2019

Restructuring Euro Area Sovereign Debt: Have the Options Narrowed?

W. Mark C. Weidemaier

Restructuring Euro Area Sovereign Debt: Have the Options Narrowed?

W. Mark C. Weidemaier*

Contact:
UNC School of Law
160 Ridge Road, CB #3380
Chapel Hill, NC 27599-3380
email: weidemaier@unc.edu
tel: 919-843-4373

Abstract: This Essay examines the intersection between two key attributes of sovereign debt governance in the Euro Area. First, sovereigns mostly issue bonds governed by their own law. This "local law advantage" should make debt restructuring comparatively easy, for the sovereign can change the law to reduce its debt. The second attribute is the so-called Euro CAC, a contract-based restructuring mechanism mandated by the Treaty Establishing the European Stability Mechanism (ESM). Euro CACs let a bondholder supermajority approve a restructuring and bind dissenters. Since 2013, nearly all Euro Area sovereign debt has included the clause. Many believe the ESM Treaty requires governments to use the Euro CAC to restructure. But if so, the Treaty is a suicide pact, for the design of the Euro CAC is flawed. In a meaningful subset of cases, the clause will not provide adequate debt relief. This Essay makes two primary contributions. First, using an Italian restructuring as an example, it explains why the ESM Treaty does not, in fact, require the use of the Euro CAC. Second, it examines the legal constraints—the most pertinent of which derive from the European Convention on Human Rights—that do restrict the use of local law advantage.

Keywords: Sovereign Debt, Eurozone, Italian debt, Sustainability

JEL Codes: F33, F34, H63

1. Introduction

The acute stage of the Eurozone sovereign debt crisis is over, but high debt, political uncertainty, and low growth leave some governments little room to respond to economic shocks. Official actors maintain the view, even after Greece's 2012 restructuring, that there will be no

* Ralph M. Stockton, Jr. Distinguished Professor, University of North Carolina School of Law. For helpful comments and questions, thanks to Lee Buchheit, Mitu Gulati, Yannis Manuelides, Jeromin Zettelmeyer, and to workshop participants at the Third Interdisciplinary Sovereign Debt Research and Management Conference.

more sovereign debt restructurings in the Euro Area.[1] Despite this insistence, the prospect of another restructuring does not seem so unlikely.[2] The goal of this Essay is to assess whether recent developments have eliminated one of the key restructuring tools available to Euro Area sovereigns.

My inquiry lies at the intersection of two features of Euro Area sovereign debt. The first is that sovereigns tend to issue bonds governed by their own law. This 'local law advantage' makes it comparatively easy to restructure bond debt.[3] To use an extreme example, a government might enact legislation imposing a 50% tax on payments to bondholders. Less extreme examples are easy to find. In 2012, Greece undertook the largest sovereign debt restructuring in history by passing a law providing for a collectively-binding restructuring vote taken across most of the country's local-law debt stock.[4] The recent restructuring in Barbados has followed a similar approach.[5] In the 1930s, as countries abandoned the gold standard, the United States changed its law to retroactively eliminate contractual protections indexing bond payments to gold.[6] To be sure, there are legal constraints, and some uses of local law advantage—such as the 50% tax—may be prohibited. In general, however, local-law debt is easily restructured.

---

[1] Mehreen Khan and Claire Jones, *Draghi Gets Hot Under the Collar After Dutch MP Grilling*, 10 May 2017 (quoting ECB President Mario Draghi as saying, 'We don't want to speculate on the probability of things that have no chance of happening. Why are you asking me that?'), available at https://www.ft.com/content/cf0719a1-fcaf-3458-b99d-1425b2a36e78?mhq5j=e6.

[2] See, e.g., Kate Allen, *Italian Bank Bond Binge Revives Fears of Sovereign 'Doom Loop'*, 27 Feb. 2019, available at https://www.ft.com/content/07ad20c8-3a83-11e9-b72b-2c7f526ca5d0

[3] Buchheit and Gulati, 'Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds', *University of Bologna Law Review (Univ. Bologna Law Rev.)* (forthcoming, written 17 April 2018).

[4] Zettelmeyer, Trebesch and Gulati, 'The Greek Debt Restructuring: An Autopsy,' 28 *Economic Policy (Econ. Policy)* (2013) 513, 554 & n. 47.

[5] Barbados Government Information Service, *Final Creditor Participation for Debt Exchange Offer*, 30 Oct. 2018, available at https://gisbarbados.gov.bb/blog/final-creditor-participation-for-debt-exchange-offer/.

[6] S. Edwards, *American Default: The Untold Story of FDR, The Supreme Court, and the Battle Over Gold*, (2018).

This would clearly be true for governments in the Euro Area, were it not for a second feature of Euro Area sovereign debt. As part of the response to the sovereign debt crisis of 2010-2013, Euro Area governments mandated the inclusion of standardized collective action clauses (CACs) in all bonds issued after January 1, 2013 with a maturity of over one year. These 'Euro CACs' let a bondholder supermajority approve a debt restructuring in a vote that binds dissenters. Euro Area governments hoped the clauses would ensure 'private sector involvement' in cases where the new European Stability Mechanism (ESM) provided emergency loans to a debtor nation.[7] If bondholders do not take losses, bailout funds will line their pockets; this buys time and may help a sovereign facing a liquidity problem, but it does no good if the problem is insolvency.

The combination of local law advantage and Euro CACs creates one of the central uncertainties affecting any restructuring of Euro Area sovereign debt. History teaches that borrower governments can easily restructure debt governed by their own laws. But this intuition co-exists with a widespread sense that Euro CACs make it harder for governments to exploit local law advantage. The reasons are often left unstated but seem driven by the view that governments *must* use the Euro CAC to restructure. So understood, Euro CACs are a mixed blessing. They open a new path to debt relief for a sovereign that can win the support of a bondholder majority, the size of which is defined ex ante. But they impede other paths, which a desperate (or opportunistic) sovereign might travel to ease its debt burden.

The goal of this Essay is to ask whether Euro CACs in fact have this effect. To summarize the argument: I am skeptical that Euro CACs materially constrain local law advantage. From the perspective of the restructurer, Euro CACs are the safe option, not the only one. A sovereign that

---

[7] Preamble ¶ 12, Treaty Establishing the European Stability Mechanism, (2012) T/ESM 2012-LT.

satisfies the Euro CAC's voting requirements can rest easy; its restructuring will leave no holdouts and will survive almost any legal challenge.[8] But a sovereign that has issued local-law debt remains free to alter its law to facilitate restructuring. This path involves more risk. The sovereign is constrained by its own law and institutions, by international law, and (in the Euro Area) by European law and institutions. Yet the constraints are not absolute; there is room for the prudent exercise of local law advantage. Moreover, the introduction of the new CACs should not cause tribunals to view the use of local law advantage with greater skepticism. The reason is that, given serious flaws in the current design of the CACs, a sovereign restructurer's failure to use the clause does not signal that it is acting opportunistically. I doubt a Euro Area sovereign would eschew the CACs without good reason, but the option is there.

2. Are Euro CACs the Exclusive Option?

An example will help clarify the argument. I will use Italy, although the argument could be applied to other sovereigns. There is reason to believe that Euro CACs will prove inadequate to solve the creditor-side collective action problems that can jeopardize a debt restructuring. The question is whether the government has other tools at its disposal.

