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Can Collective Action Clauses Migrate to the Latam Corporate Bond Market?

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Customary English law-governed bond documentation for corporate issuers includes provisions in the trust deed that permit the issuer and specified percentages of bondholders to modify the basic economic terms of the bonds without requiring that each holder agree, and any such modifications, if adopted by the requisite number of holders (usually at properly convened meetings), become binding on all holders regardless of whether they agreed to them. These so-called "collective action clauses" (or CACs) were designed to facilitate orderly out-of-court restructurings of contractual obligations arising under English law and particularly to deal with situations where all the bondholders cannot be traced or where a dissenting minority unreasonably blocks a generally beneficial reorganization.

Bond documentation governed by New York (or other U.S. state) law has historically not included these provisions and indentures governing bond offerings in the United States, including private "Rule144A" offerings made by Latin American issuers, invariably include provisions that require the affirmative vote of each holder "affected" by a substantial modification (such as maturity, interest rate or guarantor or collateral release) in order to be effective.

There are several reasons for this. First of all, the availability in the United States of the Chapter 11 reorganization process for many issuers provides an accessible judicial mechanism for the super-majority of creditors to exert control over a dissident minority if adjustment to fundamental economic terms is necessary. In addition, the U.S. Trust Indenture Act of 1939, a federal law that applies to most registered offerings of debt securities in the United States, effectively prohibits such provisions in bond indentures that are required fundamental to be qualified - essentially those for bond offerings that are required to be registered with the Securities and Exchange Commission under the U.S. Securities Act of 1933. Finally, although exempt offerings, such as private placements or offerings of debt securities by sovereign states, are not subject to Trust Indenture Act, the U.S. institutional investor market, the principal buyers of corporate bonds - has largely shunned these types of clauses and indentures for exempt offerings have generally included the same sort of protections that are present in qualified indentures.

Furthermore, if an exempt offering is subject to registration rights (which is common in offerings by companies that are already reporting companies under the U.S. Securities Exchange Act of 1934), the subsequent registration or the exchange offer or resale registration statement will entail the need for indenture qualification where the CACs would not be permitted, even if the indenture for the exempt offering would technically allow it.

In the late 1990s, there began a progressive awareness in the sovereign debt market that the inclusion of CACs in either the fiscal agency agreement or indenture governing bonds issued by sovereign issuers, particularly those that had a history of default and restructuring, was desirable. This was in part due to the absence of a workable insolvency regime for sovereign states and the long history of difficult negotiations between states and their private sector creditors who were mostly bondholders in the post-Brady Bond era. The exemption for sovereign issuers from the constraints of the Trust Indenture Act provided the legal basis for the inclusion of such provisions in sovereign bond documentation governed by New York law. In 2003, Mexico became the first country to include a collective action clause in its sovereign bonds, contrary to market convention at the time. The sovereign bond market grew increasingly accustomed to these clauses, in large part because of the urging of the U.S. Treasury and the multilateral institutions which were anxious to avoid a repetition of the history of minority holdouts holding sovereign debt restructurings hostage to their claims. Today, most indentures and fiscal agency agreements for sovereign issuers that are governed by New York law contain CACs. The typical provision allows holders of 85% of the outstanding principal amount of the bonds to amend material terms of the bonds, although some countries have included lower thresholds, such as 75%.

The practice of including CACs for pure sovereign issuers progressively migrated to the quasi-sovereign or sub-sovereign issuer market as well, mostly for the same reasons. A debt restructuring of a sub-sovereign entity that is

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not subject to a corporate insolvency regime in the applicable jurisdiction is largely subject to the same types of concerns and should be easier to manage if CACs are included to eliminate or at least reduce hold-out pressure. Bonds offered by Argentine provinces and governed by New York law, for example, now routinely contain these same provisions.

Why not include CACs in bond documentation governed by New York law for exempt offerings of debt securities by Latin American corporate issuers? Given the restructuring experience of the past several years, one might reasonably conclude that the concerns underpinning the need for contractual pressure on small “hold-out” minorities are equally present, particularly for issuers located in jurisdictions where the bankruptcy regime may be somewhat untested or where there is concern as to the ability of the judicial system to apply it, or both.

