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Eurobonds: Legal Design Features

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Abstract: In light of proposals for Eurobonds, this article explores central legal features of the Eurobond proposals. Section 2 focuses on the development of the law governing sovereign bonds and assesses the potential, but limited role of international law for Eurobonds. Section 3 considers the equal treatment of bondholders, looking at the two potential sources of non-discrimination obligations for sovereign bonds and their relevance to Eurobonds. Section 4 turns to two crucial design features of Eurobonds which existing proposals mostly address only in passing: (i) which legal entity issues Eurobonds; and (ii) what form of debt mutualization Eurobonds involve.

Keywords: Eurobonds, legal design, law, issuer, European Monetary Union, sovereign debt, European Debt Management Agency

1 Introduction

Sovereign bonds are contracts closely linked to the functioning of the State. Their character has gradually and partially shifted over the last 200 years, from public to private contracting. In particular, whereas in the nineteenth century the law of the sovereign debtor invariably applied to sovereign bonds, the choice of an external governing law has become increasingly common over the course of the twentieth century.

The article shows that there are no fundamental legal obstacles to the introduction of Eurobonds¹ if the 19 Eurozone member states were to reach a political agreement on their introduction. There are no likely avenues for Eurobonds to be challenged under international law.

This article is structured into three sections. Section 2 examines the law governing sovereign bonds. Section 3 considers the equal treatment of bondholders. Section 4 turns to two important design features of Eurobonds which

¹ This article does not consider potential obstacles under European Union law. See Jörn Axel Kämmerer's article in this issue.

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existing proposals mostly address only in passing: (i) which legal entity issues the Eurobonds; and (ii) what form of debt mutualization do the bonds involve.

2 The relevance of international law to Eurobonds

The proper law for sovereign bonds has long been controversial. Historically, contracts whereby states or their subnational entities borrow money from private creditors² were subject to the rebuttable presumption that the law of the borrowing state applied (Borchard and Wynne, 1951:67; Mann, 1973; Lalive, 1962:434). Financial instruments issued by the State in its territory were seen as “creatures” of the law of the latter. Traditionally then, the law of the issuing country governs sovereign bonds.

Sovereign bonds are never governed by international law (Megliani, 2014:105; Farchy, 2016).³ This fact does not imply that international law is altogether irrelevant for sovereign bonds in general, and Eurobonds in particular. International law is potentially relevant because the borrowers are states or international organizations, and international law applies to both as subjects of international law. But it does not follow that their bonds are governed by international law. For Eurobonds, there are at least three possibilities as to who could issue them: (1) Eurozone member states collectively; (2) a future or existing international organization, such as the European Stability Mechanism (ESM); (3) a private financing vehicle such as the European Financial Stability Facility (EFSF). In the first two scenarios, international law would play some role because the issuer is a subject of international law.

Yet the role of international law for Eurobonds is probably going to be limited. Eurobonds, like all other existing sovereign bonds, are likely to be governed by some domestic law, rather than international law. Irrespective of the format of Eurobonds, international law will not govern them.

International law would apply largely in the background and only to specific issues. Consider the following three issues that depend at least partly on

² *Mount Albert Borough Council v. Australasian Temperance and General Mutual Life Assurance Society*, [1938] A. C. 224, 239.

³ Even the Ukrainian bond held by the Russian Federation from issuance is governed by English law, rather than international law, Ukraine U.S. \$1,984,838,000 5.00 % Notes due 2015, see Farchy (2016). Ukraine defaulted on this bond at the end of 2015, and the Russian Federation contemplated litigation before the English courts, see Khan (2016). Occasionally, inter-governmental loans are concluded in treaty form and governed by international law, but this is nowadays very rare, e. g. “Agreement Dated 10 December 2010 £3,226,960,000 Credit Facility for Ireland Provided by The Commissioners of Her Majesty’s Treasury” (2010) (governed by English law).

customary international law: (1) whether it is possible to sue a state in the courts of another state for disputes arising out of the sovereign bond (sovereign immunity) (Yang, 2015; Fox and Webb, 2013);⁴ (2) how responsibility for servicing bonds is divided in cases of state succession and a possible break-up of the Eurozone (Stanic, 2001);⁵ and (3) possible state defenses based on the a state's temporary inability to service its bonds, or its inability to pay, such as economic necessity (Sykes, 2015). Investment treaties may provide a measure of protection to the holders of Eurobonds – though arbitral tribunals are divided on whether investment tribunals have jurisdiction over sovereign bonds (see Section 3).

2.1 Does international law prevent the introduction of Eurobonds?

The answer is almost certainly no. No rule of international law presents obstacles to the introduction of Eurobonds – this is not surprising given that sovereign bonds are not, as explained below, governed by international law. Moreover, international law does not, as a rule, prevent states from entering into commercial transactions as they see fit. It is only when it comes to defaults on Eurobonds, or their eventual restructuring, that international law may place outer limits on how such restructuring may be achieved. Provided there is political agreement on the introduction of Eurozone, financial market lawyers will be able to devise a structure for the issuance of Eurobonds that will survive legal challenges.⁶ Creative lawyers and policymakers came up with the structure of the ESM – which survived challenge in *Pringle* (De Witte and Beulkers, 2013)⁷ – and they would be able to achieve the same outcome for Eurobonds if asked.

⁴ In practice, domestic codifications such as the Foreign Sovereign Immunities Act in the United States (FSIA) and the State Immunity Act (SIA) in the UK determine whether or not a borrowing state benefits from sovereign immunity. It is today widely recognized, following *Republic of Argentina v. Weltover, Inc.* 504 US 607 (1992), that sovereign bonds are commercial transactions that do not attract any immunity. Moreover, both the FSIA and the SIA provide that sovereigns can waive their immunity from jurisdiction in the courts of other states, which they routinely do, though the terms of such waivers vary.