---

[8] Proof of vote rigging or coercion might suffice to invalidate the vote, but these should be rare instances. *See generally* Martinelli, 'Euro CACs and the Existing Rules on Sovereign Debt Restructuring in the Euro Area: An Appraisal Four Years after the Greek Debt Swap', *A Dynamic Economic and Monetary Union (ADEMU)* Working Paper Series WP 2016/043 (May 2016) at 9-10; Waibel, 'Opening Pandora's Box: Sovereign Bonds in International Arbitration', 101 *The American Journal of International Law (Am. J. Int'l Law)* (2007) 711, at 724.

A. Italy's Potent Local-Law Advantage

Italy's sovereign debt exceeds 2 trillion Euros; more than 90% is governed by Italian law.[9] Any restructuring plan will face challenges. Most notably, Italians hold most of the debt and much of this concentrated in Italian banks. Domestic creditors will suffer deeply in a restructuring. From the legal perspective, however, it appears rather simple to restructure Italian debt, at least if we temporarily ignore the Euro CACs.[10]

In a restructuring, any sovereign with mostly local-law debt operates from a position of relative strength. Some would argue that Italy's position is even stronger. Most uses of local law advantage require the government to change the rules after borrowing the money. This creates legal risk, for the law generally protects property rights and disfavors retroactivity. Years of litigation followed Greece's decision to retroactively impose a collective voting mechanism. Greece has won before every tribunal, but litigation continues to this day.[11]

By contrast, some mechanisms for restructuring Italian debt arguably do not raise such acute retroactivity concerns. For example, the 2003 Consolidated Act regulating Italian public debt authorizes the Ministry of Finance to issue decrees permitting the Treasury, "to proceed, in order to restructure the national and external public debt," to take a number of steps, including

---

[9] Except where noted, figures are extracted from Banca D'Italia, *The Public Finances: Borrowing Requirements and Debt*, 15 Mar. 2019, available at http://www.bancaditalia.it/pubblicazioni/finanza-pubblica/.

[10] To be sure, there are complexities. For example, although miniscule in proportion to the overall debt, some foreign-law bonds expressly promise to pay bondholders ratably, creating the risk that holdouts might seek to enjoin payments to restructuring participants. *See* Weidemaier and Gelpern, 'Injunctions in Sovereign Debt Litigation', 31 *Yale Journal on Regulation (Yale J. Reg.)* (2014) 189.

[11] Grund, 'Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe', 12 *Capital Markets Law Journal (Cap. Mkts. L. J.)* (2017) 253.

"the transformation of maturities."[12] Though I am agnostic as to the meaning of this law, some argue that it provides authority for the government to unilaterally extend the maturities of Italian bonds.[13] If so, bondholders can hardly complain if the government, in good faith, takes advantage of restructuring authority that was on the books at the time of the loan.

Whether or not Italian law currently lets the government act unilaterally, Italy might change its law to facilitate restructuring of local-law bonds. The complication arises from the Euro CAC mandate in Article 12 of the Treaty Establishing the European Stability Mechanism (ESM). An international treaty operating outside EU law, the ESM mechanism provides emergency liquidity assistance to member states that have lost market access.[14] There are no clear rules about when private creditors must take losses as a condition of a sovereign borrower's access to ESM loans.

---

[12] Decree of the President of the Republic of December 30, 2003, no. 398 (published in the Official Gazette of 9/3/2004, Supplemento ordinario no. 37).

[13] Andrew Edelen, Paige Gentry, Jessalee Landfried, and Theresa Monteleone, *A Mature Approach: Using a Unilateral or Voluntary Extension of Maturities to Restructure Italian Debt* (Jan. 10, 2013), *at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2077995. As Giampaolo Galli explains, Italian officials apparently disagree with the argument. *See* Giampaolo Galli, *Collective Action Clauses and Sovereign Debt Restructuring Frameworks: Why and When is Restructuring Appropriate* (June 3, 2019 draft), *at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3386125. As noted, I do not have a strong view on this question. I note, however, that many objections to the existence of a unilateral restructuring power are expressed in conclusory terms. One argument (expressed to me privately) invokes language in past framework decrees issued by the Ministry of Economy and Finance, authorizing the Italian Treasury to restructure "by mutual consent" and stating that "restructuring operations do not modify the terms and conditions of single loans ordered unilaterally by the issuing authority." *See, e.g.,* Republic of Italy, Ministry of the Economy and Finance, Framework Decree No. 99912 dated December 18, 2012. But these decrees do not conclusively answer the question. The Consolidated Act authorizes the Ministry to delegate powers to the Italian Treasury each year. The Ministry does this by decree. The decrees typically confer only a subset of available powers; they do not purport to describe the full powers the Ministry might confer. For instance, the 2019 decree does not expressly authorize restructuring, although that is an available power. *See* Republic of Italy, Ministry of the Economy and Finance, Framework Decree dated January 2, 2019. To return to the "mutual consent" language emphasized by those who deny the ability to restructure unilaterally: Why would these decrees stress the need for "mutual consent" if the Consolidated Act did not permit non-consensual restructurings? One does not normally disclaim the intent to delegate powers that do not exist.

[14] Grund and Stenstsröm, 'A Sovereign Debt Restructuring Framework for the Euro Area', 42 *Fordham Journal of International Law (Fordham Int'l L.J.)* (Forthcoming Oct. 2018) 795, at 806.

But the Treaty recognizes that, at least in some cases, it will be politically and economically foolish to disburse bailout funds only to have the recipient government immediately use the funds to pay private creditors. Euro CACs were viewed as a tool to ensure 'an adequate and proportionate form of private sector involvement' in such cases.[15] Approximately 70% of Italian bond debt now includes the new clauses; soon bonds with Euro CACs will comprise nearly the entirety of Italy's debt.

Euro CACs include two separate mechanisms for modifying the bonds' payment terms and other so-called 'reserved matters.'

- The issuer may solicit separate votes for each bond series affected by the modification. To simplify, if holders of 75% in aggregate principal amount of an affected series vote in favor, the modification binds all holders in that series.[16]
- Alternatively, the issuer may propose a cross-series modification in which votes are aggregated across multiple series in a so-called 'dual-limb' vote. The issuer must win the approval of (i) 75% in aggregate principal amount of the entire group *and* (ii) over two-thirds of each affected bond series. If dissenters hold one-third or more of any series, it is excluded from the restructuring.

For present purposes, the primary difference between these approaches is that, in a series-by-series vote, dissenting creditors must acquire over 25% of a series to block the modification. In a cross-series vote, that proportion rises to 33 percent.

Whichever path the issuer chooses, there will be holdouts. Greece's experience is illustrative. There, the government had to conduct bond-by-bond votes in the subset of its debt governed by foreign law. Nearly half of the votes failed, and in all but one case, holdouts

---

[15] ESM Treaty, Recital 12.

[16] In fact, the voting threshold depends on whether the vote is conducted at a meeting (75% of the aggregate principal amount represented at the meeting) or by written resolution (66.67% of bonds then outstanding). Given the quorum requirement for a meeting, a modification can in theory be approved with the support of a bare majority.

commanded well over one-third of the vote.[17] Returning to the Italian example, it is easy to envision a scenario in which an attempt to restructure Euro CAC bonds leaves significant number of holdouts.[18] It is precisely this scenario in which a Euro Area sovereign might consider the use of local law advantage.[19] Do the CACs foreclose that option?

