FPRI Foreign Policy Research Institute

BOND OF WAR

RUSSIAN GEO-ECONOMICS IN UKRAINE'S SOVEREIGN DEBT RESTRUCTURING

Russia Political Economy Project

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Foreign Policy Research Institute

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Russia Political Economy Project

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Executive Summary

Maximilian Hess

Russia and Ukraine have spent the last four years locked in a conflict with many fronts, from the battlefields of Donbas to the servers of Ukrainian businesses. This paper will examine one under-studied front: the dispute between Russia and Ukraine over a contested $3 billion Eurobond sold by Ukraine's government and purchased by Russia's National Wealth Fund in December 2013.

The paper first outlines the sale of the bond and then examines a number of specific contractual terms that have proven controversial. The paper next explains how the dispute led from the halls of the International Monetary Fund (IMF) to a British courtroom. It then looks to identify Russia's geo-economic strategy in the loan and subsequent legal dispute. Next, the paper positions this strategy within global developments in geo-economic policymaking, sovereign bond markets, and Russian foreign policy. Finally, it concludes by examining the dispute's implications for Russian geo-economic policy and sovereign debt markets.

A Dispute within a Larger Conflict

More than 10,000 people have died since the outbreak of the war in eastern Ukraine. The country's economy has been ravaged by Russia's annexation of Crimea and subsequent pressure campaign. Yet, Russia's military campaign is only one part of the conflict, which has also struck Ukraine's energy market, its computer networks, its export industries, and nearly every sector of the economy. One important, but relatively unnoticed, battlefield is in the realm of financiers and lawyers in Dublin and London. This battle began in European sovereign debt markets and has stretched into the International Monetary Fund's (IMF) headquarters in Washington, D.C. It is ongoing, and retains the potential to push Ukraine into financial crisis. This dispute—Russia's $3 billion loan to Ukraine during the height of the Euromaidan protests in late 2013 and the subsequent debate about whether Ukraine must repay it—could even prove as significant to the course of the conflict as the ongoing fighting in the Donbas.

In recent decades, countries increasingly have used financial instruments and economic policy to achieve foreign policy aims. Russia's loan to Ukraine is a stark example, and its study can also shed light on an arguably under-covered area of Russian foreign policy. It came in the form of a Eurobond, which is a bond issued in a foreign currency and foreign jurisdiction, in this case U.S. Dollars and English law. This loan and the subsequent dispute demonstrate Russia's ability to use debt as a geopolitical tool, but also its adroitness in capitalizing on international institutions in doing so.

The dispute over the Eurobond is among the most novel developments in Russia's foreign policy toward the Ukraine crisis—though it has received far less coverage than the Kremlin's other tactics for using economic leverage to achieve political aims, such as its lawsuits against Ukrainian state energy firm Naftogaz or the hacking of Ukrainian banks. The conflict centers on sovereign debt restructurings, an aspect of international political economy often left to lawyers, bond traders, and hedge funds. Through its use of the Eurobond, Russia sought to limit Ukraine's access to capital markets and gain political leverage over Kyiv. It also sought to blur long-standing practices differentiating private and inter-governmental debt to boost its position in the dispute and, in doing so, shape international institutions to its advantage.

The bond itself was the first time one government used a Eurobond structure to loan funds to another. It featured non-standard terms and a legal structure that significantly boosted Russia's leverage beyond that of a more traditional bilateral loan. Because the bond was a market-traded instrument, its terms were released by the Irish Stock Exchange,[1] revealing several unique

1 Not Attributed (Ukraine). "U.S.$3,000,000,000 5.00 per cent. Notes due 2015," (Prospectus). Prospectus posted to Irish Stock Exchange. 24 December 2013, www.ise.ie/debt_documents/Prospectus%20-%20Standalone_25530800-5cc1-4737-bf87-6a24d142af6d.PDF.

21 November 2013	Euromaidan protests begin
17 December 2013	Russian-Ukrainian Action Plan Agreed, including plans for $15 billion in loans
24 December 2013	Ukraine sells $3 billion Eurobond to Russia's National Wealth Fund
17 February 2014	Ukraine files with Irish Stock Exchange to add $1.98 billion to earlier Eurobond
21 February 2014	Yanukovych signs agreement on settlement of political crisis
22 February 2014	Yanukovych flees Kyiv and removed from office by legislature
1 March 2014	Pro-Russian forces seize first government buildings in eastern Ukraine
18 March 2014	Russia annexes Crimea
26 March 2014	Ukraine formally requests IMF bailout
5 September 2014	Minsk Protocol on conflict in east Ukraine agreed, but quickly collapses
11 February 2015	Second Minsk Protocol (Minsk II) agreed, but quickly collapses
12 February 2015	Terms of Ukraine's IMF bailout agreed
20 February 2015	Present lines of control in eastern Ukraine established after Russian intervention and seizure of Debaltseve
27 August 2015	$18 billion debt restructuring plan with private bondholders reached
10 December 2015	IMF changes policy to allow loans to sovereigns in arrears to official creditors
16 December 2015	IMF recognizes Russian-held bond as official debt
30 December 2015	Ukraine defaults on Russian-held Eurobond principal repayment
17 February 2016	Russia files suit against Ukraine at London High Court
29 March 2017	London High Court issues summary judgement in favor of Russia
23 June 2017	Ukraine appeals High Court ruling
19 January 2018	UK Court of Appeals hearings begin
14 September 2018	Court of Appeals orders full trial, Russia to appeal

Former Ukrainian President Viktor Yanukovych and Russian President Vladimir Putin in April 2011. (Source: premier.gov.ru)

provisions.[2] Had Kyiv sold additional bonds to Russia as planned—on December 17, 2013 then-Ukrainian President Viktor Yanukovych and Russian President Vladimir Putin agreed to $15 billion in bond sales—these provisions may have caused Kyiv significant damage.[3]

The bond dispute has encompassed several "firsts." It marked the first time that Russia, or any other sovereign state, chose to purchase outright the whole issuance of a market-tradable Eurobond to loan money to another country. This "first" enabled Russia to pressure Ukraine, threatening to force Kyiv into default as well as to bar financial support from the International Monetary Fund. Ultimately, the IMF chose to change its rules to prevent Russia from blocking its bailout of Ukraine. Legal action over the Eurobond then began in British courts in early 2016, and although appeals continue, the initial ruling dismissed Ukraine's arguments in favor of Russia.

Outside of energy markets, Russia's adroit mixture of geopolitics and economics is vastly under-covered. Examining Russia's dispute with Ukraine over the Eurobond reveals the Kremlin's fluency in international sovereign debt matters. Less than two decades after Russia's 1998 default, the Kremlin has become a pioneer in using debt instruments as geo-economic tools—and this burgeoning policy tactic presents a risk to both global financial institutions and sovereign debt markets.

2 Gulati, Mitu. "Mr Putin's Clever Bond issue;" and Cotterill, Joseph. "Ukraine $1,984,838,000 5.00 per cent Notes due 2015 — and the burning tyres therein," *Financial Times' Alphaville Blog*, 19 February 2014, https://ftalphaville.ft.com/2014/02/19/1776612/ukraine-1984838000-5-00-per-cent-notes-due-2015-and-the-burning-tyres-therein/.

