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RESTRUCTURING SOVEREIGN DOMESTIC DEBT AND THE INTERNATIONAL FINANCIAL ARCHITECTURE

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RESTRUCTURING SOVEREIGN DOMESTIC DEBT AND THE INTERNATIONAL FINANCIAL ARCHITECTURE

Sovereign domestic debt restructurings are now likely to occur more frequently. This briefing reviews aspects of the international financial architecture which has evolved with sovereign external debt restructurings as the main focus and considers specific issues arising in the domestic debt restructuring context.

Overview

Since the onset of the COVID-19 pandemic the International Monetary Fund (the "**IMF**" or the "**Fund**") has published the following three papers on the restructuring of sovereign domestic debt:

- Issues in Restructuring Sovereign Domestic Debt (November 2021)[1]
- A background paper to the above (August 19, 2021)[2]
- Restructuring Domestic Sovereign Debt: An Analytical Illustration (February 2023)[3]

As is discussed in these papers, domestic debt has risen considerably as a share of total debt in emerging market and developing economies since the turn of this century. Reasons include the deepening and growing maturity of domestic capital markets and, particularly since the onset of the COVID-19 pandemic, the financing of debtor country fiscal deficits (which themselves have either arisen or grown often as a direct consequence of the costs of healthcare, social safety net and other support measures taken as a result of the pandemic).

As noted as a key conclusion in the November 2021 IMF Paper, "Restructuring of sovereign debt issued under the domestic law – domestic debt for short – may become more frequent in the future". Further, a key conclusion in the August 19, 2021 paper was "Restructuring of domestically issued debt is likely to play a key role in the resolution of future debt crises".

Recent experience in the market place is consistent with these views. In the current environment, those countries in which public debt levels are regarded as unsustainable (with a high probability) by reference to the IMF's debt sustainability analysis ("**DSA**"), which also have high levels of domestic debt, will need to consider a domestic debt restructuring. A number of the issues likely to arise in this context are reviewed in the IMF papers. Decision makers will need to consider a number of factors which are either unique to domestic debt restructurings, or are more pronounced where domestic debt restructurings are in contemplation.

1 Issues in Restructuring Sovereign Domestic Debt, IMF Policy Paper No. 2021/071. Available here.
2 Available at the link included in footnote 1.
3 Restructuring Domestic Sovereign Debt: an Analytical Illustration, Working Paper No. 2023/024. Available here.

In the absence of an international insolvency or bankruptcy regime applicable to sovereign debtors under which an orderly reorganisation of the financial claims of a sovereign debtor can be achieved, policymakers and practitioners have crafted restructuring transactions by reference to the current international financial architecture. However, this has, to date, largely developed and evolved to seek to address challenges arising in the context of the need to restructure sovereign external debt rather than sovereign domestic debt.

What is domestic debt?

For these purposes it is helpful to dwell a little on the distinction between sovereign domestic and external debt and what is meant by sovereign domestic debt in this briefing. In different contexts, the following three reference points are used to describe sovereign domestic debt:

- state debt held by residents of the debtor country (this is the so called residency criterion)

- state debt denominated solely in domestic currency; in this context, the logic is that having monetary autonomy (and the ability to create new domestic money) through a debtor country's central bank provides considerable flexibility if, say, the sovereign domestic debt stock is too high; note that this logic breaks down where a debtor country is in a currency union, such as the Euro Area or the Eastern Caribbean Currency Union

- state debt governed by local law (which benefits from the so called local law advantage)

In this briefing, we use the final category only to describe sovereign domestic debt (which, for brevity, is referred to as domestic debt). This approach is consistent with that used in the November 2021 IMF paper. Where other definitions of domestic debt are relevant to key points made, we attempt to refer to them in the discussion.

The current international financial architecture

The current international financial architecture, which has continued to evolve in response to developments in practice, now comprises many important features and the following elements are reviewed in this briefing by reference to the prospect of restructuring of sovereign domestic debt, namely:

- the key role of the IMF as a lender to a country in financial distress; the following related issues are also considered:

  - the purposes, mandate and functions of the IMF

  - conditionality built into IMF-supported financial assistance Programs

  - the IMF's debt sustainability analysis

  - the IMF's Arrears Policies and Financing Assurances Policy (each as described below)

- the use of the Paris Club and the Paris Club's comparability of treatment provision
- the G20/Paris Club Common Framework
- collective action clauses ("**CACs**") in private sector bond contracts under which, in broad terms, once applicable voting thresholds have been reached, potential holdouts are crammed down

We also review a number of the key legal, regulatory and practical features which are different in domestic debt restructurings as compared to external debt restructurings.

It is instructive to begin with a consideration of the purposes, mandate and functions of the IMF.

IMF – Purposes, Mandate and Functions

The purposes of the IMF are set out in Article I of its Articles of Agreement as follows:

"Article I
Purposes

The purposes of the International Monetary Fund are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article."

The description given by the IMF of its mandate on its website is as follows:

> *"The IMF promotes global macroeconomic and financial stability and provides policy advice and capacity development support to help countries build and maintain strong economies. The IMF provides short- and medium-term loans to help countries that are experiencing balance of payments problems and difficulty meeting international payment obligations."*

It is clear from Article I and this description of the IMF's mandate that the international or cross border component is fundamental to the IMF's role. In arrangements where IMF lending[4] is involved, the mandate description requires there to be a balance of payments problem. Where a debtor country is seeking IMF financial assistance, IMF policies come into play, including the lending into arrears policies. These are designed in part to protect the IMF's lending exposure, and, in practice, in conjunction with conditionality built into IMF-supported financial assistance Programs and de facto preferred creditor status for IMF lending, generally achieve that aim. IMF policies are typically also designed in practice to assist in the prospects of the member's restoration to external debt viability over the Program period.

