Has a restructuring credit event occurred with respect to the Republic of Ireland?

On 18 January 2011 the first drawdown (5.8B EUR) of the IMF loan to the Republic of Ireland occurred (see http://debates.oireachtas.ie/dail/2011/01/20/00067.asp under Point 78).

The IMF certainly enjoys *de facto* preferential creditor status in accordance with its status as an International Financial Institution and the IMF has claimed preferential creditor status with regards to their loan to the Republic of Ireland – see the press conference transcript (http://www.imf.org/external/np/tr/2010/tr120210.htm) and the pg 100 of the IMF report (http://www.imf.org/external/pubs/ft/scr/2010/cr10366.pdf).

In the event that the Republic of Ireland is unable to meet its financial obligations at some point in the future no one denies that the IMF loan will be repaid first or that bondholders will not receive scheduled payments if the IMF loan is in arrears. From a practical perspective the existing Irish bonds have become subordinated to the IMF loan.

The formal requirements of the ISDA Credit Derivative Definitions require that a change in the ranking in priority of payments causing the Subordination of an Obligation (in this case any bond issued by Ireland under domestic law) to the IMF loan is announced by the Republic of Ireland in a form that binds all holders of the Obligation. There are three important criteria that must be met i) there must be a change in the ranking in priority of payment; ii) the change must bind all holders of the subordinated obligation; and iii) the change in the ranking in priority of payments must cause a Subordination which means that there exists a contractual arrangement providing that A) upon liquidation, dissolution, reorganization or winding-up of the Republic of Ireland claims of the IMF will be satisfied prior to claims of the bondholders or B) the bondholders will not be entitled to receive or retain payments in respect of their claims against the Republic of Ireland at any time that the Republic of Ireland is in payment arrears or is otherwise in default under the IMF Loan.

i) The phrase “ranking in priority of payment” implies that the creditors’ rights as to priority of payment when the Republic of Ireland is unable to meet its financial obligations need to be compared and ordered in a relative manner. The Irish bonds do not contain express provisions as to their priority status. The IMF’s preferred creditor status implies that the Republic of Ireland will not restructure or reschedule the IMF loan, that the IMF will be paid back first in the case of insolvency and no payments will be made to bondholders if the IMF loan is in arrears. The existence of these rights puts the IMF in a preferred position compared to that of an ordinary bondholder who has no express rights with respect to priority of payment. In this way there is a relative ranking between the IMF and the Irish bondholders that is simply a matter of fact and does not need to be incorporated into the contract between the Irish government and their bondholders or in an intercreditor agreement between all creditors. The change in the ranking occurs because originally no bondholder had any express rights with respect to priority of payment and consequently there was no ranking amongst the bondholders. However after the IMF loan was drawn down on 18 January 2011, a creditor with preferential rights with respect to their treatment in the instance of insolvency came into existence. This caused a change in the ranking of priority of payments.

If the existing Irish bondholders were vested with rights with respect to priority of payment in the instance that the Republic of Ireland was unable to meet its financial obligations then an agreement between the Republic of Ireland and the IMF could not vary those rights due the principle of contractual privity. However the priority of an Irish bondholder in a sovereign debt restructuring has never been expressly delineated in the terms and conditions of an Irish sovereign bond or in Irish Law, therefore an Irish sovereign bondholder has no express right with respect to this matter. As such the Republic of Ireland may freely grant such a preferential right to the IMF that changes the ranking of priority of payments without varying a contractual term in the original bondholder's terms and conditions.

ii) The key issue is to define the meaning of "binding" or "bound" within the context of a "change in the ranking in priority of payments". As described above, ranking in priority of payments is a relative concept whereby the relevant rights that are specified in the terms and conditions of the individual obligations with respect to priority of payment if the Republic of Ireland was unable to meet its financial obligations are compared and appropriately ranked. While the ranking may be explicitly delineated in an intercreditor agreement executed by all relevant creditors, it is also possible that the ranking is simply due to a factual comparison of the rights granted to each creditor in the instance of the insolvency of the borrower. In this case (which is the relevant one in the case of Ireland) the ranking is due to a matter of fact and imposes no specific obligation upon the bondholders which can be legally enforced by either the Republic of Ireland or the IMF. However the creditors whose claims are deemed to be subordinated by the factual ranking have no legal entitlement to object to that ranking as the factual ranking is based upon an analysis of the terms and conditions of each obligation of the Republic of Ireland. A holder of an Irish bond only has an entitlement to object if the terms and condition of his bonds are violated; since the terms and conditions of the Irish bonds do not contain express terms specifying its priority there are no legal grounds to object. Additionally the holder of an Irish bond is not a party to the contract between the IMF and the Republic of Ireland and therefore has no legal entitlement to object to the terms of that contract – specifically the term that grants any preferred creditor status to the IMF. In this way the subordination binds all holders of the Irish bonds as they have no legal entitlement to object to the change in facts that caused a change in the ranking in priority of payments.