⁵ E.g. the break-up of Former Yugoslavia and the associated questions of how the responsibility for servicing the debt is divided among the successor states.

⁶ Particularly EU and constitutional challenges.

⁷ *Thomas Pringle v. The Government of Ireland, Ireland and the Attorney General*, C-370/12, Judgement, 27 November 2012.

2.2 Bonds governed by domestic and external domestic law

A bond is a contract according to which, in exchange for credit, bondholders are repaid the principal on maturity and receive a stream of regular interest payments over time. For medium and long term sovereign debt securities issued (i. e. whose maturity is greater than one year), a common distinction is between notes (medium term) and bonds (long term). Many countries issue a couple of different types of debt securities: France issues *Bons du Trésor à intérêts annuels* (BTAN) and *Obligations Assimilable du Trésor* (OAT), Germany *Schätze*, *Bobls* and *Bunds*, the United Kingdom *Gilts* and the United States *T-Notes* and *T-Bonds*.

A first category of bonds is governed by domestic law and subject to the jurisdiction of domestic courts. These bonds are typically issued under domestic statutes or otherwise under domestic law and have retained their “public” character. Their key features – the lack of choice of law clauses, the limited or non-existent documentation and the absence of an express provision for access to the ordinary (civil) courts – underscores their public character. For example, the documentation of US Treasury bills, UK Gilts, French *Trésors* and German *Bunds*⁸ typically sets out the basic financial terms and certain modalities for the issuance and trading of the instruments, but contains few or no covenants protecting holders of these instruments.⁹ Covenants are important to creditors because their breach leads to an event of default, thereby encouraging the state to repay its bonds and loans (Wood, 2007:8–01). This article touches on two types of covenants: (i) the negative pledge and (ii) *pari passu* clauses.

Eurozone countries, like other OECD countries, largely issue bonds with no or only limited documentation, with few or no legal protections for bondholders. Countries such as the United Kingdom, Germany, France and the United States issue all of their debt under their own law and subject to the jurisdiction of their own courts. Domestic bonds typically lack an express choice-of-law provision, and are often deemed to be subject to the sovereign borrower’s law (IMF, 2004:14). These bonds also typically lack waivers of immunity from jurisdiction and enforcement. Legal protections in case of a default or restructuring on domestic bonds are minimal (Sturzenegger and Zettelmeyer, 2006:56).

⁸ Bekanntmachung der Emissionsbedingungen für Bundesanleihen, Bundesobligationen, Bundesschatzanweisungen und unverzinsliche Schatzanweisungen des Bundes (Germany), 21 December 2012, VII A 2 – WK 2202/07/0001.

⁹ E.g. for Spain, the General Budgetary Law, Ley 47/2003, BOE Num. 285, 27 November 2003, BOE-A-2003-21614, in conjunction with an annual ministerial order, Orden ECC/1/2014, “de 2 de enero, por la que se dispone la creación de Deuda del Estado durante el año 2014 y enero de 2015 y se recogen las Cláusulas de Acción Colectiva normalizadas and a Resolution of the General Secretariat of the Treasury and Financial Policy for each debt security”.

By contrast, external bonds contain extensive documentation, with protections for bondholders such as negative pledges (Buchheit, 1992), *pari passu* clauses (Chabot and Gulati, 2014) and events of default. Courts in important financial centers such as London and New York routinely regard sovereign bonds issued in this way as ordinary commercial transactions (UK Supreme Court 2011, US Supreme Court 1992). The borrowing country virtually always submits to the jurisdiction of the courts in an important financial center. Furthermore, externally governed bonds typically include a broad waiver of sovereign immunity from jurisdiction, if not enforcement.

The main Debt Issuance Program of the European Stability Mechanism does not fit neatly in either category. These financial instruments are similar to those of external sovereign bonds, with some variations. On the one hand, the governing law is English law. English courts have jurisdiction and the documentation is more extensive than is typically the case for domestic law governed sovereign debt instruments. Yet there are very few covenants in these debt instruments (no negative pledge, no events of defaults).

2.3 The evolution of the law governing sovereign bonds

Until the twentieth century, virtually all sovereign bonds lacked an express choice of law clause and were impliedly governed by domestic law, including bonds issued by peripheral countries in Latin America and Asia (Delaume, 1967:92; Stowe, 2002; League of Nations, 1939:74–75).¹⁰ Bonds were widely regarded as quintessential “public” law contracts, and the idea that States would ever subject themselves to another country’s laws when issuing bonds was unthinkable. Sovereign bonds were regarded as so closely connected to the exercise of a State’s public functions and the exercise of its sovereignty that a State would never subject itself to another State’s laws.

Over the course of the twentieth century, the view that countries subject themselves to an external private law when borrowing abroad gained ground (Borchard and Wynne, 1951:4). The express submission to the external law of an important financial center became more common, particularly for less credit-worthy countries. Conversely, sovereign bonds issued on international capital markets and governed by some external law such as English or New York are nowadays widely considered to be archetypical private law contracts.

¹⁰ *Smith v. Waguelin and Others*, [1869] L.R. 8 Equity, London Cases 198; *Payment of Various Serbian Loans Issued in France, France v Kingdom of the Serbs, Croats, and Slovenes*, Judgment, PCIJ 260 Series A no 20 (PCIJ 1929).