Clearly, many countries in financial distress will have both an external debt problem and a domestic debt problem. In seeking financial assistance from the IMF, conditions to lending (or to ongoing lending) built into IMF-supported financial assistance Programs may in practice necessitate a domestic debt restructuring (for example to bring down overall public debt levels or projected gross financing needs ("**GFNs**")). Discussions would need to take place between debtor country decision makers and IMF staff on the reasons for any such condition linked to the domestic debt; the most obvious connection would be restoration of overall financial stability in the debtor country. In measuring overall public debt levels in a single currency (e.g. US dollars), the exchange rate will determine the US dollar amount of domestic debt denominated in domestic currency. More generally, over time, connections between such domestic debt and external debt will also be affected through the country's exchange rate policies. Similarly, a country's monetary policies which influence inflation, exchange rate and reserves objectives will also be relevant in this context, as will any capital or exchange controls.

However, there may also be instances in which a debtor country only has a domestic debt problem. In instances where a domestic debt only problem is characterised by debt only in domestic currency, in the absence of significant holdings of domestic debt by non-residents and a balance of payments problem, the IMF may reasonably take the view that a classic IMF Standby or Extended Fund Facility with IMF lending and conditionality would be inappropriate and difficult to reconcile with its mandate. The position would be more complex where a large proportion of the domestic debt is denominated in foreign currency and where the debtor country has been using capital and exchange controls to manage the exchange rate.

4 Generally, IMF "lending" technically takes the form of the debtor country exchanging its currency for reserve assets in the Fund (e.g. SDRs or US dollars). This process is referred to as a "purchase" from the IMF's General Resources Account and is the functional equivalent of the IMF lending.

This takes us to a consideration of the IMF's functions. These include surveillance under Article IV, technical assistance under Article V, section 2 (b) and financial assistance under Article V, section 3. In this context, there is also a regulatory power under Article VIII, section 2. Clearly, these functions could be relevant in connection with the composition of domestic debt and, if issues associated with high domestic debt levels are relevant to exchange rate polices or currency practices which are inconsistent with the obligations of members under Article VIII, the IMF would have a natural role. However, the point remains that classic IMF lending is likely to be constrained unless there is a balance of payments problem.

One practical consequence is that we are likely to see some domestic debt restructurings without any classic IMF lending, which would mean that the tools available through conditionality in IMF lending and other aspects of the current international financial architecture would not necessarily be employed. The IMF papers on domestic debt restructurings identify historical instances in which domestic debt restructurings have taken place in isolation (i.e. in the absence of the restructuring of external debt).

IIn instances where both a domestic debt restructuring and an external debt restructuring are in clear contemplation, there is also a commercial factor linked to sequencing, particularly from the perspective of private creditors. Under the current international financial architecture, the debtor country will become bound by the Paris Club comparability of treatment provision if, following an IMF-supported Program, the Paris Club creditors agree terms before the private sector creditors. As mentioned in the "*The Paris Club and the Paris Club's comparability of treatment provision*" section below, generally, it is a pre-condition to Paris Club restructurings that the debtor country has an IMF-supported Program and the outputs from the DSA are typically followed by the Paris Club creditors for the purposes of settling the financial terms of the Paris Club restructuring. Private sector creditors therefore have an incentive to move swiftly at the outset. However, where there is also a domestic debt restructuring in contemplation, that incentive shifts because the classic Paris Club comparability of treatment provision does not extend to domestic debt denominated in domestic currency. The concern from private sector creditors therefore becomes that the holders of domestic debt may not share in the burden of payment adjustment on a proportionate basis (or indeed at all). Where both a domestic debt restructuring and an external debt restructuring are in clear contemplation, private sector creditors therefore have an incentive to require domestic debt restructurings to proceed before private sector debt restructurings, so that the shape of that deal is known before the private sector debt deal.

Conditionality built into IMF-supported Financial Assistance Programs

Generally, when a member country draws upon financial resources of the IMF, that member agrees to policy adjustments effectively by way of conditions to IMF loans. Typically, conditions are phased so that they limit access to further resources. Assuming that the conditions are regarded by the IMF as being effective for the purposes of overcoming the problems which gave rise to the need to request financial assistance, then the linkage to the "adequate safeguards" referred to in Article I(v) is

clear. Also of relevance in this context is Article V, Section 3(a) of the IMF's Articles of Agreement which is set out below:

> *"Section 3. Conditions governing use of the Fund's general resources*
>
> *(a) 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."*

Conditionality in this context is therefore key to protecting the quality of IMF lending. In practice it is also an important signal to markets and so should serve to improve the prospects for future private sector investment and lending.

> *As stated by the IMF itself:*
>
> *"Conditionality helps countries solve balance of payments problems without resorting to measures that harm national or international prosperity. In addition, the measures aim to safeguard IMF resources by ensuring that the country's finances will be strong enough to repay the loan, allowing other countries to use the resources if needed in the future. Conditionality is included in financing and non-financing IMF programs with the aim to progress towards the agreed policy goals.*
>
> *Member countries that borrow from the IMF have primary responsibility for selecting, designing, and implementing policies to make their economic program successful. The program is described in a letter of intent, which typically includes a memorandum of economic and financial policies for more detailed description of the policies. The program's objectives and policies depend on a country's circumstances.*
>
> *The overarching goal is always to restore or maintain balance of payments viability and macroeconomic stability while setting the stage for sustained, high-quality growth. For low-income countries, there is an additional objective of reducing poverty."*

The reference to the inclusion of conditionality in non-financing IMF Programs means that other elements of the purposes of the Fund in Article I would need to be drawn upon in that context.

Conditionality takes the form of prior actions (i.e. steps required before IMF approval of financing or before a review will be completed); quantitative performance criteria (i.e. specific measurable macroeconomic variables, such as aggregate money supply or a ceiling on external debt); indicative targets (for example a ceiling on state borrowing

from the central bank); and structural benchmarks in the form of reform measures (e.g. steps to improve fiscal transparency).

Conditionality is an area in which there has been considerable evolution in the approach of the Fund over the years. It is also an area in which the IMF conducts periodic reviews[5].

It is clear from this description that whilst a balance of payments problem is required for IMF lending, many of the conditions incorporated into IMF lending are in areas designed to have a more fundamental and far broader impact and, in practice, they may spill over into areas which effectively require high levels of domestic debt to be addressed by the debtor country.