3 Walker, Shaun. "Vladimir Putin offers Ukraine financial incentives to stick with Russia," *Guardian*, 18 December 2013, https://www.theguardian.com/world/2013/dec/17/ukraine-russia-leaders-talks-kremlin-loan-deal.

The Genesis of a Bond of War

Mass demonstrations broke out in Ukraine at the end of November 2013, centered on Kyiv's Maidan Nezalezhnosti (Independence Square). The protesters opposed then-President Viktor Yanukovych's decision to abandon plans to sign an Association Agreement with the European Union (EU). Yanukovych instead announced that he would renew talks with Russia on deepening relations. On December 17, 2014, Yanukovych met with Russian President Vladimir Putin and agreed to accept a series of loans from Moscow that were to amount to $15 billion, ostensibly aimed at helping the Ukrainian economy.

Putin himself was asked by a Ukrainian journalist in a subsequent press conference if he could "clarify if these $15 billion are the price for the rejection of the EU Association Agreement? How much would you be willing to pay?" Putin responded in a revelatory jest, "Right, the discussion is getting serious. Well, how much do you need?"[1]

Putin continued, "These $15 billion are to support the budget, to be able to pay salaries, pensions and social security benefits." He claimed, "It has nothing to do with Maidan or Ukraine's negotiations with Europe."[2] Furthermore, Putin noted, "We have extended this loan oncommercial terms."[3] This last claim is misleading: when Putin and Yanukovych met, the yield on internationally traded Ukrainian Eurobonds was 12 percent; by contrast, the two-year Eurobond that Russia bought required Kyiv to pay only five percent of face value in annual interest.[4]

Euromaidan in Kyiv, December 2013. (Source: Nwassa Ghatoush, Flickr)

Governments frequently extend loans to each other, including on non-commercial terms, for geopolitical reasons. The initial loan under the Russia-Ukraine package was for $3 billion. Because the bond had a five percent coupon, Ukraine only had to pay $150 million annually to service its debt to Russia, well below the market rate. The coupon was lower than Ukrainian debt yields even before the Euromaidan protests broke out and lower than they have been at any point since (see Figures 1 and 2). Moscow, in other words, was giving Ukraine access to cheap financing. The interest rate was so cheap, in fact, that Moscow was effectively loaning money to Ukraine at a loss.[5]

1 News Conference of Vladimir Putin. Transcript released by the Kremlin, 19 December 2013.

2 Ibid.

3 Ibid.

4 The action plan they announced would cause the yield to fall to 8.64 percent by the time the bond was formally sold a week later; see, also, Lerrick, Adam. "A Solution to the Ukraine-Russia Bond Stand-Off," *AEIdeas Blog* October 2015, American Enterprise Institute, https://www.aei.org/wp-content/uploads/2015/10/A-solution-to-the-Ukraine-Russia-bond-standoff.pdf.

5 The yield on comparable Russian debt was higher than the interest rate on the loan to Ukraine.

Troops of Terms

Ukraine has borrowed from Russia before. It has also issued Eurobonds and had 11 Eurobonds outstanding at the time, all under English law and with normal wording.[1] However, the Russian-held Eurobond differed from those previous issuances, though most of the text was the same. It included new terms that could bite.

How the loan came to be issued as a Eurobond—an unprecedented structure for bilateral sovereign loans—is disputed.[2] Using the Eurobond structure enabled the loan to be executed quickly, which was certainly a consideration as protests in Kyiv escalated. A British court later noted, "Ukraine used the same procedures as it used to issue the 31 other Eurobonds . . . over a period of 13 years."[3] The Cabinet of Ministers of Ukraine, led by then-Prime Minister Mykola Azarov and dominated by their Party of Regions, approved the Eurobond three days after Yanukovych and Putin met in Moscow.[4]

Joint press point with Mykola Azarov and Martin Schulz in Brussels, May 2012. (Source: europarl.europa.eu)

Russia's National Wealth Fund bought the entire issue four days later. Russia's state-owned bank VTB became the sole manager.[5]

However, the new notes were "indistinguishable in *most*," but not all, ways. The most significant change stipulated that "even if Ukraine continues to pay this debt in full and on time, the contract terms enable Russia to demand early repayment, triggering a cascade of defaults."[6] If Ukraine's debt-to-GDP ratio exceeded 60 percent, Russia could accelerate repayment.[7] Adding this term to the boilerplate language of Ukraine's previous

1 Gelpern, Anna. "Russia's Contract Arbitrage," *Capital Markets Law Journal*, Volume 9, Issue 3, pp. 308–326, 1 July 2014. Accessed via Georgetown Law Faculty Publications and Other Works, 1448. pp. 1-23, https://scholarship.law.georgetown.edu/facpub/1448.

2 Bagchi, Kanad. "The Ultimate Sovereign Debt Showdown: Russia & Ukraine likely to battle it out in court!," *LSE Euro Crisis in the Press blog*, 12 November 2015, blogs.lse.ac.uk/eurocrisispress/2015/11/12/the-ultimate-sovereign-debt-showdown-russia-ukraine-likely-to-battle-it-out-in-court/.

3 The Law Debenture Trust vs. Ukraine. (2017) EWHC 655 (Comm). Case No: FL-2016-000002. The London High Court, Justice William Blair. 29 March 2017, https://www.judiciary.uk/wp-content/uploads/2017/03/law-debenture-v-ukraine-final-judgment-summary-20170329.pdf.

4 Not Attributed."Ukraina razmestila evrobondy na 3 mlrd dollarov [Ukraine places 3 million dollars in Eurobonds]," Lb.UA, 23 December 2016, https://lb.ua/economics/2013/12/23/249408_ukraina_razmestila_evrobondi_3.html.

5 Allen & Overy (Global Law Intelligence Unit). "How protective are Ukraine's international bonds?," March 2014, p. 60, www.allenovery.com/SiteCollectionDocuments GLIU_-_Ukraine_international_bonds_(Mar_2014).pdf.

6 Gelpern, Anna. "Russia's Contract Arbitrage," p. 5.

7 Cotterill, Joseph. "Stopping a Russian Bond Invasion," *Financial Times' Alphaville Blog*, 24 March 2015, https://ftalphaville.ft.com/2015/03/24/2122168/stopping-a-russian-bond-invasion/.

Eurobonds was certainly not in Kyiv's interest.

Ukraine's debt-to-GDP ratio was set to rise quickly in December 2013 amid concerns over the Ukrainian economy and debt loading.[8] Bond yields rose (see Figure 1), fueled not only by the Euromaidan protests, but also by Ukraine's dip into recession in late 2012-early 2013[9] and its rapidly expanding budget deficit.[10] The cost of servicing Ukraine's debts also rose notably over the preceding years (see Figure 3). It would have been easy at the time to envisage Ukraine's debt-load exceeding the trigger. Had Ukraine taken significant loans from the West or the IMF, its debt load would likely have exceeded the stipulated ratio.[11]

At a press conference on December 19, 2013, Putin implied that all the $15 billion in support to Ukraine would be done via the Eurobond mechanism. This announcement pushed Ukraine toward the 60 percent limit. If Russia were to accelerate repayment on a sum larger than $3 billion, it would likely have forced Ukraine into economic collapse.