Much of the writing on this question involves the scenario in which a sovereign borrower leaves the Euro and redenominates local-law debt into the new currency. In that context, some observers appear to believe that Euro CACs forbid redenomination unless approved under the Euro CAC's voting procedures.[20] Others disagree; to them, CACs offer no protection whatsoever to holders of local-law debt.[21] Of course, redenomination is a relatively extreme example of a sovereign's ability to manipulate its own law. But even when discussing more likely scenarios,

---

[17] *See* Zettelmeyer, Trebesch and Gulati, 'The Greek Debt Restructuring: An Autopsy', 28 *Economic Policy (Econ. Pol'y)* (2013) 513, 554 & n. 47; Grégory Claeys and Antoine Mathieu Collin, *Does the Eurogroup's Reform of the ESM Toolkit Represent Real Progress?,* 13 Dec. 2018, available at **http://bruegel.org/2018/12/does-the-eurogroups-reform-of-the-esm-toolkit-represent-real-progress/.**

[18] Holdout dynamics may differ from the Greek scenario. Holders of Greece's English-law debt had the right to accelerate and demand full payment if the government defaulted. There seems to be no corresponding right to accelerate Italian debt. Nevertheless, holdouts can 'piggyback' on the ECB's large holdings of sovereign bonds. The ECB will not vote in favor of a debt restructuring. Although it keeps its holdings below the threshold necessary to prevent modification, its large stake reduces the size of the investment needed for a prospective holdout to acquire a blocking position. On this dynamic generally, see Yannis Manuelides, *Using the Local Law Advantage in Today's Eurozone* (draft dated June 17, 2019), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3405422.

[19] Of course, for bonds without CACs, including pre-2013 local-law bonds, the issuer would have little choice but to rely on its local law advantage.

[20] For example, a 2017 report by Mediobanca Securities on Italian redenomination risk assumed that the government would not even attempt to redenominate CAC bonds. Mediobanca Securities, *Italy: Re-denomination Risk Down as Time Goes By*, 19 Jan. 2017, available at http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf

[21] John Dizard, *Delusional Lawyering Won't Save European Bonds*, 24 Feb. 2017, available at https://www.ft.com/content/8b16caf0-fa88-11e6-bd4e-68d53499ed71

academics and policymakers seem to think that bonds with Euro CACs will prove harder to restructure.[22]

To make the question concrete, consider two ways Italy might use its local law to modify the rights of Euro CAC bondholders. The first, described earlier, is to unilaterally extend bond maturities using existing authority under Italian law. Call this the 'reprofiling' option. The second option, modeled on the Greek Bondholder Act, is a 'retrofit CAC.' Here, the government prefers to solicit bondholder assent to a restructuring but recognizes that existing contractual mechanisms—including the Euro CACs—will leave an unacceptably high proportion of holdouts. To solve the problem, it retroactively enacts legislation providing for a single restructuring vote aggregated across the entire local-law debt stock. This 'single limb' approach differs from the Euro CACs in that it does not allow dissenting voters to acquire a blocking stake in a single series of bonds.[23]

In relevant part, this is what the Euro CACs have to say about these possibilities. For simplicity, I quote the provision dealing with cross-series modification; the emphasis is mine: 'In

---

[22] Grund, 'Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe', 12 *Capital Markets Law Journal (Capital Markets L. J.)* (2017) 253, at 266-271; Panizza, 'Public Debt Risks in Italy: Myths, Facts, and Policies', 10 *Capital Markets L. J.* (2015) 181, 188; Iversen, 'The Future of Involuntary Sovereign Debt Restructurings: Mamatas and Others v. Greece and the Protection of Holdings of Sovereign Debt Instruments Under the ECHR', 14 *Capital Markets L. J.* (2017) 34, 46; Jean Pisani-Ferry and Jeromin Zettelmeyer, *Could the 7+7 Report's Proposals Destabilize the Euro? A Response to Guido Tabellini* 20 Aug. 2018, available at https://voxeu.org/article/could-77-report-s-proposals-destabilise-euro-response-guido-tabellini; Helen Haworth, '*CAC'ed*, 1 Nov. 2012, available at https://bit.ly/32i7aoI, at 8.

[23] As an example, in the Greek restructuring referenced earlier, 17 of the 34 votes taken to restructure English-law bonds issued by the Greek government or state railways and transit systems failed. In these 17 failed votes, holdouts controlled, on average, 87% of the debt. However, holdouts controlled just under 28% of the entire English-law debt stock of these entities. Had the bonds been subject to a single-limb CAC with a voting threshold under 72 percent, all 34 would have been restructured. These figures, which are only approximate, are derived from Table A4 in Zettelmeyer, Trebesch and Gulati, 'The Greek Debt Restructuring: An Autopsy', 28 *Economic Policy (Econ. Policy)* (July 2013) 513.

the case of a cross-series modification, the terms and conditions of the Bonds and debt securities of any other series … *may be modified* in relation to a reserved matter with the consent of the Issuer and' the requisite proportion of bondholders.[24] The Euro CACs define 'reserved matter' to include, among other things, an extension of maturities or a change to the voting thresholds required to modify the bonds:

> 'reserved matter' in relation to the Bonds means any modification of the terms and conditions of the Bonds or of any agreement governing the issuance or administration of the Bonds that would:
>
> > (i) change the date on which any amount is payable on the Bonds;
> >
> > …
> >
> > (ix) change the principal amount of outstanding Bonds or, in the case of a cross-series modification, the principal amount of debt securities of any other series required to approve a proposed modification …[25]

Those who believe CAC bonds constrain the use of local law advantage apparently interpret these provisions to *require* the issuer to obtain bondholder approval before making a change that implicates a reserved matter. The argument proceeds by implication. The Euro CACs provide that the bonds 'may be modified' if the proposal satisfies the specified voting threshold. Therefore, the argument goes, the bonds *may not* be modified when that voting requirement is not satisfied, even if the bond is subject to the issuer's own law. The following section explains why I do not think this is correct. Euro CACs do not negate other sources of restructuring authority,

---

[24] Again, and assuming the votes are taken at bondholder meetings, a cross-series modification requires approval by holders of 75% in aggregate principal amount of all affected bonds in the aggregate, plus separate approval by holders of 66.67% of each affected series. Note that these figures ignore the potential impact of quorum requirements, which potentially reduce these voting thresholds.

[25] Decree of the Ministry of the Economy and Finance (D.M.), 7 Dec. 2012, n.96717 at 7, in Official Gazette (G.U.) 18 Dec. 2012, n.294 (It.).

including the use of local law advantage. It is a separate question whether the Euro CACs restrict the restructurer's options in more subtle ways. I defer that question until Part 3.

B. The Argument for Treating Euro CACs as Optional

To begin, it is worth emphasizing that the Euro CACs do not expressly say that sovereigns must use the CAC to restructure. The CACs do not say, for instance, that the 'terms and conditions of the Bonds … may be modified in relation to a reserved matter *only* with the consent of the Issuer and' the requisite proportion of bondholders. All they say is that a bond 'may be modified' through the CAC. Nothing about the statement necessarily implies that the bonds may not be modified in other ways. To be sure, one might infer that such a prohibition exists. My point is only that the text does not require the inference. In fact, as a textual matter, it is not even necessary to view the use of local law advantage as a 'modification' to the terms and conditions of the bonds.[26] One therefore needs a reason, independent of the text, to interpret the CACs as a constraint.