In the 1930s, the issue of governing law for sovereign bonds had divided the House of Lords and the lower courts in *Rex v. International Trustee for the Protection of Bondholders*.¹¹ The case concerned UK bonds issued in New York, and payable at the holder's option in either London or New York. The bonds were silent on which law governed them. The Court of Appeal, upholding the trial court, had adopted the presumption that in case of doubt the sovereign's own law applied. Yet the House of Lords broke new ground finding that New York law applied under ordinary conflict of laws principles. That the UK was party to the contract deserved great weight but did not compel the conclusion that English law governed the contract.

After World War II, official loans by one State to another were often modeled on private loans and it became common to choose some domestic law as the governing law. International lending transactions more generally came to be often governed by the domestic law of the intermediaries arranging the transaction, in many cases English and US investment banks and law firms.

From the point of view of creditors, an important advantage of choosing an external law is the large degree of insulation in debt restructurings, when compared to bonds governed by domestic law. Domestic-law governed bonds give States far greater room for maneuver in financial distress than external bonds, as illustrated most recently by the Greek sovereign debt restructuring in March 2012. Greece restructured its domestic bond stock by retrofitting collective action clauses (CACs) onto its Greek-law governed bonds, and then using them to incentivize participation in the exchange offer (Zettelmeyer et al., 2013:513–63, Kupelyants, 2015:Ch6).

The Greek debt restructuring in 2012 and the Argentine *pari passu* litigation in New York illustrate how central the choice of governing law and jurisdiction is to the success of sovereign debt restructurings. On the one hand, the fact that most of Greece's bonds were governed by local law¹² greatly facilitated the debt workout process thanks to a change in Greek legislation to retroactively include CACs (Zettelmeyer et al., 2013). On the other hand, the choice of New York law as the governing law of the bonds and New York City as the place of jurisdiction in *NML v. Argentina* stacked the deck in favor of holdout creditors,¹³ as compared to bonds governed by domestic law and subject to domestic jurisdiction. It triggered Argentina's second default in 14 years.

¹¹ *Rex v. International Trustee for the Protection of Bondholders A.G.*, [1937] AC 500.

¹² See Reserve Bank of Australia *Statement on Monetary Policy* (May 2012), Box B: of the €206 billion bonds of the 2012 restructuring, Greek law bonds amounted to €177 billion, i. e. 86%.

¹³ *NML Capital, Ltd. v. Republic of Argentina*, No. 12, 105 (2d Cir. 2012); *NML Capital, Ltd. v. Republic of Argentina*, No. 12, 105 (2d Cir. 2013).

New York and English laws are the most widely used external governing laws. The governing law for emerging markets' sovereign bonds over 1987–1997 was distributed as follows: 41.5% of bonds were governed by NY law, 26.6% by English law, 19.2% by German law and 11.3% by Japanese law (Hallak, 2011). The share of German and Japanese law as governing law of sovereign bonds has declined over time (Gulati and Scott, 2012).

The increased use of Euro Medium Term Note (EMTN) programs following the introduction of the Euro led issuing Eurozone countries to systematically choose English law as the governing law. A few exceptions remain, such as Belgium and Italy, which also issue under New York law. This trend towards English law has been especially pronounced for European countries that previously issued under German or French law. The external legal advisors for these issuing countries, often English law firms, may have also played a role (Gulati and Scott, 2012).

The main question with respect to governing law of Eurobonds is which domestic governing law will Eurozone member states choose. A choice of German law as the governing law could be a compromise and provide assurance to the German public (in preference to English or New York law). A possible downside is that a German-law governed Eurobonds might not gain market acceptance as quickly as a New York or English-law governed one, given the tiny share of German-law governed sovereign bonds today (less than one percent of the total outstanding external bonds).

Following this treatment of the governing law of existing sovereign bonds, the next section considers whether there are any rules of international law that limit the extent to which states can differentiate among creditors in sovereign debt restructurings. It also considers two important covenants, *pari passu* and negative pledge clauses, in this context, and their implications for Eurobonds.

3 Equal treatment of bondholders

Crucial for a possible equal treatment obligation is what the governing law says on the equal treatment of bondholders. As this section shows, there is no general equal treatment obligation as regards sovereign borrowing. There are two potential sources of non-discrimination obligations for sovereign bonds. First, covenants in the contracts underlying the bonds. And second, international law in the form of international investment law. This section first considers contracts, before examining the potential impact of obligations under investment treaties.

3.1 Contractual obligations not to discriminate

With regard to possible contractual non-discrimination obligations, it all depends on whether the issuer includes covenants to that effect in the debt instruments. But even if the issuer includes such covenants, they are limited in crucial respects, and typically fall far short of an affirmative equal treatment obligation.

Several Eurobond proposals envisage debt instruments with different priority ranking.¹⁴ From the perspective of international law, such a hierarchy among creditors is unproblematic. In fact, debt instruments governed by some domestic law are beyond the scope of application of international law at the point of issuance. As discussed in the previous section, it is likely that international law does not even come into play at the point of issuance, because some domestic law, rather than international law, will govern them.

Even if Eurozone member states were to choose international law as the governing law for Eurobonds (a choice that is extremely unlikely, and would almost certainly be ill-advised in view of market practice and marketability), they would be free to design Eurobonds as comprised of senior and junior bonds (or any other permutation of seniority) without violating a purported rule of international law requiring equal creditor treatment in all circumstances.

Ex ante, when one or several states consider in what form to issue bonds or other debt instruments, they are free to adopt any seniority structure they like. Just like it is perfectly possible in domestic laws to create senior, junior, or mezzanine debt, the same is true of Eurobonds. What is not possible, as a rule, is to discriminate within a particular class of creditors ex post. But ex ante, the principle of party autonomy – in this case the autonomy of the issuer to choose the priority structure it sees fit – reigns supreme.