Debt Sustainability Analysis

At its most fundamental level, sovereign debt is sustainable if the sovereign is able to meet all of its financial obligations in full and on time without needing to resort to exceptional financing.

The broad topic of debt sustainability is important to many areas of the work of the IMF and it is relevant to both the surveillance and lending functions of the Fund. The analytical methods drawn upon to assess various aspects of debt sustainability have given rise to a large body of literature including within the IMF itself and these methods have evolved and been refined over time. At present the IMF distinguishes between market access countries and low income countries through different frameworks for assessing debt sustainability (in simplistic terms that distinction is relevant because at the end of an IMF lending program a market access country would be expected to be able to access the marketplace for financing on sensible financial terms, as opposed to a low income country where there is no such expectation and which in more normal circumstances would tend to draw upon concessional financing and donor resources)[6].

The debt sustainability analysis is inherently complex and now operates through the use of probability associated with a potential outcome, such as debt distress. There is recognition of the uncertainty surrounding the most probable outcome. Whilst the probability of debt being unsustainable above a specified threshold (e.g. 50%) is used as a key reference point for the ultimate assessment on debt sustainability, those conducting the analysis will be expected to exercise judgement rather than rely solely on the mathematical output from the analytical model. The frameworks also incorporate risk signals which may arise over different parts of the overall time horizon used in the analysis. As in all such exercises where a model is used as a proxy for reality, the quality of the data used as inputs is key and this is well recognised. There are many elements incorporated into the model a number of which capture or are relevant to domestic debt, these include, in simple terms, overall public debt levels, anticipated budget deficits and the gross financing needs of the country over time. Clearly, where relevant risk signals indicate that challenges will arise during periods which are part of

5 The last such review (in 2018) is available here.

6 A description of the framework for market access countries (which has been snappily renamed as the Sovereign Risk and Debt Sustainability Framework for Market Access Countries (MAC SRDSF) is available here. A description of the framework for low income counties (known as the LIC DSF), which is a joint initiative with the World Bank is available here.

the overall time horizon under consideration then inevitably this would precipitate a discussion on whether a domestic debt restructuring should be in contemplation.

Where there is a high risk that debt is unsustainable, the solvency problem vs liquidity problem becomes relevant. Whilst these distinctions are not rigid, in broad terms a solvency problem would indicate that debt levels are too high and so debt reduction is required whereas a liquidity problem should be solvable through a re-profiling exercise in which the amortisation structure of the debt is modified.

The IMF's Arrears Policies

The central condition deriving from these policies is that any member country in arrears to external creditors at the time financing from the Fund is requested, will only be able to access lending from the IMF if the IMF's arrears policies are satisfied.

There are three arrears policies, broadly distinguished by reference to creditor type. In declining order of severity, these are as follows:

1. The Non-Toleration Policy (the "**NTP**") – broadly designed for International Financial Institution ("**IFI**") creditors, such as the World Bank;

2. The Lending into Official Arrears Policy (the "**LIOA**") – broadly designed for official bilateral creditors (e.g. Paris Club members); and

3. The Lending into Arrears Policy (the "**LIA**") – broadly designed for private external creditors.

These arrears policies were recently reviewed in an IMF Policy Paper dated May 18, 2022.

The Non-Toleration Policy

Previously, all official creditors were covered by the NTP and so the IMF was prevented from lending to countries owing unresolved arrears to official bilateral creditors, unless those arrears were covered by a Paris Club agreement or the creditor consented to the Fund providing the financing. Following a review in 2015, the current three layered position was effectively adopted. In essence, the current version of the NTP requires arears to be cleared or, for the World Bank group, an agreed plan needs to be in place; or for other IFIs there needs to be a credible plan (the special position of the World Bank group reflects the 1989 IMF-World Bank Concordat). Where there is official sector involvement in the debt restructuring ("**OSI**"), claims which would otherwise be subject to the NTP may instead be subject to the LIOA if certain conditions are met (such as the claim in question is not owed to a Reserve Currency Union central bank; does not form part of a Regional Financing arrangement or is not owed to a multilateral development bank with membership which includes more than half of the Fund's own members and the members of that multilateral development bank also have over half of the Fund's total voting power). Clarifications associated with the NTP and other technical refinements to this general description are set out in Annex I to the Supplementary Information Paper attached to the May 18, 2022 IMF Policy Paper on Arrears.

The Lending into Official Arrears Policy

Broadly, arrears owed to official bilateral creditors are either dealt with under the NTP or, where there is a Fund-supported program under which the restructuring of OSI claims is required, the LIOA applies. Under the LIOA, the IMF may provide financing 'despite sovereign arrears to official bilateral creditors on direct bilateral claims in carefully circumscribed circumstances'. The main elements are: where there is an adequately representative Paris Club agreement arrears are regarded as eliminated under the LIOA when financing assurances are given; if another representative forum emerges, the IMF may engage with it (this is a clear reference to the committee contemplated under the Common Framework); where the Paris Club criterion does not apply, the following conditions need to be met for the IMF to consider lending, namely, in simple terms: (i) prompt financial support is essential and the member is pursuing appropriate policies, (ii) the debtor is making good faith efforts to reach agreement with the creditor for a contribution consistent with the parameters of the Fund-supported program, and (iii) any decision to provide financing would not have an unduly negative effect on the IMF's ability to mobilise financing packages in future cases. Determinations will be made on a case by case basis. The full LIOA sets out guidance on the 'adequately representative', 'contribution', 'direct bilateral claim', 'good faith' and 'undue negative effect' reference points. An official bilateral creditor may also simply consent to IMF financing notwithstanding the arrears owed to it. Whilst unresolved arrears remain outstanding all disbursements under a financing program will be subject to financing assurances. Finally, provision is made for a more flexible approach in response to emergency situations such as natural disasters.