Nothing in Italian law, or in the ESM Treaty, provides an obvious reason. Italy implemented the Euro CACs in a 2012 decree by the Ministry of Economy and Finance.[27] As noted, the Ministry's authority to issue this decree derived from Italian law, which (at least arguably) also allowed the government to unilaterally extend bond maturities (i.e., the reprofiling option).[28] Conceivably, the introduction of Euro CACs removed this option. The argument for this

---

[26] As an economic matter, one might find it hard to distinguish between, say, a 20% tax on principal payments and a CAC vote in which bondholders accept a 20% principal haircut. But as a semantic matter, the distinction is easy to make. The tax is a fiscal measure under which the government collects higher taxes; it does not change the government's obligations under the bonds. Thus, even if the Euro CACs allowed modification 'only' with bondholder consent, as suggested in the text, one would need non-textual reasons to interpret the CACs to forbid other restructuring techniques based on local law.

[27] Republic of Italy, Ministry of the Economy and Finance, Framework Decree No. 96717 dated December 7, 2012.

[28] *See* supra text at notes 11-13.

result points to other decrees issued by the Ministry after the introduction of Euro CACs, which may have conditioned the Italian Treasury's restructuring authority on "mutual consent."[29] Perhaps these decrees evidenced the Treasury's view that, after the Euro CACs, unilateral action was no longer an option.

But even if one concedes this argument—which is not obviously correct[30]— the reference to "mutual consent" does not mandate the use of the *Euro CAC*. To the contrary, the reference comfortably includes a range of other consent-based restructuring techniques. Begin with an easy example. Imagine a debt exchange in which investors swapped old securities for new ones with different payment terms. Such a restructuring would plainly satisfy any consent requirement, though it would not involve the Euro CAC. To take a more pertinent example, imagine the Italian government passed a new law creating a retrofit CAC for the entire local-law debt stock. Whatever objections one might have to such a law, it would strain credulity to deny that the restructuring involved bondholder consent. To be sure, a retrofit CAC does not involve *every* bondholder's consent, but unanimity is not necessary. If it were, the Ministry's (occasional) references to "mutual consent" would forbid use of the Euro CACs themselves.[31]

Thus, even if current Italian law envisions only consent-based restructuring techniques, the retrofit CAC remains an option. Moreover, national laws can and do change. In a debt crisis, laws often change to facilitate restructuring. That is, after all, why prominent figures in the sovereign

---

[29] Republic of Italy, Ministry of the Economy and Finance, Framework Decree No. 99912 dated December 18, 2012.
[30] See text accompanying note 13.
[31] To be sure, other legal constraints might come into play. Italian law would no doubt forbid, say, a retrofit CAC in which one bondholder's assent sufficed to bind everyone. The point is only that no provision of Italian law categorically requires the use of the Euro CACs, contrary to the (unofficially) expressed views of some Italian finance officials.

debt markets refer to local law *advantage*.[32] Even if current Italian law required the use of Euro CACs, the government might change the law if necessary to obtain adequate debt relief. Would doing so constitute a violation of the ESM Treaty?

Nothing in the text of the Treaty implies that governments must use the Euro CACs to restructure. Article 12 provides only that:

> Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical.

It is possible to interpret this language to prohibit the use of local law advantage, at least where the government changes its law in a way that implicates the CAC and its reserved matters. Again, however, nothing in the text requires that interpretation. Treaty interpretation is a complicated subject, and I do not want to wade into debates about interpretive methods.[33] But certainly this text does not expressly forbid a legislatively-imposed reprofiling or CAC retrofit—our two examples of local law advantage.

Moreover, although governments must perform treaty obligations in good faith and cannot work to defeat a treaty's purposes,[34] there is little evidence that the ESM's purpose was to forbid non-CAC restructuring methods. The idea for the Euro CACs originated in 2010, in the wake of the controversial first bailout of Greece. The Eurogroup statement announcing the plan to implement CACs obliquely referenced the need for rules 'to provide for a case by case

---

[32] See, e.g., Buchheit & Gulati, supra note 3; Manuelides, supra note 18.

[33] On which *see, e.g.*, ILC, Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law, Report of the Study Group on the Fragmentation of International Law, UN Doc. A/CN.4/L.682, 13 Apr. 2006.; O. Dörr and K. Schmalenbach (eds), *Vienna Convention on the Law of Treaties: A Commentary* (2012), at 521-570.

[34] O. Dörr and K. Schmalenbach (eds), *Vienna Convention on the Law of Treaties: A Commentary* (2012), at 521-570 and 445-447.

participation of private sector creditors.'[35] Given the context, this statement can only be understood as a response to the vehement complaints made about the Greek bailout, and in particular about European leaders' refusal to impose losses on private creditors.[36] Because CACs were already established in some segments of the market and could be used without legal risk, it is safe to assume that Euro Area officials viewed them as a preferred method for eliminating holdouts, in the event 'private sector involvement' was deemed economically or politically necessary in connection with the disbursement of emergency loans.[37] But to say that European officials wanted to disempower holdouts is not to say that they wanted to fashion a set of handcuffs for governments.

The Economic and Financial Committee's (EFC) Sub-Committee on EU Sovereign Debt Markets—which drafted the Euro CACs—seems to have shared this understanding. Euro CACs have two voting thresholds, a lower one for non-reserved matters and a higher one for 'reserved matters.' The list of reserved matters varies depending on the nature of the instrument. In bonds governed by foreign law, the list includes 'any modification … that would … change the law governing the Bonds.' This prevents the issuer from converting the bond into a local-law bond with the support of only a bare majority (or even less) of bondholders.

---

[35] Statement of the Eurogroup (28 Nov. 2010).

[36] Gelpern and Gulati, 'Sovereign Snake Oil', *Law and Contemporary Problems (Law & Contemp. Probs.)* (forthcoming 25 Dec. 2014), American Univ. WCL Research Paper No. 2011-05, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1732650.

[37] *See* Antonio Sáinz de Vicuña y Barroso, 'Identical Collective Action Clauses for Different Legal Systems: A European Model', in P. Kenadjian, K. Bauer and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 15, at 20.

However, the sub-committee anticipated that, in bonds governed by local law, the definition of 'reserved matters' would *not* include changes to the governing law. The explanation for this choice is telling:

> The Committee believes there is no need to treat a change from the issuer's own domestic law as a reserved matter 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. In so treating a change in governing law, the Committee does not mean to suggest that euro area government issuers will in fact exercise their sovereignty in relation to any series of bonds, or that modifying the terms of a bond by means of domestic legislation does not itself raise difficult legal issues.[38]

This comment is consistent with my argument, in which Euro CACs represent the safe restructuring option for an issuer of local law debt, but not the only option. For an issuer willing to face the 'difficult' legal issues (explored below), local law advantage remains an important tool.

This understanding of the Euro CACs is consistent with the views of many prominent sovereign debt experts writing at the time of adoption. To be sure, there was a great deal of uncertainty surrounding the Euro CACs, reflected in a series of papers debating the impact of the new clauses.[39] Although the idea originated before Greece's 2012 restructuring, the drafters of the clauses were well-aware of the Greek restructuring and of objections to the Greek Bondholders

---

[38] EFC Sub-Committee on EU Sovereign Debt Markets, *Collective Action Clause: Explanatory Note*, 26 July 2011, available at https://europa.eu/efc/euro-area-model-cac-2012_en, at 6.

[39] *See* P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013).