Importantly, even taken together, the negative pledge and the *pari passu* clause fall short of a general, contractual equal treatment obligation. Not only do they often have significant, built-in limitations (e.g. they apply only to external indebtedness such that the borrower is free to differentiate between domestic and external indebtedness), but both are negative obligations not to grant security (negative pledge) and not to subordinate beneficiary creditors. There is no general, positive obligation to treat all creditors equally, or to treat all creditors “in like circumstances” equally.

¹⁴ E.g. senior “blue bonds” and junior “red bonds” in Delpla and von Weizsäcker (2010) and senior and junior tranches in the ESBies proposal of Euro-nomics in Brunnermeier et al. (2011).

The negative pledge is a contractual obligation by borrowers to preserve the position of unsecured creditors. A simple negative pledge provides: “The borrower will not create or permit to exist any security interest on any of its assets”. The borrower promises not to encumber its assets for the benefit of other creditors.

Negative pledge clauses constrain the debtor’s ability to pledge collateral going forward (Scott and Gelpert, 2012:1258; Feilchenfeld, 1934:635; Martha, 2015:491). Borrowers commit not to grant security to other creditors, or in the alternative, to grant equivalent security to the creditors benefitting from the negative pledge. Negative pledges seek to ensure that unsecured creditors are not worse off. They do not give them any sort of priority vis-à-vis other unsecured creditors.

In sovereign bonds, the negative pledge is often limited to external indebtedness, defined variably as bonds in foreign currency, or issued with non-residents in mind. Negative pledges provide much less protection to creditors than security, because they do not restrict other unsecured liabilities ranking equally, nor do they allocate specific assets to the service of the loan. As a result, debt dilution through additional unsecured debt is perfectly possible (Chatterjee and Burcu, 2012; IMF, 2004).

A standard *pari passu* clause provides as follows: “The borrower’s obligations under the loan agreement will rank *pari passu* with all its other unsecured liabilities”. *Pari passu* clauses do not guarantee equal payment in fact; rather, they only protect creditors from having lower priority than other unsecured creditors.

Under the traditional interpretation, the debtor does *not* promise to pay creditors pro rata in default. The debtor only promises creditors not to subordinate their debt to others. Subordination of a creditor occurs where one creditor, the “subordinated” or “junior” creditor, agrees not to be paid by a debtor until another creditor, the “senior” creditor, of the common debtor has been paid (Calligar, 1960). According to this interpretation, then, *pari passu* too does not amount to an equal treatment guarantee of creditors benefitting from the clause.

On the alternative, ratable payment interpretation of the *pari passu* clause, whenever the borrower pays any creditor, it has to make ratable payments to its other covered creditors. The 1989 case of *Elliot Associates v Banco de la Nacion* rested on such a broad interpretation of the *pari passu* clause. The Belgian courts recognized that Elliot had the right to receive a proportional share of Peru’s payments on external debt. More recently, Judge Griesa of the Southern District Court of New York adopted this ratable payment interpretation in litigation related

to Argentina's restructuring.¹⁵ Some recent boilerplate *pari passu* clauses expressly repudiate the ratable payment interpretation of the clause.¹⁶

3.2 Obligations not to discriminate under investment treaties

With respect to international investment law, it is only *ex post*, at the point of a sovereign debt restructuring, that international law may, in extreme cases, come into play if the debtor discriminates between creditor classes and (1) the bonds do not already provide for or (2) such discrimination lacks any rational basis. Particularly problematic is nationality-based discrimination, i. e. a sovereign's decision to only restructure bonds held by, say, German nationals or residents. Conversely, there is no rule of general international law that different categories of creditors need to be treated equally. The only type of differentiation that may be problematic is nationality-based discrimination under investment treaties (Waibel, 2007).

Consider these two illustrations of differential treatment that are likely to be permissible under international law. First, more favorable treatment of pension funds as compared to other asset managers would likely have a rational basis. So would the preferential treatment of bond holdings of national central banks and the European Central Bank. In the Greek restructuring of 2012, Greece issued a new International Security Identification Number (ISIN) to bonds held by the European Central Bank and national central banks not long before the restructuring, and subsequently did not include the bonds with this new ISIN in the restructuring (Trebesch and Zettelmeyer, 2014).¹⁷ Some creditors alleged unsuccessfully that this re-numbering of the bonds held by the ECB subordinated

¹⁵ *NML Capital, Ltd. v. Republic of Argentina*, No. 12, 105 (2d Cir. 2012); *NML Capital, Ltd. v. Republic of Argentina*, No. 12, 105 (2nd Cir. 2013). The English courts have thus far not followed the lead of New York courts on this issue, see *Knighthood Master Fund LLP v. The Bank of New York Mellon*, [2015] EWHC 270 (Ch).

¹⁶ E.g. International Capital Market Association, Standard Clause, May 2015: "The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank *pari passu*, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, further, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa".

¹⁷ An International Securities Identification Number (ISIN) uniquely identifies a financial instrument. It is based on ISO 6166 of the International Organization for Standardization.

private creditors to the ECB in a way that triggered a restructuring credit event.¹⁸ The same result likely applies under bilateral investment treaties.

A limited equal treatment obligation may apply under international investment treaties, provided Eurobonds qualify as an “investment” for the purposes of these treaties.¹⁹ But authorities are divided on whether sovereign bonds qualify as investments in the first place. Most-favored nation (MFN) and national treatment (NT) clauses in investment treaties protect foreign investors (which may include bondholders) from nationality-based discrimination. MFN prevents discrimination among investors of different nationalities²⁰ NT prevents discrimination between foreign investors covered by the investment treaty in question and domestic investors. The NT and MFN clauses in BITs allow bondholders to assert discrimination based on nationality. Neither clause is likely to come into play in our context.