The Lending into Arrears Policy

This policy applies to both sovereign arrears to external private creditors and non-sovereign arrears where they are caused by the imposition of exchange controls. In broad terms, determinations are made on a case by case basis and, where there are sovereign arrears to private creditors, the Fund is able to provide financing only where: "(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors." Where exchange controls are the cause, the second criterion extends to good prospects for the removal of exchange controls and the collaborative agreement is between private debtors and their creditors. On the potentially sensitive topic of good faith, the full LIA refers to the usefulness of clarity in conjunction with flexibility by reference to the circumstances of each case and provides guidance on how that balance may be struck. Whilst outstanding arrears to private creditors remain outstanding all disbursements under a financing program will be subject to financing reviews allowing the Fund broadly to monitor the situation. Again, provision is made for a more flexible approach in response to emergency situations such as natural disasters. For the purposes of pre-emptive restructurings (i.e. typically before a payment default) where the debt sustainability analysis indicates that an external private creditor restructuring is needed, the ideal is that the transaction should proceed before approval of the Fund arrangement. In order to provide flexibility, the pre-emptive restructuring may occur at a later date and the Fund may provide financing broadly if it has adequate assurances that the transaction will be successful. The LIA only applies to an external debt claim in arrears and 'external' for these purposes is determined by reference to the residency criterion. The full LIA provides further detailed guidance.

Arrears to the Fund itself

Finally where arrears are outstanding to the IMF itself, in simple terms, further drawings under any existing arrangement are suspended and any request for new IMF financing will not be approved until the arrears are cleared.

These policies effectively create a set of incentives which have assisted in shaping debtor and creditor behaviour. The clear context within which these arrears policies were written is one in which the member country has a balance of payments problem and an external debt restructuring (or re-profiling) is in contemplation. Whilst local law governed foreign currency debt held by external creditors may fall within these policies, they are not designed for application to all of the debt claims included in most domestic debt restructurings.

Financing Assurances Policy

In simple terms this policy requires that a Fund-supported program may not be approved unless it is fully financed. Similarly, a review under such a program cannot be completed unless it is fully financed (and so that could limit further lending). Any financing gaps need to be filled and the member needs to be in a position to repay the Fund during the applicable period after the end of the program.

More specifically, where the expectation is that the official sector will provide new external financing there are (i) 'firm commitments' of that financing for the next 12 months; and (ii) 'good prospects' that adequate financing will be available for the remaining period of the program.

In broad terms, in instances where there is a high probability that debt is unsustainable, and the debtor country is not in arrears, the IMF needs assurances that debt sustainability will be restored and the program will be fully financed: for official bilateral creditors, the Fund requires 'specific and credible' assurances on the applicable debt relief or financing; for IFIs which are to provide new financing, again 'specific and credible' assurances are required; and in relation to private creditors, the IMF needs to a form a judgement that a credible process is underway to restore debt sustainability and to fill the private sector's share of any financing gaps.

Generally speaking, in instances where there is a high probability that debt is unsustainable, and the debtor country is in arrears, the requirements of the financing assurances policy depend on the type of creditor to whom the arrears are owed:

- where there are arrears to private creditors, the IMF may take the view that debt sustainability will be restored if any restructuring offer is consistent with the program and the LIA policy is satisfied
- where there are arrears to official bilateral creditors, the IMF may take the view that debt sustainability will be restored if the Fund's LIOA policy is satisfied

For emergency financing the financing assurances policy effectively reduces to the need for the Fund to form a judgement that the member will be in a position to repay the IMF.

The Paris Club and the Paris Club's Comparability of Treatment Provision

The Paris Club is a long standing informal group of government creditors (official bilateral creditors), currently with 22 permanent members which among other matters seeks to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries.

There is a recognition that, in some cases, Paris Club creditors no longer represent a simple majority of a country's official bilateral creditors. This is as a result of the increased lending activities of non-Paris Club official bilateral creditors, including China and India. Whilst not permanent members of the Paris Club, China and India are associate members of the Paris Club.

The agreement among Paris Club members and a debtor country is typically condensed into Agreed Minutes which set out the financial parameters of the agreed deal and is then followed by bilateral agreements with each individual Paris Club member which is party to the Agreed Minutes.

Paris Club members agree to adhere to six principles, two of which, conditionality and comparability of treatment are particularly relevant in our context.

The Paris Club describes conditionality as follows:

> *"The Paris Club only negotiates debt restructurings with debtor countries that:*
>
> - *need debt relief. Debtor countries are expected to provide a precise description of their economic and financial situation,*
> - *have implemented and are committed to implementing reforms to restore their economic and financial situation, and*
> - *have a demonstrated track record of implementing reforms under an IMF program.*
>
> *This means in practice that the country must have a current program supported by an appropriate arrangement with the IMF (Stand-By, Extended Fund Facility, Poverty Reduction and Growth Facility, Policy Support Instrument). The level of the debt treatment is based on the financing gap identified in the IMF program.*
>
> *In the case of a flow treatment, the consolidation period coincides with the period when the IMF arrangement shows a need for debt relief. When the flow treatment extends over a long period of time (generally more than one year), the Paris Club agreement is divided into phases. The amounts falling due during the first phase are treated as soon as the agreement enters into force.*

> *Subsequent phases are implemented following completion of conditions mentioned in the Agreed Minutes, including non-accumulation of arrears and approval of the reviews of the IMF program."*

The direct link with an IMF-supported Program is clear. In practice the DSA is used to determine the financing gap referred to above and the Paris Club seeks to fill its share of the financing gap through revised payment terms on the debts owed to it by the debtor country seeking debt relief.

The Paris Club describes comparability of treatment as follows:

> *"A debtor country that signs an agreement with its Paris Club creditors should not accept from its non-Paris Club commercial and bilateral creditors terms of treatment of its debt less favorable to the debtor than those agreed with the Paris Club."*

In practice a Paris Club comparability of treatment, generally in standard form, is included in Paris Club Agreed Minutes. An example of a standard comparability of treatment provision is set out below:

> *"In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Republic of [ ] commits to seek promptly from all its external commercial and bilateral creditors debt reduction and reorganisation arrangements on terms comparable in net present value to those set forth in these Agreed Minutes for credits of comparable maturity. Comparability of treatment for debt reduction in net present value is assessed not only on the basis of the reduction in the face value of the debt but also on the terms of repayment of the debts not cancelled. Consequently the Government of the Republic of [ ] commits to accord all categories of creditors – and in particular creditor countries not participating in these Agreed Minutes, commercial banks and bond holders – a treatment not more favourable than that accorded to the Participating Creditor Countries."*

The Paris Club description of the distinction between external debt and domestic debt is as follows.