A recent trend has emerged, most notably in European high-yield bond offerings, of including CACs in bond documentation governed by New York law where the offering is placed in part in the United States with institutional investors in reliance on the exemption from registration provided by Rule 144A under the Securities Act. Most of these offerings appear to be primarily by European issuers, with a Rule 144A tranche, and are often denominated in Euros. Although U.S. law firms, presumably through their London offices, are often listed as legal advisors to the issuer and the initial purchasers, because the offerings are primarily marketed in Europe, the English law practice of including CACs seems to have migrated to New York law-governed indentures, at least for offerings of securities by issuers located or listed in London or areas east of London. It is somewhat unclear as to whether this development was a deliberate attempt to incorporate CACs into the documentation or whether it was a more casual attempt to adapt an English law concept into a New York law-governed document.

Can we expect other corporate bond offerings in the United States market to follow suit? Exempt offerings for purely U.S. issuers, such as for U.S. reporting companies wishing to access the Rule 144A market quickly, with registration rights presumably to follow, will be forced to continue excluding CACs in the indentures because the subsequent registration of the exchange offer or resale shelf registration statement with a qualified indenture will act to preclude the inclusion of these clauses.

However, what about non-reporting foreign issuers who offer Rule 144A “for life” debt without registration rights? Except for U.S. reporting issuers, the vast majority of corporate bond deals out of Latin America are done on that basis. If the jurisdiction where the issuer is likely to be subject to insolvency proceedings (presumably the place of incorporation or principal place of business) has a bankruptcy law that is well accustomed to handling cross-border insolvencies with foreign creditors and has a timely and efficient process for dealing with cases where pre-bankruptcy arrangements can be worked out and enforced by local courts, then CACs may not be perceived as strictly necessary or appropriate. If, however, the market perceives that there may be some benefit to having a contractual mechanism to amend economic terms of the bonds with a super-majority vote without the need for unanimous consent, would the U.S. institutional investor market readily accept CACs in corporate debt offerings for Latin American issuers?

Some issuers in emerging markets end up choosing English law as opposed to U.S. law (principally New York law) to document the transaction solely for the reason that CACs are standard fare in English law bond documentation and that CACs are desirable. The perception is that English law provides a customary legal framework for the inclusion of such clauses. Presumably U.S. institutional investors who purchase debt securities of emerging market issuers that are otherwise attractive from an economic perspective are not dissuaded from making a purchase because the bond documentation happens to include a trust deed governed by English law and includes a CAC. If so, then why would the same investor object if the CAC were included in an indenture governed by New York law?

Conversations with buy-side emerging markets investors reveal that they are often unaware of the differences between the two sets of legal rules or that CACs are even included in the trust deed. However, when faced with the question of whether they would object to New York law governed indentures for corporate issuers including a CAC, the answer is invariably negative, with the caveat of having a threshold for super-majority consents that is not unreasonably low for fundamental modifications. What is unreasonably low? Many investors seem to be prepared to live with an 85% threshold, the level included in a substantial majority of bond indentures for sovereign and quasi-sovereign issuers, expressing concerns that any lower threshold would be problematic.

Given the ability of small minorities of bondholders to disrupt a debt restructuring of a corporate issuer in cases where a substantial majority has arrived at some satisfactory arrangement with the issuer, and taking due note of the fact that English law bond documentation already provides for the modification of economic terms with a super-majority vote, it seems that indentures governed by New York are at a competitive disadvantage, particularly for issuers located in jurisdictions where the bankruptcy process is not considered by market participants as a particularly appealing alternative to enforcing a consensual debt restructuring. This is likely perceived to be the case in many Latin American jurisdictions. Thus, the time may have come to contemplate CACs in New York law-governed corporate bond offerings by Latin American issuers, at least for those who are not reporting issuers in the United States. As with many innovative features in legal documentation, it may take only one offering to pave the way, but CACs may see the light of day in the corporate bond market in the not-too-distant future.

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