Act.[40] But authors writing contemporaneously generally shared my understanding of the clauses,[41] and the same is true for authors writing more recently.[42]

The most potent counter-argument is premised on the fact that the ESM Treaty requires sovereigns to introduce CACs 'in a way which ensures that their legal impact is identical.'[43] At least at first glance, some uses of local-law advantage—especially retrofit CACs—might seem to run afoul of this requirement. For example, assume that a financially-distressed Euro Area sovereign has both local- and foreign-law bonds with Euro CACs but believes that it cannot use these clauses to restructure without leaving an unacceptably high number of holdouts. Thus, it plans to enact legislation, akin to the Greek Bondholders Act, providing for a restructuring vote aggregated across the entire local-law debt stock, with a voting threshold for approval lower than that found in the Euro CAC.

Some authors suggest that a CAC retrofit of this sort would violate the ESM's admonition that CACs must be introduced so that 'their legal impact is identical.'[44] The objection seems to be

---

[40] *See, e.g.,* Lachlan Burn, 'Bondholder Resolutions in the Courtroom', in P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 73, at 82-83.

[41] *See* Klaus-Albert Bauer, 'The Euro Area Collective Action Clause—Some Questions and Answers', in P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 3, at 9; David G. Sabel, 'An Introduction to the Euro Area's Model Collective Action Clause', in P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 29, at 31-32.

[42] Martinelli, 'Euro CACs and the Existing Rules on Sovereign Debt Restructuring in the Euro Area: An Appraisal Four Years after the Greek Debt Swap', *A Dynamic Economic and Monetary Union (ADEMU)* Working Paper Series WP 2016/043 (May 2016) at 10; Grund, 'Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe', 12 *Capital Markets Law Journal (Capital Markets L. J.) (2017)* 253, at 266-271.

[43] ESM Treaty Art. 12(3). The requirement is consistent with the general intent of ensuring a 'level playing field' among Euro Area states. Claus-Michael Happe, 'Towards a Level Playing Field', in P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 25, at 25.

[44] 'A natural understanding of [ESM Article 12] this clause would seem to prohibit not only the issue of bonds with non-conforming collective action clauses but also the later unilateral amendment of Euro Area

that the voting threshold in the retrofit CAC would differ from the threshold in the issuer's foreign law bonds, and also from the threshold in bonds issued by other Euro Area sovereigns. To support the objection, one might also point to the fact that the EFC Sub-Committee responsible for drafting the Euro CACs rejected the so-called 'single limb' voting method, which aggregates the vote across the entire debt stock without allowing bondholders to acquire a blocking position in a single series of bonds. As it explained this decision:

> The Committee ultimately rejected this approach notwithstanding its evident administrative advantages (and its use in many statutory insolvency regimes) because of the perceived unfairness of allowing a series of bonds to be modified over the objection of a majority of the affected holders in the absence of any supervising judicial authority, as well as related legal concerns that a single aggregate approval threshold might not be enforceable throughout the euro area.[45]

Yet it makes relatively little sense to interpret the ESM Treaty to forbid CAC retrofits. The Treaty's text may permit that interpretation, but the text does not require it, and it is easy to envision cases in which the interpretation would seriously undermine the Treaty's objectives.

First, the interpretation I advance here—in which the Euro CACs are an option, not a constraint—*does* assign identical legal effect to the Euro CACs. A modification vote held pursuant to the clause will operate in the same way for every bond and every issuer, with identical voting thresholds, quorum requirements, etc. In addition, all Euro CACs have the identical legal effect in that they do not purport to negate other sources of restructuring authority conferred by other provisions of the bond. The governing law clause is one such provision. If that clause stipulates to

---

CACs to suit a particular issuer's needs in times of crisis.' Klaus-Albert Bauer, 'The Euro Area Collective Action Clause—Some Questions and Answers', in P. Kenadjian, K. Bauer, and A. Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (2013) 3, at 10.

[45] EFC Sub-Committee on EU Sovereign Debt Markets, *Collective Action Clause: Explanatory Note*, 26 July 2011, available at https://europa.eu/efc/euro-area-model-cac-2012_en.

the application of the issuer's own law, the issuer has additional restructuring tools at its disposal. These tools are independent of the CAC. Not only do they derive from an independent contract provision, but because local-law bonds are often associated with higher borrowing costs, it is also fair to say that the issuer has *purchased* additional restructuring flexibility.[46] In every bond, then, the Euro CAC has an identical legal impact—i.e., none—on the sovereign's ability to contract for more restructuring discretion.

The text of the ESM Treaty may not require this interpretation, but the interpretation is textually permissible and is more, not less, consistent with the Treaty's purpose. To be sure, Euro Area officials involved in the creation of the ESM were troubled by Greece's restructuring methods. As Grund and Stenstsröm note, the restructuring 'revealed significant inefficiencies in the euro area's crisis resolution framework.'[47] And officials clearly hoped that, once CACs were in place, Euro Area sovereigns would no longer need to resort to such methods.[48] As explained earlier, however, it is unlikely that a Euro Area sovereign would resort to changing its local law—with the legal risks that entails—if it thought it could win sufficient debt relief using the Euro CAC.

When there is genuine doubt about the efficacy of Euro CACs, the question boils down to whether the ESM Treaty means to deny European sovereigns the ability to obtain meaningful debt relief from private creditors. That cannot be the intended result. For one thing, a debtor government

---

[46] Marcus Chamon, Julian Schumacher and Christoph Trebesch, *Foreign Law Bonds: Can They Reduce Sovereign Borrowing Costs?*, 114 JOURNAL OF INTERNATIONAL ECONOMICS 164 (2018); Michael Bradley, Elisabeth de Fontenay, Irving Arturo De Lira Salvatierra and Mitu Gulati, *Pricing Sovereign Debt: Foreign Versus Domestic Parameters*, 24 EUROPEAN FINANCIAL MANAGEMENT 261 (2018).
[47] Grund and Stenstsröm, 'A Framework for Sovereign Debt Restructuring in the Euro Area', *Fordham Journal of International Law (Fordham Int'l L.J.)* (forthcoming, Sept. 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3261152, at 9.
[48] *Id*. at 13.

might not seek or receive ESM funding. In such cases, it makes no sense to interpret the Treaty to categorically forbid the government to retrofit an effective CAC. When not putting money at stake, Euro Area sovereigns have only an attenuated interest in another sovereign's restructuring methods. To be sure, a CAC retrofit might unsettle debt markets, and other sovereigns will take notice. But it would be quite remarkable for other sovereigns to claim that the restructuring government had already ceded, by treaty, so fundamental an attribute of sovereignty as the ability to make its own law. If that was the intent, one would expect the ESM Treaty to say so directly, rather than by offering a vague admonition that Euro CACs must have identical 'legal impact.'

If a sovereign receives ESM funding and enacts a retrofit CAC, it will almost surely have the tacit support of European officials. (If officials could not abide its restructuring methods, it is unlikely they would approve funding.) In such a case, it would be especially odd for a tribunal to interpret the ESM Treaty to forbid the sovereign's methods. As noted, the Euro CACs do not expressly forbid the use of local law advantage. Given this textual ambiguity, the views of European officials should carry substantial weight. If they do not view the Treaty as a categorical bar to retrofit CACs, a tribunal should be reluctant to impose its own view of the matter.[49]

3. Other Constraints on Local Law Advantage

Even if Euro CACs do not categorically forbid the use of local law advantage, they may inform how a tribunal thinks about the legality of a sovereign's restructuring methods. Might a sovereign find it harder to justify the use of local law advantage for bonds that already have CACs? Here, I focus on first principles, asking whether the presence of Euro CACs *should* affect how

---

[49] Grund, 'Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe', 12 *Capital Markets Law Journal (Capital Markets L. J.)* (2017) 253, at 266-271.

tribunals evaluate a government's use of local law advantage. I then turn to questions of remedy in cases where a sovereign's use of local law advantage infringes investors' rights.