> *"External debt and domestic debt*
>
> *External debt is generally defined using a residency criterion: it is debt owed by public and private entities resident in a country to non-residents. This type of debt has a direct impact on the balance of payments of the debtor country. The domestic debt, on the contrary, is debt owed by resident entities to other resident entities in the country.*

However, for practical purposes, external debt is sometimes compiled according to the currency of the debt and without using a residency criterion (being then similar to foreign currency debt)."

Given the strong linkage with the IMF, it is not surprising that, at their core, Paris Club debt treatments are generally crafted with a focus on the restructuring of public external debt of the debtor country. This does not read across well into domestic debt restructurings (one exception would be public debt governed by local law issued by a country in a currency union, where for many purposes external and domestic debt are indistinguishable other than by reference to the residency criterion). The key linkage in external debt restructurings between Paris Club transactions and those for non-Paris Club official bilateral creditors and private sector creditors is through the comparability of treatment clause which, as can be seen, refers to other external bilateral and commercial creditors and so does not seem to have been designed with domestic debt restructurings in contemplation.

Common Framework

As mentioned earlier, the COVID -19 pandemic materially affected the ability of many countries in already vulnerable financial circumstances to service their debt obligations in full and on time. The Debt Service Suspension Initiative ("**DSSI**") represented a swift response by the G20 and the Paris Club to the short-term consequences of the COVID-19 pandemic on government finances for the 73 eligible low income countries ("**LICs**"), following the IMF and World Bank call to action. It was noteworthy for its co-ordination at the G20 level on debt matters and provided cash flow relief with few conditions (e.g. request for financing (emergency or otherwise) from the IMF).

The April 2020 G20 Finance Ministers and Central Bank Governors Communiqué regarding the DSSI also called on the private sector to participate "on comparable terms" to those set out for official sector bilateral creditors. While the production of Terms of Reference for Voluntary Private Sector participation in the DSSI and other documents[7] to facilitate participation provided a framework for engagement, take-up was low, not least because of the hesitation of debtor countries to request it. Further, the private sector continued to provide financing.

Whilst it was generally accepted that the DSSI was a timely response by official bilateral creditors to COVID-19, it was recognised that this did not address medium term debt distress. The end of the DSSI gave rise to the Common Framework for debt treatment beyond the DSSI (the "**Common Framework**") (which establishes a more durable framework for providing debt relief to DSSI-eligible countries). The Common Framework represents more of a return to the use of pre-existing international financial architecture, save that the G20 coordination on debt matters will continue as the official sector will

7 To aid debtor countries in utilising the DSSI, the Institute of International Finance ("**IIF**") published a toolkit comprising a Template Waiver Agreement to be used in connection with bilateral and syndicated loan arrangements to waive default events that could arise from a sovereign debtor's announcement of its intention to participate in the discussions with the official sector, a Term Sheet in Respect of a Framework Agreement for Loan Debt and a Technical Note on Consent Solicitations. See also "Work of the PCG and the IIF Committee for Sovereign Risk Management to Convey Private Sector Perspectives and Facilitate Private Sector Participation with respect to the G20/Paris Club Debt Service Suspension Initiative (DSSI) and the Common Framework for Debt Treatments beyond the DSSI" (which was written by Clifford Chance) on pages 12-15 of the IIF's 2021 Annual Report.

be represented not solely through the Paris Club but also through G20 official bilateral creditors that are not Paris Club members (e.g. China, India, Turkey and Saudi Arabia). A new official sector creditor committee is to be established in response to each request for debt treatment. Under the Common Framework, like the DSSI, the process must be initiated by the debtor country. However, unlike the DSSI, the debtor country must have an agreed IMF-supported Program (e.g. an Extended Credit Facility) and an IMF-World Bank Group DSA needs to be conducted, which in practice identifies the needed debt relief.

Comparability of treatment is required under the Common Framework (but not the DSSI). This requires the debtor country to obtain from all other official bilateral and private creditors a debt treatment at least as favourable as that agreed under the Common Framework. Currently four countries have requested debt treatments under the Common Framework: Chad, Ethiopia, Zambia and Ghana. There are remaining concerns linked to the Common Framework over the speed at which official sector countries form creditor committees and the need for relevant creditor countries to move swiftly to establish new norms and procedures. In order to streamline Common Framework cases, thought could usefully be given to making the overall process more efficient including by accelerating the speed at which co-chairs of the official creditor committee are appointed and an agreed timeline and workplan are created. Overall benefits are also likely to be realised through improved transparency on debt stock matters and attempting to ensure that discussions with different creditor groups move in parallel based on timely access to similar levels of data. Thought could also be given to the means and practicalities involved with dealing with non G20 or non-Paris Club official bilateral creditors of a debtor country requesting debt treatment under the Common Framework. The development of guidelines dealing with all of these aspects would be one way forwards. Against that backdrop, in February 2023, the IMF announced that a new Global Sovereign Debt Roundtable had been established with the goal of bringing together creditors – official, old and new, and private – and debtor countries to discuss key issues that can facilitate the debt resolution process. The work of the Roundtable continues.

Given that the Common Framework also requires an agreed IMF-supported Program and is underpinned by the DSA, the points made earlier concerning the design of components of the international financial architecture being crafted around external debt restructurings as opposed to domestic debt restructurings continue to apply.

Collective Action Clauses

The implementation of debt relief arrangements for private sector debt is centred around the use of contractual mechanisms (e.g. the use of majority voting through CACs), engagement and voluntary participation. Such initiatives, including to address perceived holdout creditor problems have been, and continue to be, further refined over time and it is now routine for new sovereign bond issuances governed by New York or English law to contain the latest enhanced CACs published by the International Capital Market Association ("**ICMA**") in 2014/2015 together with a template pari passu clause disavowing the rateable payment interpretation of pari passu clauses at the heart of the Argentine litigation prior to the latest Argentina restructuring.