De jure discrimination arises from explicit nationality-based distinctions contained in legal texts, and is very unlikely to have much purchase in modern sovereign debt restructurings. No restructuring since 1945 seems to have de jure discriminated based on nationality. Foreign bondholders increasingly buy bonds issued only domestically (e. g. Russia’s restructuring in 1998 or Greece’s restructuring in 2012), and domestic bondholders buy debt issued internationally. So even if a country restructures only its debt issued internationally (or only debt issued domestically, e. g. Russia in 1998), the restructuring will affect both nationals and non-nationals of the debtor country.

Sovereign debt restructurings today often take the form of a bond exchange, where the sovereign offers all its bondholders to exchange old for new bonds with lower payments. The primary fault line of discrimination is between bondholders who participate in a restructuring and those who choose to retain their

18 ISDA EMEA DC, Issue Number 2012022401, 22 February 2012 (alleging that the European Central Bank and National Central Banks benefited from “a change in the ranking in priority of payment” as a result of the Hellenic Republic exclusively offering them the ability to exchange out of their “eligible instruments” prior to the exchange and implementation of the CACs, thereby effectively “causing the Subordination” of all remaining holders of eligible instruments).

19 ICSID tribunals affirmed jurisdiction over sovereign bonds in Regulation (EU) No 1176/2011 of The European Parliament and of The Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, *Official Journal of the European Union*; *Ambiente Ufficio S.p.A. and others v. Argentine Republic*, ICSID Case No. ARB/08/9 (2013) (formerly *Giordano Alpi and others v. Argentine Republic*) but declined jurisdiction in *Poštová Banka and Istrokapital v Hellenic Republic*, ICSID Case No. ARB/13/8 (2015). The Argentina cases settled in 2016 following the election of new Argentinean president Macri.

20 Such discrimination occurred in the 1930s, when Germany defaulted on bondholders of certain nationalities.

old bonds, rather than discrimination by nationality of the bondholders (Waibel, 2007). While perhaps domestic bondholders are more likely to participate in a restructuring than foreign nationals due to moral suasion by the official sector (e. g. pension funds or banks in the debtor country), both domestic and foreign nationals are likely not to participate in the debt restructuring.

By contrast, de facto discrimination involves factually disparate treatment of investors/investments of different nationalities. Identifying de facto discrimination raises more complex questions. In investment law, foreign investors need to meet at least two conditions for a successful non-discrimination claim: (i) less favorable treatment in relation to (ii) a comparable domestic investor (for national treatment) or a comparable foreign investor (for MFN). Not all differential treatment breaches these two non-discrimination obligations. A crucial question is the choice of the comparator (“in like circumstances”). Some tribunals adopt a broad likeness test, giving broader reach to the non-discrimination obligation because the class of investors being compared is broader.²¹ In addition, some tribunals require evidence that the discrimination be driven by protectionist motives, with the result that a showing of discrimination is significantly harder.²²

Domestic debt is often restructured under different terms than external debt. A national treatment claim could arise if a foreign bondholder suffered a deeper haircut in the external debt restructuring than a national bondholder affected by the domestic debt restructuring. However, since the original debt instruments will often differ substantially in their legal and financial terms, de facto discrimination tends to be very difficult to prove in practice.

Over time, informal seniority regimes have developed for sovereign debt (Wood, 1982) and are often used and seemingly accepted. These priorities are not underpinned by legal rules; rather they arise de facto through market practice, such as the exclusion of trade credit and other short-term lending from sovereign debt restructurings. In addition, multilateral debt has typically been excluded from sovereign debt restructurings altogether.²³ The International Monetary Fund enjoys informal priority of payment (Martha, 1990; Raffer, 2005; Boudreau and Gulati, 2014).²⁴ The Paris Club restructures official debt. While

²¹ See, for instance, *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN3467 (2004).

²² See, for instance, *United Parcel Service of America v Government of Canada*, Award on the Merits, UNCITRAL (2007).

²³ ISDA EMEA DC, Issue Number 2012022401, 22 February 2012.

²⁴ Martha argued that the preferred creditor status of IFIs is grounded in customary international law, but this view is not widely shared. For criticism see Raffer (2005).

such restructurings are not formally required to be on the same terms as other types of debt, the Paris Club itself typically insists on comparability of treatment (in particular that private debt be restructured on similar terms).

An ISDA²⁵ Determinations Committee affirmed with respect to the Irish IMF/EU program that the mere existence of a de facto priority in favor of the International Monetary Fund, based on market practice, did not trigger a credit-restructuring event under credit default swaps.²⁶ The reason for this important qualification is found in Section 2.19(b) of the ISDA Definitions, which contains an important qualification: “the existence of preferred creditors arising by operation of law or of collateral, credit support or other credit enhancements arrangements shall not be taken into account, except that, notwithstanding the foregoing, priorities arising *by operation of law* shall be taken into account where the Reference Entity is a Sovereign”. That market practice establishes an informal priority in favor of the IMF is thus insufficient for CDS to be triggered. So long as the ranking of creditors is not legally binding, no restructuring is triggered (not “by operation of law”).

3.3 Implications for Eurobonds

As we have seen in this section, sovereign borrowers can limit their freedom to differentiate among creditors when issuing the bonds by *contract* (rather than international law) – and this is common in bonds governed by external law, often with a view to increasing the marketability of the bonds, particularly for countries with a checkered history of repayment. The two most important contractual devices are negative pledge and *pari passu* clauses. They both limit the debtor’s freedom to treat creditors preferentially but they do not amount to a positive equal treatment obligation. They preserve the equal ranking of unsecured claims against the debtor’s assets, and prohibit subordination (Martha, 2015:421). As covenants, they need to be expressly included in the sovereign bond documentation. For example, the ESM’s Medium-Term Note Program does not contain either a negative pledge or a *pari passu* clause. As a result, even these limited obligations do not apply to debt notes issued under this program.