The Eurobond purchased by Moscow also included a non-standard "no set-off" provision that barred Kyiv from writing down the bond in the event of a default by subtracting the bondholder's other debts to Ukraine.[12] The provision provided protection for Russia if Ukraine secured international judgements against Russia, as it ultimately did in 2018 in its dispute with Gazprom over natural gas prices. The provision is of little value to a private market player such as a pension fund or other financial institution, which are unlikely to owe money to Ukraine. But it was very valuable for Russia.

Just months after the Eurobond's sale, a pro-European government came to power in Kyiv. Then, Russia seized Crimea, inviting a flurry of claims now being litigated. Barring Kyiv from using these future claims—such as damages incurred during Crimea's annexation—to minimize its debt obligations proved prescient.

Last, Russia used its National Wealth Fund to purchase the Eurobond, thus imposing another hurdle for Kyiv if it chose to litigate, as it ultimately would. Since Russia can argue that the National Wealth Fund is a separate entity from the government, Ukraine would have to "pierce the veil." This term refers to the legal standard of holding an entity responsible for its shareholders' other actions—in this case the Russian government, the National Wealth Fund's sole shareholder. Moscow knows how difficult this is to do under international law. Numerous lawsuits have attempted to pierce the veil to secure compensation for those who lost in Russia's 2005 nationalization of its then-largest firm, Yukos. In jurisdictions around the world, litigants have attempted to make claims against the Russian government to Rosneft which took over most of Yukos' assets, so far without success, even though the oil giant often functions as a foreign policy arm of the Russian state.[13]

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8 Rao, Sujata. "Big debts and dwindling cash - Ukraine tests creditors' nerves," *Reuters*, 17 October 2017, https://uk.reuters.com/article/uk-emerging-ukraine-debt/big-debts-and-dwindling-cash-ukraine-tests-creditors-nerves-idUKBRE99G06P20131017.

9 Not Attributed (World Bank). "Ukraine Economic Update - April 2013," World Bank, 2 April 2013, http://www.worldbank.org/en/news/feature/2013/04/02/ukraine-economic-update.

10 Pogarska, Olga and Segura, Edilberto L. "Ukraine Economic Situation October 2013," SigmaBleyzer / The Bleyzer Foundation, October 2013, p. 2, http://www.bleyzerfoundation.org/files/reports/ukraine/2013/Ukraine_EU_10_1_13.pdf.

11 Caruso-Cabrera, Michelle. "$3 billion for Ukraine to go straight to...Russia," *CNBC,* 13 March 2014, https://www.cnbc.com/2014/03/13/aid-to-ukraine-3-billion-from-imf-eu-or-us-may-go-to-russia.html.

12 Cotterill, Joseph. "Stopping a Russian Bond Invasion."

13 Rice, Brandon. "States Behaving Badly: Sovereign Veil Piercing in the Yukos Affair," Duke University School of Law, 12 October 2015, https://ssrn.com/abstract=2673335, p. 3.

From Bond Sale to Bond Battle

As anti-government and pro-Western protests raged in Kyiv, on February 17, 2014, Ukraine filed paperwork to add another $1.98 billion to the existing bond at the Irish Stock Exchange.[1] Russian Finance Minister Anton Siluanov confirmed the same day that Moscow planned to buy the issue, which would have brought the debt owed by Ukraine under the bond to just under $5 billion.[2] Yet, four days later, then-President Viktor Yanukovych fled Kyiv and was formally ousted by the legislature on February 22. The additional bond sales to Russia never proceeded.

Russia could have forced Ukraine into a disorderly default in mid-2014 had it triggered the previously mentioned debt-to-GDP provision. Ukraine's debts quickly exceeded the 60 percent level, as the economy crumbled amid fighting in the Donbas and the annexation of Crimea. Already, in March 2014, the country requested an IMF bailout.

Nonetheless, Kyiv made the first coupon payment on the Eurobond to Russia in June 2014—despite Moscow's seizure of Crimea, its halt on gas supplies, and its role in inciting conflict in Ukraine's east. Defaulting on the Russian-held note could have triggered defaults on Ukraine's other debts. Meanwhile, Russia declined to include the bond in its list of official debt holdings at the Paris Club, the forum where participating sovereign states typically negotiate official debt restructurings.[3] This move did not stem from inexperience or naivete: Russia had participated in Ukrainian debt restructurings at the Paris Club before, and after the annexation of Crimea and outbreak of the war in eastern Ukraine, it was clear that Ukraine would need to restructure its debts again.[4]

Russia's refusal to restructure the Eurobond through the Paris Club created ambiguity about whether the debt was official or private. Though there were no known efforts between Ukraine's private bondholders to work with the Kremlin to force a hold-out—that is, to refuse Kyiv's attempts to avoid default by restructuring private debts with new terms less attractive to investors—the bond's commercial structure would have made this previously unheard of situation possible. Russia could even have sold the bond to a third party had it so desired.

In February 2015, the IMF announced a $17.5 billion bailout program for Ukraine. Russia did not vote against the package even though it envisaged restructuring Ukraine's private debts. The yield on Ukraine's two-year debt in late 2014 and early 2015 was extremely volatile, ranging from nearly 14.2% on December 10, 2013 to 6.4% on January 7, 2014 before spiking again to nearly 20% on February 19, 2014 (see Figure 1). This volatility demonstrated how messy the market thought the restructuring could be. But the

1 "Report of the Irish Stock Exchange: Admission Notice." RNS Number: 2764A. Irish Stock Exchange, 17 February 2014, www.ise.ie/app/announcementDetails.aspx?ID=11867349.

2 Not Attributed. "Russia to buy eurobonds worth $2 bln from Ukraine this week - Siluanov," *Interfax*, 17 February, 2014, https://en.interfax.com.ua/news/economic/190508.html.

3 Sadowksi, Rafał. "Ukraine on the financial front – the problem of Ukraine's foreign public debt," *OSW Commentary*, 5 August 2015, https://www.osw.waw.pl/en/publikacje/osw-commentary/2015-08-05/ukraine-financial-front-problem-ukraines-foreign-public-debt.

4 Gelpern, Anna. "Russia's Contract Arbitrage," p. 6.

Ukrainian President Petro Poroshenko with Christine Lagarde, Director of the International Monetary Fund in June 2017. (Source: president.gov.ua)

IMF's math already contained clues as to its stance on the Russian-held Eurobond.

The Fund expected $5.2 billion in financing to be freed up by restructuring Ukraine's private debts. Yet, Kyiv had more than $7 billion in external sovereign debt payments due in 2015.[5] Nearly half of this sum was due to Moscow via the $3 billion Eurobond. The IMF figures meant that Russia would not be repaid in full that year, as freeing up $5.2 billion from the "debt operation" would not leave sufficient funds to do so.

But Russia did not seek to block the IMF's rescue operation. It also refrained from triggering early repayment under the debt-to-GDP breach, which could have risked legal challenges that would effectively force Ukraine into default. It quickly became clear that Russia planned to employ the new instrument in another manner.