To begin, even if a government's use of local law advantage violates the ESM Treaty, it does not follow that disappointed investors can assert claims based on the violation. Nothing in the ESM Treaty expressly provides access to any international tribunal for private parties injured by a state's failure to comply, nor do existing dispute settlement systems obviously extend to such claims.[50] Although private parties have come to play a greater role in the enforcement of international law,[51] it is likely that enforcement of the ESM Treaty will be left to the contracting states.

Perhaps the most likely scenario for disappointed investors involves a sovereign that has enacted a retrofit CAC, prompting challenges to the law as an unlawful interference with property. A retrofit CAC is the most likely use of local law advantage for several, related reasons. First, it is reasonable to assume that sovereigns prefer (and will find it legally safer) to avoid unilateral restructuring methods and instead to solicit affirmative creditor support for the restructuring. Second, many Euro Area sovereign bonds, including most bonds issued before 2013, have no mechanism at all for holding a collective restructuring vote. Third, even Euro CAC debt may prove inadequate to counter the very real threat of holdouts. The reason, as noted earlier, is that Euro CACs allow holdouts to block a restructuring vote in any series of bonds by acquiring a stake of

---

[50] Despite an increasing tendency to grant private access to international tribunals—on which see Paul B. Stephan, *Privatizing International Law*, 97 Virginia L. Rev. 1573, 1607-11 (2011)—enforcement of the ESM Treaty is likely up to the Contracting Parties. The ESM Treaty includes procedures (such as Article 37) for resolving disputes between ESM Members, or between ESM members and the ESM itself, but does not explicitly address the possibility of disputes involving aggrieved investors.

[51] On which see Paul B. Stephan, *Privatizing International Law*, 97 VA. L. REV. 1573, 1607-11 (2011).

one-third (or less) in that series. A retrofit CAC is the most straightforward solution to these problems.

In the wake of a restructuring conducted pursuant to a retrofit CAC, an aggrieved bondholder might prefer to sue for non-payment in accordance with the terms of the bond, seeking money damages equal to the face value of the bond plus accrued interest. That is the usual remedy in breach of contract cases involving unpaid bond debt,[52] but it is less apt for litigation challenging a retrofit CAC, which will often be premised on the claim that the sovereign has unlawfully interfered with property rights (or with rights conferred by a bilateral investment treaty).[53] For example, Article 42 of the Italian Constitution protects against the deprivation of property unless the deprivation is for reasons of "general interest" and the government makes "provisions for compensation." The European Convention on Human Rights (ECHR) provides similar protections and also requires domestic courts to provide "an effective remedy" for Convention violations.[54]

Some exercises of local law advantage would almost certainly violate these protections. Consider, for example, a law that retroactively eliminated the right to seek damages for the

---

[52] *See, e.g.,* A. Iversen, 'The Future of Involuntary Sovereign Debt Restructurings: Mamatas and Others v. Greece and the Protection of Holdings of Sovereign Debt Instruments Under the ECHR', 14 *Capital Markets (Cap. Mkts. L. J.)* (2019), 44-45.

[53] *See* Manuelides, *supra* note 18 at 9. A number of factors complicate efforts to recover full principal plus accrued interest (less the value of any bonds held by the plaintiff). First, investors seemingly do not have the right to accelerate Italian debt and instead may be required to sue for each missed payment or to wait for the bond to mature—a sort of death-by-thousand-cuts that will make litigation an unappealing prospect. Second, the Consolidated Act arguably confers exclusive jurisdiction over public debt cases on Italian courts. *See* Consolidated Act, Art. 81. Third, sovereign immunity may bar bondholder lawsuits to recover payment under the bonds in national courts. *See, e.g.,* German Federal Court of Justice, Case VI ZR 516/14 (8 March 2016); German Federal Court of Justice, Case XI ZR 796/16 (19 December 2017); Cass., sez. un., 27 maggio 2005, n. 6532 (It.); Cass., sez. un., 17 luglio 2008, n. 19601, at 4 (It.). Claims for interference with property under the European Convention of Human Rights offer an alternative forum for bondholders but require a violation of the Convention or its protocols.

[54] *See* European Convention on Human Rights (ECHR) Article 1 of Protocol No. 1; Article 13.

government's failure to pay in accordance with bond terms.[55] In the retrofit CAC scenario, however, the government will have a plausible argument that its use of local law advantage did not unreasonably interfere with property rights.[56] Claims under the ECHR turn on whether the government's interference with property was compatible with the rule of law, pursued a legitimate aim in the public interest, and satisfied a proportionality requirement.[57] Here, the tribunal's analysis will be guided by a number of recent cases, most notably *Mamatas and Others v. Greece*.[58] Given the attention that case has already attracted,[59] I focus here on the proportionality analysis, which asks whether the government's actions strike a reasonable balance between collective welfare and the individual rights of creditors.[60]

A. Opportunism vs. Welfare Maximization: Do Euro CACs Change the Balance?

The following discussion assumes that a sovereign enacts CAC retrofit legislation providing for a single restructuring vote taken across the entire local-law debt stock, that the sovereign thereafter holds a successful restructuring vote, and that a disappointed investor then files a lawsuit seeking full payment before a domestic or international tribunal. Stripped to its essence, the tribunal's job in such a case is to decide which party has acted opportunistically and to fashion an appropriate remedy. Let me briefly elaborate on this general point before turning to

---

[55] *See, e.g. Pressos Compania Naviera S.A. and Others v. Belgium*, App. No. 17849/91 (ECHR, 20 Nov. 1995), s. 34.
[56] *See, e.g., Scordino v. Italy (No. 1) Judgment*, App. No. 36813/97 (ECHR 29 Mar. 2006), s. 126.
[57] *See, e.g.,* Aida Grgić et al., *The Right to Property Under the European Convention on Human Rights* (Council of Europe 2007).
[58] Mamatas and Others v. Greece, App no 63066/14 (ECHR, 21 July 2016), s 99.
[59] *See, e.g.,* Iversen, *supra* note 52; Manuelides, *supra* note 18.
[60] Tolek Petch, LEGAL IMPLICATIONS OF THE EURO ZONE CRISIS: DEBT RESTRUCTURING, SOVEREIGN DEFAULT, AND EURO ZONE EXIT at 125 (Wolters Kluwer 2014) ("If the member State invokes a legitimate public interest (such as an economic or financial crisis), the question will be whether a fair balance has been struck between the competing interests of the individual and of the community as a whole.").

whether a tribunal's analysis should be different when the investor's bond already included a Euro CAC.

Debtor-creditor relationships often involve some risk of opportunism. A sovereign acts opportunistically when it pushes through a debt restructuring even though it can pay its public debt without imposing politically or economically infeasible levels of austerity on the populace.[61] It is not easy to distinguish cases in which the sovereign cannot pay from cases in which it acts opportunistically in this fashion. However, if a tribunal detects opportunism, it should enforce the creditor's claim.