²⁵ The International Swaps and Derivatives Association (ISDA) is a trade organization in the market for over-the-counter derivatives. Headquartered in New York, it created a standardized contract – the ISDA Master Agreement – for derivatives. Determinations committees are fact-finding bodies with respect to the ISDA Master Agreement. See further Waibel (2014).

²⁶ Republic of Ireland, Issue Number 2011031101, 11 March 2011; The Hellenic Republic, Issue Number 2012022401, 22 February 2012 (ECB and national central bank priority).

The Blue Bond proposal moves in the direction of an explicit seniority structure for sovereign debt which the more recent sovereign debt literature favors (Bolton and Jeanne, 2009; Chatterjee and Eyigungor, 2012; Gelpern, 2004; International Monetary Fund, 2004; Zettelmeyer, 2003; Tirole, 2002). Because red bonds are reserved for indebtedness in excess of 60% of GDP, the proposal gives seniority to those creditors who lent earlier in time. This approximates a first-in-time priority rule and could help to prevent the externality of debt dilution. Assuming fixed creditworthiness, additional lending dilutes existing debt.

Delpa and von Weizsäcker's blue/red bonds, if introduced, would almost certainly not contain any *pari passu* clauses, and hence the seniority of the blue bonds would not be problematic within the context of the blue/red bonds themselves. Moreover, provided the issuer of blue bonds were an entity other than the existing Eurozone sovereign borrowers, there would be no issue with any *pari passu* clauses in existing Eurozone member state indebtedness because such clauses only extend to the same issuer. It would equally be unproblematic for more junior red bonds to be created by existing Eurozone member state debtors.

4 The identity of the issuer and the modality for mutualizing debt

This section considers two additional legal features of three Eurobond proposals, and compares them to two existing institutions, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). The two features are (1) the identity of the issuer and (2) the way in which the debt obligations are “mutualized”.

4.1 The identity of the issuer

There are three main possibilities for who the issuer of Eurobonds could be: (1) Eurozone member states collectively, following the model of the German Bund-Länder-Anleihe of 2013; (2) an existing or future international organization similar to the ESM; (3) a private entity modeled on the EFSF. The Blue/Red Bond proposal leaves this question open, but as it does not mention any organization, it is likely that the authors intended for the Eurozone member states collectively to act as the issuer. The German Council of Economic Experts

(2011) and the euro-nomics group (Brunnermeier et al. 2011) envisage dedicated organizations to fulfill this task (the European Redemption Fund, and “a public international institution”, respectively).

There does not necessarily need to be single issuer. The first option is for the 17 Eurozone Countries to issue debt jointly (and assume a pro rata liability for each Eurobond). With the German Bund-Länder-Anleihe, each of the 11 issuers is liable on a pro rata (proportionate) basis for its share (Deutsche Finanzagentur, 2013).

The Federal Republic of Germany and ten German states issued this joint bond “as several and not joint debtors”. The result is that each of the 11 issuers can default individually and is severally liable for its share. § 3 of this bond provides the liability shares for each of the 11 issuers, with North Rhine-Westphalia’s share for example being 20% and the Federal Government’s share being 13.5%. § 3 (2) provides that “Each Issuer shall be liable *pro rata* for their own payment obligations arising from the Bonds. Under no circumstances shall an Issuer be liable for the default of the relevant other Issuers”.

This bond does not contain any provision for acceleration or events of default. If the State of North Rhine-Westphalia, for example, defaulted, and the other 10 issuers remain current on their debt, then principal repayments need to be made by the non-defaulting issuers in accordance with the bond’s terms on maturity (no acceleration), whereas creditors could only sue North Rhine-Westphalia for its 20% share in the Frankfurt courts. Only North Rhine-Westphalia’s debt would be accelerated.

The second option is for an existing international organization, or another dedicated international organization, to issue debt Eurobonds. The Eurozone as such – which does not have legal personality – is not an option as the issuer for Eurobonds. Nor is the European Union the appropriate organization to assume the task of issuing Eurobonds, given the lack of congruence between EU and Eurozone membership.

The ESM is an international financial institution established by treaty and expressly vested with international legal personality (Article 2, ESM Treaty). Like other international financial institutions such as the World Bank and the International Bank for Reconstruction and Development, the ESM borrows on capital markets to fulfill its stability mandate. The issuer is the ESM itself. The debt instruments the ESM issues are governed by English Law, and the courts of Luxembourg-City have exclusive jurisdiction to settle any disputes.²⁷

²⁷ Article 12.1 (governing law) and Article 12 (2) (jurisdiction), Master Dealer Agreement Relating to European Stability Mechanism Debt Issuance Programme, 9 March 2015.

When international organizations borrow, their member states are not, as a rule, liable instead of, or in addition to, the organization for the organization's debts (Amerashinge, 2005:363).²⁸ The organizational veil is respected. If the ESM were to default, for instance, the Eurozone member states would not be responsible for the entire stock of the ESM's outstanding debt instruments. The ESM is responsible for the ESM's debts; Eurozone member states are not liable; they only guarantee to the extent of their guarantees the ESM's liabilities (the ESM benefits only from a several, and not a joint and several guarantee of all member states). Article 8(4) of the ESM Treaty expressly states that “[n]o ESM Member shall be liable, by reason of its membership, for obligations of the ESM”.