A restructuring of Ukraine's Eurobonds, bar the one held by Russia, was agreed to in August 2015. As these negotiations were underway, Kyiv continued to make payments on the coupons due to Russia under the Eurobond, including in June 2015.[6]

There were no notable private holdouts to the restructuring.[7] Kyiv insisted that Russia's Eurobond should also be restructured on the same terms, given it was a private market Eurobond. Although the Kremlin did offer to reprofile the Eurobond, it requested far better terms than offered to the other private creditors, which Kyiv refused.[8] On September 7, 2015, Russia's Finance Minister Anton Siluanov stated, "We will turn to the relevant judicial bodies . . . and we will question the validity of the IMF program to Ukraine" if Russia was not repaid on time.[9] The IMF's

5 Gelpern, Anna. "Ukraine: One Debt Tea Leaf in the IMF Program," *Credit Slips Blog*, 12 March 2015, www.creditslips.org/creditslips/2015/03/ukraine-one-debt-tea-leaf-in-the-imf-program.html.

6 Sadowksi, Rafał. "Ukraine on the financial front – the problem of Ukraine's foreign public debt."

7 Not Attributed. "Ukraine's Sovereign Restructuring," Weil, Gotshal & Manges, November 2015, https://www.weil.com/~/media/files/pdfs/2015/ukraine-sovereign-restructuring.pdf.

8 Buckley, Neil; Donnan, Shawn; and Hille, Kathrin. "Russia proposes restructuring of $3bn Kiev debt," *Financial Times*, 16 November 2015, https://www.ft.com/content/c4a2eaa6-8c7f-11e5-8be4-3506bf20cc2b.

9 Arkhipov, Ilya and Doff, Natasha. "Russia Will Question Ukraine's IMF Program If Bond Not Paid," *Bloomberg,* 7 September 2015, https://www.bloomberg.com/news/articles/2015-09-07/russia-will-question-ukraine-s-imf-program-if-bond-not-paid.

proposed debt operation already hinted this would be the case. Of course, the private creditors who had just agreed to 20 percent principal deductions and lengthy repayment delays would have been outraged if Russia's Eurobond was repaid in full just months after they suffered losses.[10]

After Ukraine's February 2015 IMF bailout, but before the private market restructuring that September, Moscow began to argue that although the Eurobond was a market-tradable instrument, it was not private debt.[11] The Kremlin thus discarded Putin's December 2013 assertion that the bond's terms were commercial, stating that because the bond was offered on better-than commercial terms, the debt was official. This change in rhetoric served a purpose: IMF policy did not allow lending to countries in arrears to official creditors (i.e., other countries).

The Fund abandoned this policy on December 10, 2015. In announcing the change, it cited a policy paper it had commissioned, which pointedly noted that "the (IMF's) current policy can give individual official bilateral creditors a veto over Fund lending decisions."[12] On December 16, 2015, just days before the Russian-held Eurobond came due, the IMF announced that it would consider the debt official. The Fund said its ruling was based on the practices of the Paris Club as well as on the Russian government statement's implying the National Wealth Fund was acting at the behest of the Kremlin.[13] The Fund's decision defanged the risk that Russia would disrupt Ukraine's bailout and restructuring.

Russia was outraged with the IMF's rule change. Prime Minister Dmitry Medvedev compared the move to the "opening of Pandora's box."[14] Meanwhile, Putin, in a publicly televised government meeting, ordered Siluanov to prepare for a court dispute.[15] Russia clearly saw the move as an affront by the IMF to its interests. Yet, due to the structure of the Eurobond, Russia had another tool to protect its interests.

10 Ministry of Finance of Ukraine. "Fact Sheet on Agreement with Ad Hoc Committee of Creditors," 27 August 2015," https://ftalphaville-cdn.ft.com/wp-content/uploads/2015/08/Ministry-of-Finance-Fact-Sheet-2015-08-27-final-version.pdf.

11 Gelpern, Anna. "Russia's Bond: It's Official! (... and Private ... and Anything Else It Wants to Be ...)," *Credit Slips Blog*, 17 April 2015, www.creditslips.org/creditslips/2015/04/russias-ukraine-bond-its-official-and-private-and-anything-else-it-wants-to-be-.html.

12 Abbas, S. Ali et al. (International Monetary Fund Policy Paper). "Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors," International Monetary Fund, 15 October 2015, www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Reforming-the-Fund-s-Policy-on-Non-Toleration-of-Arrears-to-Official-Creditors-PP5005, p. 1.

13 Unattributed (Approved by Brendenkamp, Hugh; Hagan, Sean; and Thomsen, Poul). "Status of Ukraine's Eurobond Held by the Russian Federation," International Monetary Fund, 11 December 2015, https://www.imf.org/~/media/Websites/IMF/Imported/external/pubs/ft/scr/2015/_cr15344pdf.ashx.

14 Not Attributed. "Medvedev: MVF v sluchaye vydeleniya Ukrainye kredita otkroyet 'yashchik Pandory' [Medvedev: By Allocating credit to Ukraine, the IMF will open 'Pandora's Box']," *Vzglyad*, 12 February 2016, https://vz.ru/news/2016/2/12/793878.html

15 Donnan, Shawn; Hille, Kathrin; and Olearchyk, Roman. "Russia threatens to sue Ukraine after IMF vote on rescue cash," *Financial Times,* 9 December 2015, https://www.ft.com/content/0518eb1c-9e9b-11e5-b45d-4812f209f861.

Blurring the Divide between Official and Private Creditors

While Russia could have forced Ukraine into a messy default on the $3 billion Eurobond at various points in 2014-15, the choice to argue the debt was official signaled that the Kremlin had selected a different path. The IMF rule change, as Medvedev's comments indicate, was part of Russia's perceived long-running conflict with the Western-led international order. When this strategy failed to increase Russia's leverage over Ukraine's economic future, the Eurobond's structure guaranteed another form of protection to help Moscow retain leverage over Kyiv: English contract law.

Private and official debts differ in that private debt concerns banks and bondholders, whereas official debt refers to bilateral and multilateral loans.[1] Restructurings of official debt are primarily, but not always, conducted by the Paris Club. Restructuring of private debts owed by a sovereign take place through a variety of mechanisms, including the so-called London Club, but increasingly through creditor committees. The latter is often the case with Eurobonds.[2] When committees cannot agree to restructuring terms with the defaulting party, jilted bondholders appeal to the courts of law in the jurisdiction where the bonds were issued. As a result, most Eurobonds are issued under New York or English law.

As mentioned, Ukraine's Russian-held bond was issued under English law. On February 17, 2016, Moscow formally sued, through the Law Debenture Trust, a British corporation that held the bond on behalf of Russia's National Wealth Fund. Ukraine used a host of defenses, from arguing the debt was "odious," to claiming it was issued under duress, to claiming Russia's violation of international law invalidated the debt.[3] All of these arguments were dismissed, and on March 29, 2017, the High Court issued a summary judgement in Russia's favor.