Of course, there is a corresponding risk of creditor opportunism, which is a well-known consequence of the fact that there is no bankruptcy for sovereigns.[62] Even if a restructuring would maximize collective welfare, individual creditors have an incentive to hold out for full payment. This can delay restructuring, prolong the suffering of citizens and residents, and extend the period of non-payment for creditors.[63] If a tribunal detects this sort of opportunism, the optimal result would be to force the creditor to abide by the terms of the restructuring. In the context of a CAC retrofit, then, a dissenting creditor should be bound by the vote if the sovereign used its local law advantage in a good faith effort to solve the holdout problem and maximize collective welfare.

The foregoing discussion is not tied to any specific source of law, but it captures the essence of the tribunal's role and maps reasonably well onto legal doctrine.[64] For example, in disputes

---

[61] *See generally* Choi, Gulati, and Posner, 'The Evolution of Contractual Terms in Sovereign Bonds', 4 *Journal of Legal Analysis (L. Leg. Analysis)* (2012) 131.
[62] *See, e.g.,* J. Sachs, *Theoretical Issues in International Borrowing* (1984), at 54.
[63] *See, e.g.,* Eichengreen and Mody, 'Do Collective Action Clauses Raise Borrowing Costs?', 114 *The Economic Journal (Econ. J.)* (2004) 247, at 248.
[64] For more extensive discussion of cases, many of which followed in the aftermath of the Greek restructuring, *see* Steffen, Grund and Schumacher, 'Collective Action Clauses in the Euro Area: A Law and Economic Analysis of the First Five Years', *Capital Markets Law Journal (Cap. Mkts. L. J.)* (forthcoming,

implicating Article 1 of Protocol No. 1 to the European Convention on Human Rights, a key question is whether the sovereign's interference with property rights strikes an appropriate balance between the general interests of the community and the specific interests of the property-holder; the property holder must not bear a disproportionate share of the burden.[65]

When a Euro Area sovereign's debt has no mechanism for eliminating holdouts, it is relatively easy to see how a tribunal might resolve this question in the sovereign's favor. Reputational constraints already limit a sovereign's incentives to default or threaten default. So does the fact that a debt restructuring will harm local holders of the sovereign's debt, including financial institutions, which may need to be recapitalized. A priori, then, there is no reason to presume that a sovereign has acted opportunistically. And when its debt lacks a mechanism for eliminating holdouts, the benefits of a CAC retrofit are clear. Of course, there must still be evidence to support the need for restructuring.[66] But in this scenario, it is entirely plausible for the sovereign to argue that a retrofit CAC represented a proportionate balancing of collective versus individual interests.

Jan. 18, 2019); Iversen, 'The Future of Involuntary Sovereign Debt Restructurings: Mamatas and Others v. Greece and the Protection of Holdings of Sovereign Debt Instruments Under the ECHR', 14 *Capital Markets (Cap. Mkts. L. J.)* (2019) 34; Grund, 'Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe', 12 *Capital Markets Law Journal (Cap. Mkts. L. J.)* (2017) 253; Grund, 'The Legal Consequences of Sovereign Insolvency: A Review of Creditor Litigation in Germany Following the Greek Debt Restructuring', 24 Maastricht Journal of European and Comparative Law (MJECL) (2017) 399; T. Petch, *Legal Implications of the Euro Zone Crisis: Debt Restructuring, Sovereign Default, and Euro Zone Exit* (2014), at 125.

[65] *Pressos Compania Naviera S.A.*, *supra* note 55 par. 38; *Case of Scordino*, *supra* note 56 par. 102-03; ECtHR, *Affaire Mamatas et Autres c. Grèce,* Appl. no. 63066/14, 64297/14 et 66106/14, Judgement of 21 July 2016, at s. 106-107; General Court of European Union (EGC), *Dr. K. Chrysostomides and Co. v. Council of the European Union et al.*, Judgement of 13 July 2018, at s. 254.

[66] Thus, in the *Mamatas* case, the ECHR noted Greece's 'serious political, economic, and social crisis.' ECtHR, *Affaire Mamatas et Autres c. Grèce,* Appl. no. 63066/14, 64297/14 et 66106/14, Judgement of 21 July 2016, at s. 106-107. (my translation)

Should a tribunal be more skeptical of this argument when the affected debt already included the new Euro CAC? At least at first glance, there seems to be reason for skepticism. After all, the debt already had a mechanism designed to address creditor-side opportunism. The sovereign would surely have used this mechanism if it thought the restructuring proposal had sufficient creditor support. From the fact that the sovereign instead adopted a CAC retrofit with a lower voting threshold, shouldn't we assume that creditors were deeply skeptical about the need for (or terms of) a restructuring and that the sovereign was simply trying to impose unreasonably large losses on creditors?

This argument has a certain logic, but it also overstates the case. Even if the use of local law advantage is associated with a greater risk of opportunism, the increase in risk is likely to be small. It bears repeating that reputational constraints already limit incentives to act opportunistically. If one believes (as I do) that Euro Area sovereigns will try very hard to avoid a debt restructuring, then the absolute risk of opportunism remains low. Moreover, Greece's largely-unsuccessful attempt to restructure its foreign law debt illustrates the significant holdout risk associated with voting thresholds equivalent to those in the Euro CACs. Finally, in many cases, concerns about opportunism will be mitigated by the fact that the sovereign enjoys at least the tacit support of European institutions (e.g., in cases where it receives ESM funding). The broader point is that the use of local law advantage is more likely to be associated with desperation than with opportunism.

B. If Retrofit CACs are a Problem, What is the Remedy?

Because Euro CACs are not the exclusive restructuring tool and should not materially change how tribunals analyze creditors' claims, Euro Area sovereigns retain the freedom to use

local law advantage to facilitate debt restructuring. In this section, however, I assume a tribunal has ruled in an investor's favor. What monetary remedy should the investor receive?

Again, the most likely legal challenge involves the scenario where a sovereign enacts a CAC retrofit and a tribunal rules that the law unlawfully interfered with a bondholder's rights to property. In such a case, the remedy should compensate for the loss in value caused by the sovereign's retroactive change to the voting threshold necessary to restructure the bond. That measure of damages, however, must take into account other causal factors that may have depressed the bond's value.[67] And in crisis—i.e., at the time the sovereign enacts the retrofit CAC—the value of the sovereign's bonds will have dropped precipitously. Thus, in *Mamatas*, the European Court of Human Rights noted:

> [T]he reference point to assess the loss suffered by the applicants cannot be the amount they hoped to receive at the time of maturity of their obligations. If the nominal value of a bond reflects the measure of the holder's claim at maturity, it does not represent the true market value at the date on which the State adopted the contested regulation… This value had probably already been affected by the declining solvency of the state… This decline in the market value of the applicants' securities suggests that … the State would not have been able to honor its obligations stemming from the contractual clauses included in the old titles, that is to say before the adoption of the [challenged] law…[68]

Although made in the context of analyzing the proportionality of the losses imposed on bondholders, this discussion has clear implications for the amount of compensation due bondholders injured by an unlawful interference with property. The appropriate measure of compensation should reflect the loss in market value attributable to the CAC retrofit. Put

---

[67] *See also Dr. K. Chrysostomides and Co.*, *supra* note 65, s. 314 ("[T]he amount of the compensation payable is calculated in relation to the true market value of those securities at the time of the adoption of the contested regulation…").