Article 8(4) restates an established rule of customary international law. When the International Tin Council collapsed, the English courts concluded, with respect to “direct actions” by creditors against the member states of the Council, a commodity organization that was unable to fulfill its financial obligations, that its member states were not secondarily liable for the organization's debts, let alone jointly and severally liable.²⁹

4.2 Form of debt mutualization

It is unclear what exactly “mutualization of debt” means under existing Eurobond proposals. The term “joint and several” and “debt mutualization” are used loosely in most Eurobond proposals. This design feature of Eurobonds is important because the economic effect of Eurobonds is likely to depend on what model of joint liability/guarantees the Eurozone chooses. And the legality of Eurobonds too may hinge on these features.

Expressions that are used include, “collective liability” (Donovan, 2012); “joint-and-several liabilities of the Eurozone” (Philippon and Hellwig, 2011); “joint and several liability” and “joint and several guarantee” (Delpla and von Weizsäcker, 2010).³⁰ Tirole (2015) speaks of full joint-and-several liability (as well as “cross-insurance”). This section looks at these terms from the perspective of

28 The issue of the liability of Member States for the acts of an international organization arose for example in relation to NATO's bombing of the Federal Republic of Yugoslavia in 1999. The FRY instituted proceedings against 10 NATO Member States, claiming they were jointly and severally responsible for NATO's conduct.

29 See Lord Templeman's judgment (at p. 476D, 480B-D, 483C, 509B-F, 511B-C, 512E-G, 513B-C, 983-4) in *International Tin Council Case, JH Rayner (Mincing Lane) Ltd v Department of Trade and Industry*, [1989] 3 WLR 969.

30 Even though their 2011 paper speaks only of “joint and several guarantee” (Delpla and von Weizsäcker, 2011).

English law – a defensible choice given the importance of English law to international financial transactions, and given the possible choice of English law as the governing law of Eurobonds.³¹

In fact, both “joint and several liability” and a “joint and several guarantee” are unlikely. There is an essential difference between a liability and a guarantee. None of the proposals for Eurobonds seems to involve genuine joint and several liability (involving all Eurozone countries as issuers), or joint and several guarantees (involving all but the issuing Eurozone country as guarantors). Joint and several liability means that a creditor can sue a single debtor for the entire debt.

Such terminological confusion also occurs in related contexts. For example, Schelkle (2012) maintains that Eurozone member states have joint and several liability for losses of the European Central Bank. However, the relevant provision, Article 33 (2) of the ECSB Statute, speaks of loss being offset “against the monetary income *in proportion* and up to the amounts allocated to national central banks”.

Where a plurality of debtors (two or more) assume contractual obligations vis-à-vis creditors, we distinguish three types of liability: (1) joint; (2) several and; (3) joint and several (Treitel, 2003:Ch. 14). Importantly, there is a single obligation of two or more debtors. A debtor who pays more than its fair share of a shared obligation may have a claim for contribution against the other debtors.

First, if a plurality of debtors has *joint* liability, then they are each fully liable for the performance of the relevant debt obligation. The debtors’ liability is joint if each Eurozone country issues debt binding all Eurozone member states. A creditor can look to a single Eurozone state for payment, ignoring other Eurozone member state debtors. It can recover 100% of the outstanding principal and interest from this single debtor, irrespective of that debtor’s responsibility. Performance by one Eurozone state discharges the others. English law presumes joint liability where two or more debtors contract together. However, that presumption can be rebutted by clear and specific words of severance.³²

Second, *several* (pro rata, separate or proportionate) liability occurs when two or more debtors make separate promises to creditors. Each debtor is liable only for its own specified obligations. If one debtor is unable to satisfy its obligation, the other debtor(s) are not liable for the former’s share.

Third, *joint and several* liability arises when two or more debtors jointly promise to pay their creditor(s) and also severally make separate promises to

³¹ The ESM’s financial instruments are already governed by English law.

³² *White v Tyndall* [1888] 13 App Cas 263.

make payment (Amerndariz and Williamson, 1993).³³ Creditors can enforce the debt, in full, against any of the jointly liable debtors. And each party is independently liable for the full extent of the debt. The debtors in effect tell their creditors: “we, and each of us, will pay”. Eurozone states are extremely unlikely to accept joint and several liability for Eurobonds.

Such liability would mean that the creditor could sue a single member of the Eurozone (ignoring all other potential Eurozone debtors) and recover 100 % from it, irrespective of that debtor’s share of responsibility. Joint-and-several liability would mean, for example, that Malta (with a GDP of around 11 billion Euros) would be liable for the Eurozone’s entire debt stock (around 10 trillion Euros, or 900 times the Maltese GDP). With joint and several liability, creditors are entitled to collect full repayment from any subset of the debtors, including just a single debtor, so we would expect creditors to look to the debtor with the highest creditworthiness/deepest pockets for repayment (Miceli, 1997:37). The example of Malta illustrates that joint and several liability of a plurality of Eurozone member state debtors is inconceivable economically and politically.

In contrast to primary liability, guarantees involve promises to pay another’s debt if the debtor fails to pay (Peel and Treitel, 2011:para. 5.014; Andrews and Millett, 2015:1–004).³⁴ There is one debtor, but that debtor’s obligations (or some of them) are guaranteed by a third party. It is a promise to answer such a liability in case of default of the debtor. The guarantee contract is ancillary to the principal contract. The principal remains primarily liable to the creditor. And the guarantor only becomes liable once the principal has failed to perform its obligations (secondary liability to the extent of the guarantee’s liability). The liability arises under the principal contract, in our case the Eurobond.