Justice William Blair's ruling made clear that while Ukraine's defense raised important questions, they were of a political nature, and the case before him was otherwise a standard contractual dispute. Using the protections of the private market and English contract law provided an initial victory for the Kremlin where international institutions did not. Ukraine appealed, however, and on September 14, 2018, the Court of Appeal ordered a full trial over Ukraine's duress arguments considering whether the loan was the result of illegitimate pressure by Moscow.[4] By structuring the loan as a Eurobond, Moscow gained significant

1 Marchesi, Silivia and Masi, Tani. "Life after default: Private versus official sovereign debt restructurings," *Vox CEPR Policy Portal*, 6 July 2018, https://voxeu.org/article/private-vs-official-sovereign-debt-restructurings.

2 Sturzenegger, Federico and Zettelmeyer, Jeromin. *Debt Defaults and Lessons from a Decade of Crises* (Cambridge: MIT Press, 2006), pp. 13.

3 Weidemaier, Mark. "Ukraine's Defense: Russian Suit Part of a 'Broader Strategy of Aggression,'" *Credit Slips Blog*, 29 May 2016, www.creditslips.org/creditslips/2016/05/ukraine-russian-suit-part-of-a-broader-strategy-of-aggression.html.

4 Ukraine (Appellant) vs. Law Debenture Trust Corporation (Respondent). (2018) EWCA Civ 2026. Case No: A4/2017/1755. The Court of Appeal (Civil Division, Lady Justice Gloster and Lord Justice David Ricahrds, 14 September 2018, https://www.judiciary.uk/wp-content/uploads/2018/09/law-debenture-v-ukraine-final-judgment-14-sept-18.pdf.

The UK Supreme Court. (Source: supremecourt.uk)

economic and political leverage over Ukraine. Russia will appeal to the UK Supreme Court, but if the Appeals Court's ruling is upheld, it raises the prospect of a long and controversial trial, one that would effectively focus on the political questions at hand.[5]

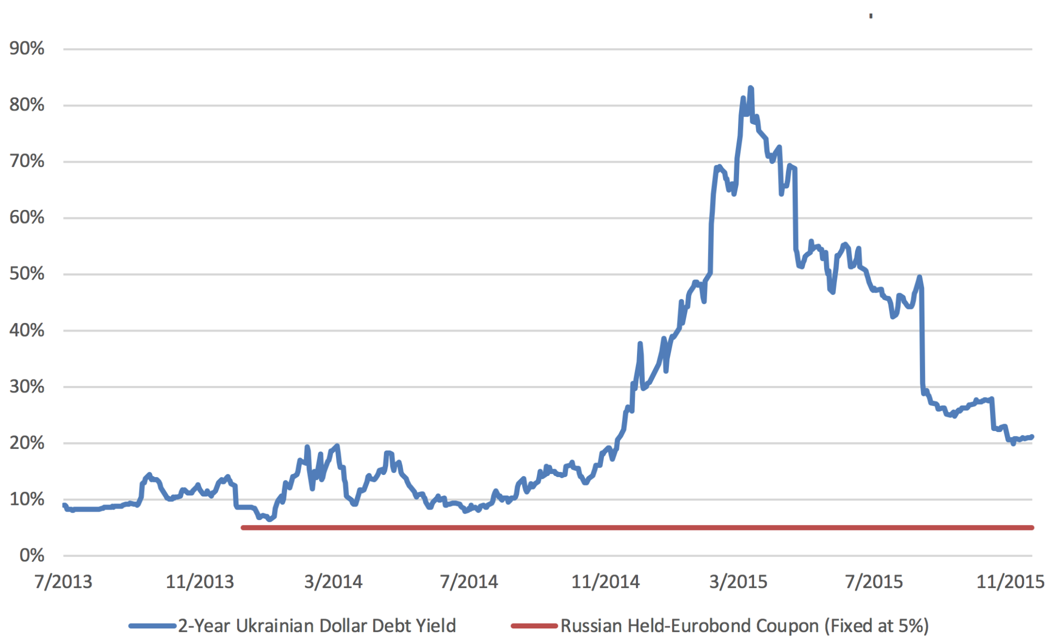
Should the Supreme Court find in Moscow's favor, it raises questions about Ukraine's debt sustainability. As the bond has been in default for more than two-and-a-half years, the interest due is mounting rapidly. Russia's lawyers have sought between $427,083 and $683,333 per day in default, which would add more than $400 million to the bill as of mid-2018.[6] These payments could become intertwined with Russia and Ukraine's other disputes, such as that between Gazprom and Naftogaz that has seen Ukraine secure a multi-billion dollar judgement in its favor. However, this will be determined by the fate of the Eurobond's "no set-off" provision. If that provision is upheld—and Ukraine may extend the process by launching further legal challenges—Russia may force Ukraine into default again.

While the Eurobond structure may have been chosen to execute the loan quickly, timeliness was clearly not Moscow's only consideration. The bond's unique provisions and Moscow's strategy of seeking protection under both British private contract law and its official creditor status demonstrate ulterior aims. Russia has successfully adapted institutional practices to fit its geo-economic strategies. While the Appeals Court ruling may mean Russia ultimately fails to gain protection over the loan from either English law or the IMF, the ruling would set a new precedent if upheld, which the Kremlin would be all but certain to describe as evidence that the global institutional order is biased against it. The Eurobond proved a novel arrow in sovereign states' quiver of geo-economic instruments capable of challenging the international order and its institutions.

5 Weidemaier, Mark. "Ukraine Wins Appeal in Russian Bond Case," *Credit Slips Blog*, 14 September 2018, www.creditslips.org/creditslips/2018/09/ukraine-wins-appeal-in-russian-bond-case.html.

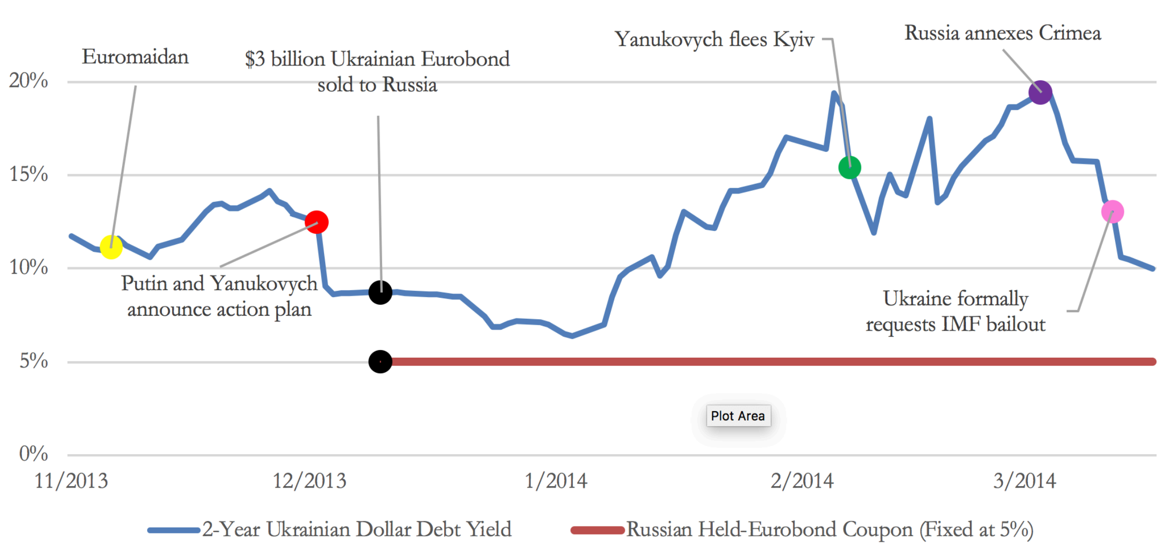
6 Doff, Natasha and Hodges, Jeremy. "Russia Seeks $683,333 a Day Interest in Ukraine Bond Lawsuit," *Bloomberg*, 24 March 2016, https://www.bloomberg.com/news/articles/2016-03-24/russia-seeks-683-333-a-day-interest-in-ukraine-bond-lawsuit.