Enhanced CACs in broad terms allow voting across various sovereign bond issuances to be aggregated in a manner with parallels to that used in US Chapter 11 corporate bankruptcy with the ability to conduct a single aggregated vote at the 75% level. If the voting threshold is reached, those bondholders which do not vote or vote against the proposal put to them are bound by the outcome of the votes and so would be crammed down, again in a manner similar to that available in US Chapter 11 proceedings.

The vast majority of international sovereign bonds are now issued with these enhanced CACs. However, it is generally accepted that there is a significant volume of sovereign debt without majority amendment provisions for payment terms. This is because some types of sovereign debt, including loans, do not generally contain majority voting for payment term revisions and because there are outstanding sovereign bonds which were issued before the adoption of the enhanced CACs with long original maturities (although most of these legacy bonds contain single series CACs, so within an individual series of bonds the minority can be crammed down if the majority votes in favour of a restructuring proposal).

With these limitations in mind, the G7, the IMF and other market stakeholders have taken a renewed interest in how sovereign loans are restructured, when necessary, following a number of years where sovereign bonds were at the centre of market innovations to facilitate sovereign debt restructurings. This gave rise to the publication on November 1, 2022 by various industry bodies (including the Asia Pacific Loan Market Association, ICMA, IIF and the Loan Market Association) of a Guidance and Explanatory Note and a suite of specimen clauses for inclusion on a voluntary and forward-looking basis in sovereign loan agreements. The process of identifying the areas to be addressed and the development of the specimen contractual provisions for use in new sovereign loan agreements was a G7 initiative lasting between 18 months and 2 years and the United Kingdom, as chair of the G7 at the relevant time, took the lead for the whole process through HM Treasury. The essential element of the policy initiative behind these specimen clauses, which are designed as 'slot in' clauses for sovereign loan agreements, is to move away from lender unanimity for payment term amendments by including majority voting provisions ("**MVPs**") in sovereign loan agreements. These MVPs operate at a recommended majority voting threshold of 75% (i.e. below the previously typical unanimous creditor consent level but above the typical majority lender voting threshold for non-unanimity matters)[8]. Overall therefore, current thinking on how to facilitate sovereign debt restructuring as it relates to external debt has focused on incremental contractual enhancements[9] as well as greater debt transparency[10] and earlier private sector creditor engagement among other things.

8 See Majority Voting for Payment Term Amendments in Sovereign Loans – Latest Addition to the International Financial Architecture (November 10, 2022), Clifford Chance. Available here.

9 See also the work of the UK-convened Private Sector Working Group: sub-group on Climate Resilient Debt Clauses which produced template climate resilient debt clauses for sovereign debt instruments. Available here from ICMA.

10 See the IIF's Voluntary Principles for Debt Transparency. Available here.

In the context of domestic debt restructurings, often much significance is given to the local law advantage (discussed further below). This has been used in some instances retroactively to introduce collective action clauses (without creditor safeguards) into domestic debt instruments. These clauses are then used to vote through the required payment changes to deliver the restructuring payment terms required under the domestic debt restructuring transaction. This was the approach taken in the Greece restructuring in 2012 which represented a combined domestic debt and external debt restructuring[11]. There are many potential problems associated with such a retroactive approach and a number of them are referred to in the November 2021 IMF Paper, including risks associated with litigation under the applicable constitution (where property rights are often protected against expropriation without adequate compensation and litigation is likely to be in the debtor country's jurisdiction) and bilateral investment treaties (where provisions designed to protect investments often extend to debt instruments and litigation or arbitration is likely to be outside the debtor country's jurisdiction).

Further, in the practical delivery of domestic debt restructurings, largely as a result of potential negative feedback linkages into the domestic economy, primarily through the banking sector, life assurance, insurance and pensions markets, approaches which differentiate between holders may need to be taken for legitimate reasons and introducing and activating cram down mechanisms may fetter the ability to distinguish between different categories of creditors and exacerbate such negative feedback linkages. This differentiation process has been occurring over a long time frame and, for example, was used in the delivery of Russia's domestic debt restructuring of GKOs and OFZs following its August 1998 moratorium. A debtor requiring that flexibility would not be attracted by collective action provisions under which there is aggregated voting and the same economic deal could be crammed down on recalcitrant creditors. Whilst, in the context of sovereign bonds, separate voting pools could theoretically be used for these purposes, as the number of separate voting pools increases, the benefits of aggregation reduce. Some creditors also have concerns associated with aggregating together external debt holders with domestic debt holders for voting purposes (that distinction does not apply meaningfully with issuers in a currency union). Any suggestion that new issuances of domestic debt instruments issued outside of a currency union should incorporate provisions of that type need to be weighed against those legitimate debtor concerns, in particular if a retrospective incorporation is in contemplation. Any country contemplating the inclusion of collective action clauses in new domestic debt issuances for the first time would also be well advised to carry out a review of its constitution and other aspects of its relevant domestic law as well as a review of any applicable bilateral investment treaties before taking that step so as to allow a meaningful risk assessment of potential legal challenges to be conducted.

11 From 1 January 2013, all euro area sovereigns were required to include new model collective action clauses in both international and domestic government securities with a maturity of over one year. It is noteworthy that this step was taken only after a detailed legal analysis of the domestic law of each euro area member state and of EU law to ensure compatibility. The requirement to use collective action clauses was also entrenched in the treaty establishing the European Stability Mechanism. See New Euro Area Model Collective Action Clause (December 13, 2021), Clifford Chance Available here.

Legal, Regulatory and Practical Features of Domestic Debt Restructurings

We now turn to review a number of the key legal, regulatory and practical features in domestic debt restructurings. Whilst some issues are conceptually similar to those applicable to external debt restructurings, many are different and our starting point is the November 2021 IMF Paper.