Guarantees are often limited, as in the case of the European Financial Stability Facility (EFSF). The EFSF and ESM guarantee structure may be a model for the Eurobonds, with a guarantee proportionate to each country’s guarantee liabilities (for example based on ECB capital shares) (Zandstra, 2011:297). Guarantees also exist in the three permutations, joint, several and joint and several, in cases where there is a plurality of guarantors.

33 Joint and several liability was initially the formula for succession into the debts of the Soviet Union – though this formula led to serious problems and the G7 modified it in 1992, with Russia taking on all the debts, except for a 16 % share assumed by Ukraine.

34 *Lep Air Services v Rolloswin Investments Ltd* [1973] A.C. 331; *Wardens and Commonalty of the Mystery of Mercers of the City of London v. New Hampshire Insurance Company* (1991) 3 J.I.B.F.L. 144, Philipps J, citing with approval the following definition of a guarantee given in Mackay (2008), para. 1013: “A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promise for the debt, default or miscarriage of another person, whose primary liability to the promise must exist or be contemplated”.

Guarantees of sovereign bonds are common: the US government regularly guarantees the loans and bonds of other states, such as Israel,³⁵ Jordan,³⁶ and Tunisia. The same applies to other states such as Japan.³⁷ International organizations also occasionally guarantee sovereign and quasi-sovereign bonds.³⁸ As Esteves and Tuncer (2016) show in their article in this issue, guarantees are also important.

The choice of joint obligation or guarantee may affect the legality of Eurobonds. Article 125 TFEU rules out guarantees to support borrowing by a member state, or the assumption of liability for “commitments of another member State”.³⁹ If, however, the 17 Eurozone states were to issue a bond jointly with several liability – following the model of the 2013 German Bund-Länder-Anleihe – Article 125 TFEU would unlikely stand in the way. They would not assume liability for “commitments of another member state”. Instead, they would assume a shared obligation with all other Eurozone member states.

Table 1 notes and compares the main features of the different Eurobond proposals in light of the article’s discussion of how these proposals would differ in terms of international legal personality, governing law, issuer, and form of debt mutualization.

As illustrated by this paper, one key question is whether Eurozone area states disappear as borrowers. But existing proposals are by and large ambiguous on whether a “European Debt Management Agency” will take the place of Eurozone member states as the issuer of sovereign bonds. This is a critical question not only from the point of view of whether and how member states are liable for Eurobonds, but also for the operation of covenants in existing debt instruments by member states.

35 22 U.S. Code § 2186 – Loan guarantees to Israel program.

36 USAID, Government of Jordan Issues \$1.5 Billion in Bonds with U.S. Guarantees (2015), www.usaid.gov/news-information/press-releases/jun-30-2015-government-jordan-issues-15-billion-bonds-us-guarantees (last visited 8 June 2016).

37 Japan Bank for International Cooperation, Government-Guaranteed Bonds in International Markets, www.jbic.go.jp/en/ir/government (last visited 8 June 2016).

38 World Bank, New World Bank Guarantee Helps Ghana Secure \$1 Billion, 15-Year Bond (2015), www.worldbank.org/en/news/feature/2015/11/18/new-world-bank-guarantee-helps-ghana-secure-us1billion-15-year-bond (last visited 8 June 2016). And MIGA’s guarantee of borrowing by Hungarian state-owned Eximbank: The world of sovereign bond guarantees, Reuters Global Investing, <http://blogs.reuters.com/globalinvesting/2013/07/19/the-world-of-sovereign-bond-guarantees> (last visited 8 June 2016).

39 The ESM does not breach Article 125, *Thomas Pringle v. The Government of Ireland, Ireland and the Attorney General*, C-370/12, Judgment, 27 November 2012, para 146.

Table 1: Comparison of legal features of Eurobond proposals.

	EFSF	ESM	Bruegel	Euronomics	German Council
Issuer	EFSF	ESM	Unclear	European Debt Agency	European Redemption Fund
International legal personality	No	Yes	Unclear	“Public multilateral institution”	Unclear
Governing Law	English Law	English Law	Not specified	Not specified	Not specified
Form of “mutualization”	Several; 780B guarantees	Several; paid-in capital 80B plus guarantees	Joint and several?	Bonds of 17 Eurozone members as collateral	Joint and several?

5 Conclusion

The paper started out with an overview of the development of the law governing sovereign bonds and an assessment of the potential relevance of international law for Eurobonds. It concluded that international law would only apply in the background, to specific issues, and in no way prevent the introduction of Eurobonds. Further, after observing the gradual change in the governance of sovereign bonds throughout the twentieth century, characterized by a shift from domestic law to external private law, it was suggested that the main question with respect to Eurobonds is which domestic governing law Eurozone member states will choose.

The paper then proceeded to assess the two potential sources of non-discrimination obligations for sovereign bonds, observing that contractual obligations not to discriminate fall short of a general equal treatment obligation and that international law is likely to come into play only in extreme cases in the form of international investment law. The paper then looked at whether the Eurobond proposals move in the direction of an explicit seniority structure for sovereign debt and whether they would include contractual non-discrimination obligations.

In Section 4 the three main possibilities for the issuer of Eurobonds (Eurozone member states collectively, following the model of the German Bund-Länder-Anleihe of 2013; an existing or future international organization similar to the ESM; a private entity modeled on the EFSF) were discussed.

Finally, the expressions used in the Eurobond proposals concerning the mutualization of debt (“collective liability”; “joint-and-several liabilities of the Eurozone”; “joint and several liability”; “joint and several guarantee”) were deciphered by looking at the terms from the perspective of English law and distinguishing three types of liability: (1) joint; (2) several and; (3) joint and several.

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