This interpretation of the word "binding" is wholly consistent with the fact that the definition of Subordination in Section 2.19(b)(i)(B) does not expressly require that the holder of the Subordinated Obligation be a party to the "contractual, trust or similar arrangement" that provides for the subordination. In the present case the "contractual arrangement" is solely between the IMF and the Republic of Ireland.

iii) Subordination is defined in two possible ways by Section 2.19, either *contractual, trust or similar arrangement providing that (i) upon the liquidation, dissolution, reorganization or winding up of the Reference Entity, claims of the holders of the Senior Obligation will be satisfied prior to the claims of the holders of the Subordinated Obligation <u>or</u> (ii) the*

holders of the Subordinated Obligation will not be entitled to receive or retain payments in respect of their claims against the Reference Entity at any time that the Reference Entity is in payment arrears or is otherwise in default under the Senior Obligation.

The precise wording of Section 2.19 states that the Subordination is due to a "contractual, trust or similar arrangement" however it does not state that the holders of the Subordinated Obligation need to be a party to that contract. As such the contract can be between the IMF and the Republic of Ireland for example.

This contract must consequently entail one of the two outcomes in order to lead to the subordination event.

Limb (i)

Within the list of restructuring events *"liquidation, dissolution, reorganization or winding up", "reorganization"* would most naturally apply to the Republic of Ireland. Upon the reorganization of the Republic of Ireland's financial obligations the preferred creditor status of the IMF would imply that the IMF's claims would be satisfied before the claims of the bondholders.

While "*liquidation, dissolution and winding-up*" imply the termination of the legal existence of the Reference Entity, "*reorganization"* implies that the Reference Entity remains in existence post the restructuring. Without an explicit requirement to terminate the legal existence of the Reference Entity, the term reorganization most naturally refers to the reorganization or restructuring of the financial obligations of the Reference Entity. In the analogous case of the financial distress of a corporate Reference Entity, the financial obligations of the Reference Entity can be reorganized in such a way to make the corporate solvent again without directly impacting its legal structure or status. Typical examples would be an English Scheme of Arrangement or US Chapter 11 Restructuring. As such it is natural for the term "*reorganization*" to apply to the Republic of Ireland.

The drafters of the ISDA Credit Derivative Definitions could have explicitly included a requirement that the *"liquidation, dissolution, reorganization or winding up of the Reference Entity"* leads to a change in the legal status of the Reference Entity but choose not to. Moreover the drafters could explicitly stated that Limb (i) of the definition of Subordination only applies to a Corporate Reference Entity similar to their explicit statement that a Subordination due to the operation of law only applies to a Sovereign Reference Entity.

Limb (ii)

If the Republic of Ireland defaults on their loan from the IMF they will not be allowed to continue to make scheduled coupon or principle payments to their bondholders without violating the preferred creditor status of the IMF. However on a first glance this does not necessarily extinguish the Irish bondholders' entitlement to receive payment in accordance with the bond's terms and conditions which is necessary to satisfy Limb (ii).

However the Bretton Woods Agreement has been passed into Irish Law as part of the Bretton Woods Agreement Act in 1957 (and amended in 1969, 1977, 1999 and 2011)

Section 3 of the Bretton Woods Agreement Act of 2011, giving effect to Article V, Section 3(a) of the Bretton Woods Agreement, states

The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

Therefore Irish Law authorizes the IMF to establish "adequate safeguards" when they extend loans; these adequate safeguards include the preferred creditor status of the IMF. As the vast majority, if not all, of the Republic of Ireland's bonds are governed by domestic Irish Law the bondholder's entitlement to demand payment when the IMF's loan is in default will be extinguished by the operation of these provisions of Irish Law. Additionally this provision of the helps evaluate the preferred creditor status of the IMF within Ireland from *de facto* to *de jure.* Support for this argument is found in an Irish newspaper article which reported that the IMF loan legally comes ahead of other debt due to its preferred creditor status (http://www.independent.ie/business/irish/imf-chief-predicts-rapid-recovery-from-our-crisis-2446657.html).