A number of key points are well made in the November 2021 IMF Paper which are directly relevant to the challenging evaluations required to be made by domestic decision makers on whether to proceed with and, if so, how to shape in practice a domestic debt restructuring, including the following:

- Solvency type considerations: the desirability of aiming for a position where domestic debt levels are sustainable without the need for protracted primary budget surpluses (or any further restructuring)
- Pre-emptive vs post default approach
- Evaluation of the risk of negative feedback channels especially with respect to the domestic banking, insurance and pension sectors
- Evaluation of the extent to which the domestic banking sector may transmit shocks into the rest of the domestic economy
- Consideration of existing capitalisation levels in the domestic banking, insurance and pension sectors
- The desirability of safeguarding these sectors and evaluation of any associated costs, including of a potential financial sector stabilisation fund
- Reviewing applicable mark to market and holding to maturity accounting rules and their potential impact on the accounting and regulatory impact of any domestic debt restructuring
- The desirability of identifying any gaps in crisis management and bank resolution frameworks
- Evaluations of any capital flight risk and whether any temporary capital controls may be appropriate
- Ongoing liquidity needs: the desirability of being able to refinance maturing obligations and to finance any new fiscal deficits; evaluations of the extent to which in practice the investor base is captive
- Evaluating advantages and disadvantages of the breadth of creditor involvement; in this context consideration of the Central Bank as a creditor and evaluations of its ability to continue to perform its key functions; banks; insurance companies; pension funds; state-owned enterprises ("**SOEs**"); individuals (retail holders) and other holders

(including non-residents) as creditors and associated impacts (including in the area of potential political influence)

- Consideration of the types of domestic debt instruments (e.g. central government securities, bank loans, guaranteed obligations, derivatives) to be included
- Consideration of intercreditor issues
- Evaluating the extent to which there may be potential spill overs into the external debt financing conditions (non-resident holders of domestic debt being potentially relevant in this context)
- Evaluating how most appropriately to commence and run the process; the extent of dialogue and transparency whilst at important junctures maintaining confidentiality
- The desirability of communication of the overall economic plan
- Evaluating the ability to create incentives to participation and disincentives to non-participation and the extent to which it is appropriate to seek to rely upon the local law advantage and the inherent associated risks
- Evaluating the desirability of incorporating collective action clauses into any new domestic debt instrument to be issued in any restructuring transaction and in future issuances (this evaluation could be expanded to broadly equivalent majority voting features in new domestic loans)

In addition, consideration will need to be given to governance issues which may arise and may need to be addressed (both at the debtor and creditor level).

A description of selected practical and legal considerations from the perspective of practitioners in the area of domestic debt restructurings is likely to be illuminating and this follows:

Identifying the target instruments and creditors

As discussed above in the context of CACs, one key distinction between restructuring external debt and restructuring domestic debt is that with regards to external debt the goal will almost surely be to restructure 100% of the debt (or as close to 100% as possible) whereas domestic considerations may mean that decision makers legitimately opt for a more targeted restructuring of domestic debt. Also as discussed above, comparability of treatment considerations may be different, particularly where there are high risks of negative feedback channels and significant disruptions to the domestic economy.

A debtor country may have multiple different types of domestic debt, which might include domestic bonds and domestic loans from local banks. The domestic debt stock may also comprise solely of local law, domestic currency debt or also include local law, foreign currency debt and the considerations may vary between those categories.

The different types of holders of domestic debt will also be relevant. These may include local banks (some of which may be state-owned), local pension funds, local insurance companies and local corporate and individual holders. It might also include overseas creditors, who may hold the same instruments as the local creditors or different instruments marketed specifically at overseas holders (perhaps in the form of diaspora bonds or similar instruments).

One likely holder of domestic debt instruments will be the central bank of the debtor country and unique considerations will need to be evaluated when deciding whether, and if so, how, to restructure those instruments. Central banks often hold domestic debt instruments for more than one purpose, for example as part of the process of achieving monetary policy objectives or the provision of liquidity to the domestic financial system through repo transactions. It may be necessary to distinguish between instruments held for these different purposes when formulating the domestic debt restructuring.

Decisions will therefore need to be taken as to which domestic debt, and which domestic creditors, are in-scope for the domestic debt restructuring. This will extend to careful evaluations of any anticipated negative feedback channels (as referred to earlier). These decisions will be highly specific to the debtor country in question.

Maintaining debt servicing

When a debtor country is in severe financial distress the realities associated with maintaining debt servicing may be different as between domestic debt and external debt. Assessments of any negative feedback channels mentioned earlier will be one factor in this context. Further, with regards to external debt, if, for example, the debtor country was facing a very large amortisation payment in circumstances where the market for new external debt raising was effectively closed, central bank swap lines were close to utilisation limits and the debtor country simply had insufficient foreign reserves to service the debt, the ability to maintain ongoing debt service may simply be lost. However, for domestic debt issued in a debtor country's own currency, there would be more flexibility (although this would be far more limited where the debtor country is a member of a currency union). The starting point in the process of seeking to restructure both categories of debt may therefore be different.

The profile of domestic creditors, may also make it important for the debtor country and all its creditors to remain current on its domestic debt, for example where its domestic debt instruments are used as collateral or regulatory capital in the domestic financial markets and a failure to perform would transmit shocks to or cause significant disruption in the domestic economy through negative feedback linkages. Separate credit ratings assigned to a debtor country's external and domestic debt may also be a factor in these difficult evaluations.

As a debtor country embarks on a domestic debt restructuring, the position on debt servicing will have an impact on the restructuring itself as it may affect incentives structures for both the debtor country and its domestic debt holders.

Other features which may be different in the external debt context include the extent to which the viability of the businesses of domestic debt holders is linked to overall

improvements in the domestic economy and so to the success of government actions in the recovery program; and the extent to which the debtor country may be able to exercise influence over domestic creditors.

Engagement strategy

Whilst in the case of external debt restructurings there are some well-established norms for the purposes of engaging with creditors (e.g. through bondholder committees), these are generally lacking in the domestic debt context. The relevant decision makers in the debtor country would be well advised to consider the engagement strategy with different groups of holders of its domestic debt carefully. There will be a linked concern to ensure compliance with relevant securities regulations and confidentiality associated with any discussions in this context, particularly at sensitive junctures and as between different creditor groups.