Figure 1: Ukrainian Dollar Debt Yield vs Russian-held Eurobond Coupon*



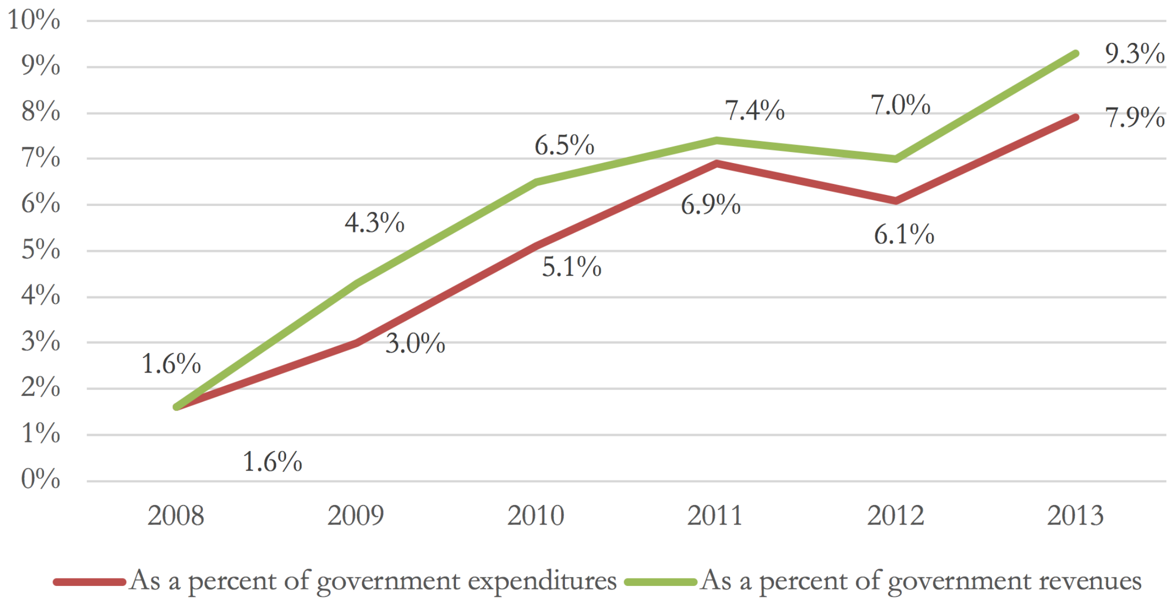
**Yield data retrieved from Bloomberg. Dates: 15 November 2013 – 4 December 2015.*

Figure 2: Ukrainian Dollar Debt Yield vs Russian-held Eurobond Coupon*



**Yield data retrieved from Bloomberg. Dates: 15 November 2013 – 31 March 2013.*

Figure 3: Ukraine's pre-Euromaidan Debt Servicing Costs*



**Data from Ukrainian Ministry of Finance. Adapted from Paientko, Tetiana. "Public debt in Ukraine: irrational management and risks leading to corruption,"* Research Papers of Wrocław University of Economics, *No. 439. January 2016. pp. 265-273, 271.*

The Sovereign Vulture Fund?

Most studies of sovereign debt disputes focus only on their economic aspects, not on the geopolitical ramifications. Yet, there is a long history of jilted bondholders mixing economics and politics to enforce their claims. The first example is arguably the British Corporation of Foreign Bondholders' support for sending British, French, and Spanish fleets to Veracruz, Mexico, in December 1861. What began partly as an attempt to enforce financial claims ultimately led to the installation of Archduke Maximilian of Austria as Emperor of Mexico.[1] In 1902, Britain, Germany, and Italy blockaded Venezuela after its then-leader Cipriano Castro refused to submit to international arbitration over various debts.[2] The subsequent adoption of the Drago-Porter Doctrine at the 1907 Hague Conference strongly curtailed such practices as signatories agreed not to resort to armed force to enforce debts.[3] While the doctrine did allow for states to take military action if the sovereign debtor refused arbitration, jilted bondholders now rely on political coercion that falls far short of war.

In the most famous sovereign debt dispute in recent years, NML Capital vs. Argentina, bondholders made geopolitical splashes to force repayment. Their actions ranged from trying to seize Argentine ships to ultimately barring the country from being able to further pay private bondholders. Ultimately, however, NML and its co-litigants were able to secure an enforcement action against Argentina through a 2012 ruling from late Southern District of New York Judge Thomas Griesa that held that Buenos Aires was in breach of its *pari passu* obligations to treat bondholders equally and that Argentina had further treated them unfairly by passing the so-called "Lock Law," agreeing with NML's argument that the law meant Argentina would not honor future U.S. court rulings.[4] Though another ruling by Judge Griesa in December 2016 would further refine and narrow the conditions for *pari passu* breaches,[5] the rulings highlighted the power of courts to enforce sovereign debt repayments. Though *pari passu* considerations have not yet proven a major part of Russia and Ukraine's dispute, it would appear the Kremlin took notice. In effect, Russia reversed the standard of holdout disputes. Rather than employing geopolitical and legal actions to improve its returns on a financial instrument, Moscow used a financial instrument to boost its geopolitical position.

1 Turlington, Edgar. *Mexico and Her Foreign Creditors*, Part of the Series: Mexico In International Finance and Diplomacy (Volume 1), (New York: Columbia University Press, 1930), pp. 91-98.

2 Griffith Dawson, Frank. *The First Latin American Debt Crisis: The City of London and the 1822-1825 Loan Bubble* (Avon: Yale University / The Bath Press, 1990), pp. 230-231.

3 Heimbeck, Lea. "Discovering Legal Silence: Global Legal History and the Liquidation of State Bankruptcies (1854–1907)," in ed. Duve, Thomas, *Entanglements in Legal History: Conceptual Approaches,* Max Planck Institute for European Legal History (Frankfurt am Main, Germany, 2014), https://www.jstor.org/stable/j.ctvqhtwr.16, pp. 476-477.

4 Shalolashvili, Irakli. "An Analysis of the Argentinian Bond Crisis," *University of Miami Inter-American Law Review,* Volume 4, Issue 6, 2015, http://repository.law.miami.edu/umialr/vol46/iss2/6, pp.194-201.

