

The Model CAC and the ICMA CAC differ in a number of respects.

- > Unlike the Model CAC, the ICMA CAC does not have any cross-series modification mechanism. It operates only in respect of the particular bond issue of which it is a term.
- > The Model CAC is intended to apply in terms of bond issues which are governed by any law. The ICMA CAC is recommended to apply only for English law governed issues.
- > The quorum thresholds in the ICMA CAC in respect of meetings which propose modifications to a reserved matter are higher – at 75% (rather than 66⅔% in the Model CAC). In addition, under the ICMA CAC a proposal to modify a reserved matter requires the approval of 75% of the aggregate principal amount of all the outstanding bonds (as opposed to those represented at that meeting). The ICMA CAC also has higher approval thresholds for written resolutions – 75% and 66⅔% for reserved and non reserved matters respectively. The Model CAC sets lower thresholds of 66⅔% and 50% respectively. It is worth noting that the thresholds in earlier drafts of the Model CAC were even lower than those in the final version. These thresholds were raised following concerned responses to the initial consultation.
- > In the ICMA CAC, certain modifications require unanimous approval. For example, modifications relating to changes to the governing law and/or jurisdiction clauses. The Model CAC treats these as reserved matters, thus necessitating only 75% approval. Furthermore, it will only be considered a reserved matter if the bonds are governed by a foreign law. According to the Committee, this is because the issuer already has the power, at least in theory, to adopt any desired modification by means of domestic legislation without changing the law governing its bonds.<sup>5</sup> We have, of course, seen an example of this when the Greek Bondholder Act was passed on 23 February 2012 pursuant to which the terms of various Greek law governed sovereign bonds were amended.
- > In the ICMA CAC bondholders may (if at least 50% agree) appoint a committee to represent the interests of all of the bondholders. The committee then has the power to enter into discussions with the issuer

<sup>4</sup> Supplementary Explanatory Note to the Model CAC released on 26 March 2012.

<sup>5</sup> The Explanatory Note to the Model CAC, released on 26 July 2011.

and, in essence, give a voice to the multitude of bondholders that it represents. There is no such concept in the Model CAC.

- > The ICMA CAC contained provisions relating to “Declaration of Acceleration” and “Withdrawal of Declaration of Acceleration”. The former permits holders of at least 25% to declare the bonds due and payable following an event of default. It is combined with the latter provision which allows that declaration to be withdrawn if the issuer receives notice in writing from at least 50% of holders that they want the relevant declaration to be withdrawn. The Committee has however recommended that such a clause be included to the extent that it is consistent with an issuer’s existing practice and applicable law. The text of such a recommended provision, along with other recommended provisions, has now been published alongside the Model CAC.

## **5 Governing Law and Enforcement**

The Model CAC included in any bond issued by a eurozone sovereign will be governed by the same law that governs the terms of that bond. Any dispute arising out of or relating to the CAC included in a bond issued by a eurozone sovereign will be resolved on the same basis and before the same courts as any other disputes arising out of or in connection with any other provision of that bond. As part of the process of implementing the Model CAC, each eurozone member state will be required to deliver a legal opinion to the Committee confirming that the model CAC will be legal, valid, binding and enforceable in accordance with its terms under the laws of that Member State. Of particular concern will be any constitutional provisions that may restrict the effectiveness of the CAC, because such provisions cannot simply be overridden by legislation but will typically require an amendment by means of a plebiscite.

## **6 Conclusion**

The Model CAC is intended to be a tool to facilitate the restructuring of eurozone sovereign debt. The efforts of the Committee in terms of requiring that the operation of the CAC be transparent and equitable are to be commended.

Given the potential impact of an exercise of the Model CAC, it is important that investors are educated as to its terms. Investors should be aware that important terms of the bonds may be amended by a defined majority of holders and that such amendments may be binding on all holders, including those who either did not vote or voted against any such amendment. They should also note that the Model CAC makes no provision for the consent of (say) 50% by number of individual holders (i.e. to prevent one or two large holders driving through a solution that favours them.) Equally investors should remember that in the context of eurozone sovereign bonds, different holders can have significantly varying interests (see paragraph 3.5 above).

To date the majority of emerging market sovereign debt restructurings have been achieved by way of an exchange offer. More recently in the Greek debt

restructuring the exchange offer was combined with consent solicitations to provide for redemption provisions in the terms of the debt instruments. It remains to be seen whether exercising the Model CAC will become the preferred method of achieving restructurings in the future. However, given that Model CAC only affects issuance from 1 January 2013, it may not be a tool which is particularly helpful in dealing with the current crisis.

## Appendix 1 – Summary of quorum and approval threshold requirements

Reserved matter modification:

	Single series (meeting)	Cross series (meeting)	Single series (written)	Cross series (written)
Quorum	66⅔%	66⅔%	N/A	N/A
Approval Threshold	75%	75% of all affected series in aggregate plus 66⅔% of each affected series	66⅔% of all outstanding bonds affected	66⅔% of all affected series in aggregate plus 50% of each affected series

Non reserved matter modification:

	Single series (meeting)	Cross series (meeting)	Single series (written)	Cross series (written)
Quorum	50%*	No option available	N/A	No option available
Approval Threshold	50%	No option available	50% of all outstanding bonds affected	No option available

\* If it is an adjourned meeting, the quorum threshold is 25%.

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