Most fundamentally it is generally appropriate in the context of a domestic debt restructuring also to discuss with any affected creditor (or representative group thereof) the reasons behind the need to revisit payment terms as well as the overall economic adjustment plan (including details on the macro-economic situation and applicable debt targets) in addition to the proposed new financial terms. Whatever structure is chosen should also enable legitimate concerns of creditors to be heard, evaluated and, if appropriate, reflected to the extent consistent with overall objectives.

Identifying the legal framework for the domestic debt restructuring

The two most often used legal systems to govern external sovereign debt are English and New York law and there are established approaches which tend to be followed when restructuring debt governed by those systems of law. Such debt will almost certainly be subject to detailed terms and conditions set out in the legal documentation, including the terms and conditions which can be drawn upon in seeking to restructure the debt (which may include the CACs or MVPs discussed above). Domestic debt is, by definition, subject to the laws of the debtor country and the laws and customs relevant to the restructuring of such domestic debt will necessarily vary from country to country. It may be the case that the local law or the terms and conditions of the relevant domestic debt instruments include provisions setting out relevant rules for conducting a restructuring but it is also quite possible that the local law does not include such provisions. This is likely to be the case where the domestic debt instruments are securities issued as bare promises to pay without detailed terms and conditions.

Where neither the local law nor the terms and conditions of the domestic debt instruments include provisions for restructuring the debt, it may therefore be necessary for a framework to be put in place before a domestic debt restructuring can take place. Depending on the country in question, this may require a political process (which itself extends to executive action and laws being passed by a legislature etc.) and constitutional considerations to be taken into account. Where the domestic debt instruments are listed on a local exchange and/or cleared in a local clearing system, the rules and regulations of that exchange or clearing system will also need to be considered. These factors will affect the timeline for the restructuring and may also affect evaluations on the prospects of any legal challenge in local courts.

Structuring the terms of the domestic debt restructuring

There are very many considerations which will go into designing the structure of a domestic debt restructuring, many of which will be specific to the situation at hand.

General considerations include:

Voluntary vs mandatory exchanges

Given the local law advantage, it may be possible for a debtor country to execute a mandatory restructuring of its domestic debt by way of legislation or executive action. There may however be legal or political reasons why this is not an expedient option. A voluntary restructuring could require greater engagement with relevant domestic creditors and perhaps the use of some incentives (see below). Generally, subject to legitimate confidentiality considerations, some type of interface through which dialogue and discussion with affected creditors is able to occur before key financial terms are settled could become important.

Incentivising participation in a voluntary restructuring

Depending on the specific situation in question, unlike in an external restructuring, a debtor country may be able to draw upon its local law advantage to provide incentives to participation or disincentives to non-participation for domestic creditors (or specified subsets of domestic creditors).

These may extend to temporary regulatory forbearance (for regulated domestic creditors such as banks (as discussed above) or insurance companies) or temporary accounting forbearance (for domestic corporate creditors more generally) to mitigate the potential impact of the proposed domestic debt restructuring.

The use of tax policy in this context is often considered so as to influence decision making on participation, for example by increasing the tax rate payable on domestic debt instruments which are not restructured or decreasing the tax rate for domestic debt instruments issued (or amended) in the restructuring.

Contractual undertakings from the debtor country can also be considered for inclusion in the terms of the domestic debt restructuring to incentivise participation. These could include a confirmation from the debtor country that it will not offer more favourable restructuring terms to domestic creditors that do not participate in the relevant offering. To the extent domestic creditors are concerned that new domestic debt with earlier payment terms may be issued, the debtor country could consider undertaking not to issue any such new debt for a defined period of time.

Legal framework for the new (or amended) instruments

A debtor country may opt only to alter the economic terms of the relevant domestic debt instruments when executing a domestic debt restructuring. Conversely, a debtor country may decide to take the opportunity to change the terms and conditions for all new domestic debt instruments so as to make general improvements or to assist in any future restructuring where that proves to be necessary. For example, the debtor country may consider whether to include more comprehensive terms and conditions such as specific restructuring provisions (either CACs, MVPs or otherwise). The issues raised in “Collective Action Clauses” above will be relevant in this context.

Specific considerations for local law, foreign currency denominated instruments

Where a debtor country has issued local law, foreign currency denominated instruments, the debtor country and its creditors holding those instruments may consider whether that debt should be restructured in its original currency or rather restructured in domestic currency (i.e. by exchanging foreign currency instruments for domestic currency instruments). Whilst external creditors may find new local currency instruments unattractive (unless they could be used in a special way, for instance in a debt to equity conversion program in sales of SOEs) the evaluations for domestic creditors may be different. Again, this will be highly fact-specific.

Conclusion

As will be seen from this briefing, the existing financial architecture has not been designed for domestic debt restructurings, which are likely to become more prevalent.

Issues in domestic debt restructurings are in a number of important respects different to those arising with external debt restructurings. There is likely to be most overlap on these issues for a country in a currency union which issues exclusively under its local law, where domestic debt and external debt can only be meaningfully distinguished by reference to the residency criterion.

In the field of domestic debt restructurings, the risks of costly and disruptive negative feedback linkages into the economy through the domestic banking, insurance and pension sectors may be high and the trade-offs which decision makers need to evaluate are likely to be highly case specific.

In the past the international financial architecture has evolved in response to issues arising in practice. The increased prevalence of domestic debt restructurings therefore raises the fundamental issue of whether it is appropriate for the international financial architecture to evolve in response and, if so, in what direction. Any such evaluation will inevitably draw upon analysis of the existing tools available to the IMF and how they may be used in practice in the domestic debt restructuring context whether by way of prevention or by way of resolution of unsustainable domestic debt.

CONTACTS

Deborah Zandstra
Partner
T: +44 207 006 8234
E: deborah.zandstra@
cliffordchance.com

Andrew Yianni
Consultant
T: +44 207006 2436
E: andrew.yianni@
cliffordchance.com

James Kelton
Senior Associate
T: +44 207006 2630
E: james.kelton@
cliffordchance.com

Azam Taiyeb
Senior Associate
T: +44 207006 4124
E: azam.taiyeb@
cliffordchance.com

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C H A N C E

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