5 Blakemore, James M. and Lockman, Michael J. "Pari Passu Undone: Game-Cahging Decisions for Sovereigns in Distress," *Emerging Markets Restructuring Journal*, No. 3, Spring 2017, https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/2017/publications/emrj-spring-2017/pari-passu-undone-gamechanging-decisions-for-sovereigns-in-distress.pdf.

The Argentine bond dispute led to a shift in the legal standards of sovereign bond markets—most notably the increased use of aggregated collective action clauses (CACs) to help prevent restructuring holdouts.[6] Under aggregated CACs, if a supermajority of bondholders agrees to a debt restructuring, it is legally mandatory for all holders of the debt to participate, even if they voted against the restructuring. While these changes seek to limit the ability of singular bondholders to disrupt a restructuring, Russia's use of the unique Eurobond structure make clear that geo-economic tactics must be kept in mind as these standards develop. Other countries may seek to increase their leverage over countries via commercial loans.

What set the Argentine debt dispute apart was that the 2012 ruling enabled the litigants to not only injure the sovereign by forcing it out of bond markets, but the ruling also negatively impacted those creditors who had agreed to restructure their Argentine debts because Buenos Aires was no longer able to pay on restructured debts without making the holdouts whole.[7] Argentina thus returned to a state of default. While this precedent was set under New York law, and not under the English law that governs Ukraine's bonds, private bondholders should be wary of Russian-drafted Eurobonds in the future, as well as other geo-economic interventions into debt markets.

6 Dougherty, Sean and Stolper, Antonia E. "Collective action clauses: how the Argentina litigation changed the sovereign debt markets," *Capital Markets Law Journal*, Volume 12, Issue 2, 1 April 2017, pp. 239–252, https://www.shearman.com/~/media/Files/NewsInsights/Publications/2017/05/Collective-Action-Clauses--CM-LJ-CM050117.pdf.

7 Buchheit, Lee C. and Gulati, Mitu G. "Restructuring sovereign debt after NML v Argentina," Capital Markets Law Journal, Volume 12, Issue 2, April 2017, pp. 231-237, scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6342&context=faculty_scholarship.

Positioning the Dispute in Russian Foreign Policy

The Eurobond dispute brings together several elements of Russia's foreign policy. First is Russia's willingness to adopt novel tactics and to take on significant risk to maintain leverage over Ukraine. Another is its desire to challenge the post-Cold War order and Western-dominated institutions. Furthermore, the dispute demonstrated Russia's willingness to be strategically patient.

Moscow took a series of drastic attempts to sustain its influence over Ukraine in late 2014. Many analysts, including the current Ukrainian government, have argued that Russia planned to invade Ukraine before the fall of the Yanukovych regime. The Kremlin itself has provided evidence that the invasion of Crimea began just before Yanukovych's ousting, though Russian officials deny this claim.[1] But even if Russia's argument that Crimea was under imminent threat from fascist hordes in Kyiv was nonsense, the Kremlin did not believe its borders could be stable with a pro-Western government in Ukraine.[2]

As the Russian-Ukrainian war broke out, the position of Russian hardliners who argued that "Russia was in a zero-sum struggle for power and influence with the West" and "needed to build geopolitical institutions of its own to counter 'Atlanticism'" strengthened.[3] However, the bond dispute shows that Moscow also seeks to use existing institutions to its own advantage. English law and IMF rules proved key to Russia's strategy of pressuring Ukraine.

Russia's most recent foreign policy doctrine, issued in December 2016, declares that "the State's foreign policy activities shall be aimed at accomplishing the following main objectives . . . to strengthen Russia's position in global economic relations . . . by using the options afforded by international and regional economic and financial organizations."[4] Russia has achieved this goal in its use of the Eurobond. Capitalizing on protections provided by an international financial organization and British contract law, Moscow has litigated against Ukraine to improve its economic and geopolitical position.

The Russian government believes institutions like the IMF exhibit an anti-Russia bias. In response, the Kremlin has challenged numerous Bretton Woods-era institutions throughout its conflict with Ukraine. In 2014, the Kremlin intensified its push to create the New Development Bank, an organization established by the BRICS states, evidence of the growing position of those abovementioned who advocated for building new geopolitical institutions. As official creditors reacted to Western sanctions against Russia—for instance, the European Bank for Reconstruction and Development (EBRD) froze loans to the country—Russian policymakers increasingly began to see

1 Not Attributed. "Lavrov prokommentiroval netochnost na medali 'Za vozrasheniye Kryma' [Lavrov commented on the error on the medal 'For the Return of Crimea'']," *Interfax*, 15 January 2018, www.interfax.ru/russia/595436.

2 Toal, Gerald. *Near Abroad: Putin, the West, and the Contest Over Ukraine and the Caucasus*, (New York: Oxford University Press, 2017), pp.198-232.

3 Ibid, pp. 210-11.

4 Foreign Policy Concept of the Russian Federation (approved by President of the Russian Federation Vladimir Putin on November 30, 2016). Published by the Ministry of Foreign Affairs of the Russian Federation, 1 December 2016, http://www.mid.ru/en/foreign_policy/official_documents/-/asset_publisher/CptICkB6BZ29/content/id/2542248.

Russian President Vladimir Putin, Indian Prime Minister Narendra Modi, Brazilian President Dilma Rousseff, Chinese President Xi Jinping and South African President Jacob Zuma join their hands at a group photo session during the 6th BRICS summit in Fortaleza in 2014. (Source: www.ndb.int)

international economic organizations as tools of the West's geo-economic efforts. In the case of the Eurobond, however, Moscow strove to turn these existing institutions in its favor, challenging the existing institutional order from within, rather than from without. While Russia's designs may have been thwarted in the IMF, they have so far met success in the British High Court.

Finally, the dispute reveals that Russia can be strategically patient. Though many analysts see Russian foreign policy as driven by tactics, not strategy, the bond dispute suggests otherwise. While we do not know who formulated the terms in the Eurobond, or ordered their formulation by the relevant lawyers, it is clear they were inserted with the intent of securing geopolitical leverage.

Why, then, was the full potential leverage of the Eurobond not exploited at the height of the Russo-Ukrainian conflict in 2014-15? Russia could have forced Ukraine into default as early as mid-2014, though it did not do so. Russia showed a strong hand, but ultimately chose not to play it. Depending on the ultimate outcome of the British court disputes, however, it may have saved the tool for a more advantageous time. For example, in August 2018, *Reuters* reported Gazprom suspended its plans to borrow in external markets, amid concerns funds could be attached following Ukraine's \$2.6 billion award from the Stockholm Arbitration Institute in Naftogaz's dispute with Gazprom.[5] The Eurobond could be included in negotiations over these debts, despite the off-set clause, or alternatively it could still be used to push Ukraine back into default later if Russia wins at the Supreme Court or in a full trial.

There are many other examples of Russia's use of economic tools in the Ukraine conflict, from the introduction of countersanctions to plans for new energy export pipelines.[6] In these areas, too, Russia seeks to twist international institutions to its benefit. Even if these efforts fail, as have Rosneft's attempt to challenge sanctions at the European Court of Justice, the trend will continue. So, too, will Ukraine's status as a testing ground for Russian geo-economic tools.