[68] *Mamatas*, *supra* note 65, s. 112 (my translation). *See also Dr. K. Chrysostomides and Co.*, *supra* note 65, s. 314 ('[T]he amount of the compensation payable is calculated in relation to the true market value of those securities at the time of the adoption of the contested regulation…').

differently, a statute like the Greek Bondholders Act does not itself revise the issuer's payment obligations or change any other terms of the affected bonds. It simply creates a new mechanism by which bondholders can agree to accept lower payments. The market value of a bond subject to this new mechanism is easily ascertained and relatively easily compared to the market value of the bond immediately before investors anticipated the retrofit CAC. This difference in market values—if there is one—represents the maximum compensation that should be awarded to bondholders.[69] In cases of relatively deep financial crisis, where the public interest in debt relief is compelling, the amount of compensation will often be quite low, perhaps even zero.[70]

4. Implications for Efforts to Revise the Euro CACs

The core of my argument is that Euro CACs offer a *safe* mechanism for eliminating holdouts—one that is virtually immune from legal challenge—but do not materially constrain other restructuring options. In particular, Euro Area sovereigns remain free to use local law advantage if they are willing to defend against the inevitable legal challenges. The law imposes real constraints on the use of local law advantage, but these are not absolute.

The most immediate implication is for ongoing efforts to reform the ESM Treaty, including the Euro CACs themselves. There is a relatively urgent and effort afoot to introduce single-limb CACs to address the widely-recognized holdout risk presented by the current Euro CAC

---

[69] To be sure, there are methodological complexities associated with determining pricing effects For example, if investors anticipate that the sovereign will enact a retrofit CAC, bond prices may incorporate this information well before the sovereign acts. But these are solvable problems.

[70] *See, e.g., Scordino*, *supra* note 56, s. 102; *Naviera*, *supra* note 55, s. 38. This example highlights the link between the damages inquiry and the proportionality requirement. If the retrofit CAC did not decrease (or even increased) the value of the bonds, then the law was almost certainly in the best interests of the creditors as a group. In such a case, the right outcome would be to reject the disappointed bondholder's claim on the merits.

template.[71] As of June 2019, Euro Area finance ministers have agreed to revise the ESM Treaty to require the use of single-limb CACs as of January 1, 2022.[72] Proponents of the change emphasized the inadequacies of the current Euro CAC template, which permits dissenters holding a one-third stake in any series of bonds to exclude that series from the restructuring.[73] The initiative also encountered predictable opposition from governments—especially Italy—concerned that the adoption of new CACs might drive up bond yields.[74]

Though I support the introduction of a single-limb CAC, reform may be less urgent, and more subtle in effect, than is often supposed. If the Euro CAC is not the exclusive restructuring tool, and in fact does little to constrain the use of local law advantage, then it is less clear that there is pressing need for a new, single-limb CAC. Nor is there a clear need for Euro Area sovereigns to formally revise the CACs applicable to the existing debt stock. If necessary to address a crisis, countries like Italy already have the power to adopt a single-limb CAC retroactively. Indeed, once the reformed, single-limb Euro CAC enters the market in 2022, one might expect a country in crisis to model any CAC retrofit law on this new template. Doing so should increase the likelihood that the retrofit will survive legal challenge—for the retrofitted voting mechanism will already have been validated by European officials.

---

[71] *See generally* European Stability Mechanism, *What Are Single-Limb Collective Action Clauses (CACs)?*, at https://www.esm.europa.eu/content/what-are-single-limb-collective-action-clauses-cacs; Grégory Claeys and Antoine Mathieu Collin, *Does the Eurogroup's Reform of the ESM Toolkit Represent Real Progress?*, BRUEGEL.ORG (Dec. 13, 2018), at http://bruegel.org/2018/12/does-the-eurogroups-reform-of-the-esm-toolkit-represent-real-progress/.

[72] European Stability Mechanism, *Explainer on ESM Reform and Revisions to the ESM Treaty* (June 24, 2019), https://www.esm.europa.eu/press-releases/explainer-esm-reform-and-revisions-esm-treaty.

[73] *See, e.g.,* Jeromin Zettelmeyer, *Managing a Deep Debt Crisis in the Euro Area: Towards a Feasible Regime*, 9 GLOBAL POLICY 70 (June 2018).

[74] Jan Strupczewski, *EU Leaders to Boost Bailout Fund Role, but Duck Talks on Deposit Insurance*, REUTERS (June 26, 2018).

Reform proponents have also justified the need for a single-limb Euro CAC by suggesting that the new (i.e., post-2022) CACs will provide "more clarity and predictability" about how future Euro Area restructurings would take place.[75] The new CACs may indeed have this effect. Yet the reasons will be more subtle than is often supposed. Without more radical change to the ESM Treaty architecture, even the single-limb Euro CACs will remain optional, not mandatory, in a restructuring. That is, if revised as anticipated, the Treaty will not give investors any formal protection against the use of local law advantage. For at least two related reasons, however, the revised Treaty will offer a great deal of informal protection. First, because a single-limb Euro CAC will more effectively deter holdouts, Euro Area sovereigns will have less need to resort to local law advantage.[76] Second, given an *effective* Euro CAC, a sovereign that eschews the CAC in favor of changes to its local law can expect increased legal scrutiny. Recall that, under the current regime, failure to use the Euro CAC reveals little information about whether the sovereign is acting opportunistically.[77] However, with a more effective CAC capable of mitigating holdout risk, a tribunal might justifiably view the use of local law advantage with skepticism. When a government cannot win the support of a creditor majority—measured across most or all of its debt stock—it is

---

[75] REUTERS, *Euro Zone Debates Rules for Simpler Debt Restructuring* (Nov. 19, 2018) (quoting ESM head Klaus Regling).

[76] Though outside the scope of this Essay, note that incentive to hold out may be different for holders of local law debt. To be sure, bondholders may vote against a restructuring proposal in the belief that European officials will waiver in their insistence that a debt restructuring precede emergency loans. This is a fairly traditional form of moral hazard present whenever official lenders provide emergency support. Yet in the usual context, many holdouts are litigation-focused investors that have bought bonds at distressed prices with the intent to accelerate—i.e., demand payment of accrued interest and the bond's face value—upon default. However, local-law bonds issued by Euro Area sovereigns may not be subject to acceleration. Instead, investors may be forced to sue for each missed payment—a sort of death-by-thousand-cuts that will make litigation an unappealing prospect. Of course, the sovereign can and will be sued when it fails to make a principal payment, but the most litigious and aggressive creditors will have little interest in non-accelerable debt.

[77] *See* supra Part 3A.

reasonable to ask whether the government is attempting to impose an unreasonably large share of the cost of adjustment onto holders of its public debt.

5. Conclusion

It has long been something of a puzzle that CACs have occupied such a prominent place in reform efforts.[78] The clauses are no panacea. A properly-structured CAC can mitigate creditor-side coordination problems while guarding against opportunistic conduct by sovereign borrowers. But the modern, dual-limb Euro CAC strikes this balance in the wrong place, allowing relatively small groups of creditors to block a restructuring that is in the collective best interest. Given its deficiencies, European officials quite sensibly created the Euro CAC as a preferred, but not an exclusive, mechanism for restructuring sovereign debt.

---

[78] Weidemaier and Gulati, 'A People's History of Collective Action Clauses', 54 *Virginia Journal of International Law (Virginia J. Int'l Law)* (2014) 52.