5 Bradley, Sandrine and Kobzeva, Oksana. "Exclusive - Russia's Gazprom suspends external borrowing amid spat with Naftogaz: sources," *Reuters*, 6 August 2018, https://uk.reuters.com/article/uk-russia-gazprom-debt-exclusive/exclusive-russias-gazprom-suspends-external-borrowing-amid-spat-with-naftogaz-sources-idUKKBN1KR1M9.

6 Vihma, Antto and Wigell, Mikael. "Geopolitics versus geoeconomics: the case of Russia's geostrategy and its effects on the EU," *International Affairs*, Volume 92, Issue 3, May 2016, pp. 605-627, https://onlinelibrary.wiley.com/doi/abs/10.1111/1468-2346.12600.

Conclusions and Consequences

The Appeals Court's September 2018 ruling raises the prospect of a trial that would consider the political, economic, and military pressure the Kremlin put on Kiev before agreeing to the loan. While the courts have so far demonstrated no willingness to introduce an odious debt doctrine, the case's fate could have a substantial impact on private debt markets.[1]

Should Russia win at the Supreme Court, other sovereigns may follow Russia's precedent and blur the line between official and private debts for geopolitical or economic gain. A victory for Ukraine based on duress or odious debt claims could have a major impact on sovereign Eurobond markets, as investors will have to more closely consider the political environment under which bonds are issued. Furthermore, additional legal disputes concerning the bond may still emerge, for example, in relation to ongoing litigation between the two countries' state gas companies, Naftogaz and Gazprom.

In the future, the Kremlin may repeat its current tactics, but with greater aggression. In 2014-2015, Russia did not seek to trigger provisions demanding early repayment and thereby forcing Ukraine into default, nor did it sell the Eurobond to a fund that could have used it to improve its negotiating position on Ukrainian debt. Russia could have sold the bond to an ostensibly private Russian investor, which would have likely enabled the Kremlin to block any private debt restructuring attempt. The Kremlin has used such techniques to shield itself from Western sanctions, such as in 2016, when Rosneft invested in Indian energy firm Essar via a partnership with the Russian investment fund United Capital Partners, a move that VTB CEO Andrey Kostin openly admitted was to avoid U.S. sanctions.[2] Partnering with a friendly, ostensibly-private partner in a future Eurobond dispute could be a tool of geo-economic aggression.

Regardless of the bond dispute's ultimate outcome, Russia is deepening its involvement in internationally traded private debt markets. The most notable example is Rosneft's acquisition of a lien guaranteed by 49.9 percent of U.S.-based energy firm CITGO in December 2016. Venezuela's state-oil firm Petroleos de Venezuela S.A. (PDVSA), the majority shareholder in CITGO, offered the shares to Rosneft as collateral for a $1.5 billion loan. The remainder of CITGO then went to holders of PDVSA Eurobonds who agreed to reprofile their bonds and extend their maturities. While Russia has not yet moved to take control of CITGO, Rosneft's stake guarantees the Kremlin a place at the table for any restructuring of PDVSA's debts.[3] The U.S. has threatened to counter any attempt by Rosneft to take majority

1 An odious debt doctrine refers to the establishing the conditions under which the debt incurred by a despotic regime should not be enforceable.

2 Unattributed (Reuters Staff). "INTERVIEW-Russia's VTB head: Rosneft-Essar deal not subject to sanctions," *Reuters*, 15 October 2016, https://uk.reuters.com/article/essar-oil-ma-rosneft-oil-sanctions-idUKL8N1CL0HT.

3 Hess, Maximilian. "Rubles in the Rubble: Russia's role in the Venezuelan restructuring saga," *BMB Russia*, 12 December 2017, https://bearmarketbrief.com/2017/12/20/rubles-in-the-rubble-russias-role-in-the-venezuelan-restructuring-saga/.

ownership in CITGO stake by implementing further sanctions or by imposing restrictions via the Council on Foreign Investment in the United States (CFIUS). In August 2018, Canadian mining firm Crystallex, which had previously secured a judgement against the Venezuelan sovereign for nationalizing its assets, was able to "pierce the veil" between PDVSA and Venezuela, potentially setting the scene for further lawsuits involving Russia if Rosneft seeks to enforce its lien.[4]

As sovereign bonds become increasingly subject to geopolitical tensions, the U.S. and Russia will try to influence their structures. In early 2018, Russia issued so-called "beryozki bonds" as part of its de-offshorization plans to encourage capital repatriation. Notably, the bonds include a prospective shield against future U.S. sanctions: principal and coupons payments may be made in euros, Swiss francs, or British pounds if the borrower is unable to do so in dollars. One beryozki bond even allows for repayment in rubles under certain circumstances.[5] The Kremlin, in other words, is carefully considering the wording of its own Eurobonds.

Meanwhile, President Donald Trump's administration has shied away from the sovereign bond guarantee program, by which the U.S. guaranteed bonds issued by foreign allies, thereby dramatically lowering their borrowing cost. The Obama administration had approved three such USAID-guaranteed bonds for Ukraine, raising Kyiv a total of $3 billion. The U.S. may be retreating from employing sovereign debt as a geo-economic instrument, just as Russia escalates its efforts to do so.

The Russia-Ukraine Eurobond issue provides insight not only into Russian foreign policy, but also into the links between geopolitics and sovereign debt markets more broadly. Russia has failed in its goal of keeping Ukraine in its geopolitical orbit. But it has proven that sovereign debt can be a tool for destabilizing a neighbor and helping to keep its government on the brink of financial collapse. The dispute should also be seen in the context of the Kremlin's challenges to the existing global international order, even if British courts rule in Ukraine's favor. The Court of Appeals' ruling noted that Russia must have been aware that it could lose in court, but even a loss would be spun as evidence that both the IMF and English courts are too politicized to be fair arbiters of international debt disputes.[6] Ukraine remains in a difficult position, facing demands from the IMF that are controversial at home, and only able to borrow from international investors at relatively high interest rates. It also faces continued legal battles with the Kremlin over the $3 billion debt. Evidence that the Kremlin is pleased with its use of sovereign debt as a geopolitical tool is present in Venezuela, where Russian lending today may give the Kremlin similar leverage in the future. Russia's controversial loan to Ukraine, in other words, is unlikely to be Russia's last foray mixing geopolitics and sovereign debt.

4 Weidemaier, Mark. "Court Lets Crystallex Attach Equity in CITGO Parent," Credit Slips blog, 10 August 2018, http://www.creditslips.org/creditslips/2018/08/court-approves-crystallexs-attachment-of-citgo-parent.html.

5 Hess, Maximilian. "Life's a birch: Russia's investors aren't rushing in to buy MinFin's new bonds," *BMB Russia*, 26 March 2018, https://bearmarketbrief.com/2018/03/26/lifes-a-birch-bond-russias-investors-arent-rushing-in/.

6 Ukraine (Appellant) vs. Law Debenture Trust Corporation (Respondent). (2018) EWCA Civ 2026. Case No: A4/2017/1755., Paragraph 175, pp. 43.

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