HERDING CATS: COLLECTIVE-ACTION CLAUSES IN SOVEREIGN DEBT—THE GENESIS OF THE PROJECT TO CHANGE MARKET PRACTICE IN 2001 THROUGH 2003

RANDAL QUARLES*

I

INTRODUCTION

One of the principal projects in international sovereign finance from 2001 through 2003 was the effort on the part of the U.S. Department of the Treasury to encourage emerging-market borrowers to include so-called collective-action clauses in the debt instruments they offered in international markets.[1] Such clauses create mechanisms that allow a specified majority of a borrower's creditors (or the creditors' representatives) to take action that is binding on all the creditors, even those which do not agree to the action. Though controversial at the outset, this effort ultimately turned out to be remarkably successful in changing market practice: beginning with the inclusion of collective-action provisions in Mexico's offering of $1 billion of dollar-denominated bonds in February of 2003, major emerging-market borrowers rapidly followed suit over the following year, and by 2005 over ninety-five percent of newly issued sovereign debt included provisions for collective action.[2]

The merits of these provisions have been debated thoroughly, both at the time the Treasury urged their inclusion and afterward,[3] and I do not propose to recapitulate those arguments here. Nor do I intend to provide a comprehensive history of the process that resulted in these changes in market practice; that,

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* Managing Director, The Carlyle Group. Mr. Quarles received a Juris Doctor degree from Yale Law School in 1984. He served as Under Secretary for Domestic Finance of the U.S. Treasury from 2005 through 2006 and Assistant Secretary for International Affairs for the U.S. Treasury from 2002 through 2005.

1. This was principally an issue for debt instruments governed by the law of New York, one of the two main jurisdictions for the governing law of nonlocal debt issued by emerging markets. Most such debt not issued under New York law was issued under English law, and sovereign debt governed by the laws of England had long included provisions for certain types of collective action by creditors.

2. *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: GLOBAL FINANCIAL SYSTEM RESILIENCE IN THE FACE OF CYCLICAL CHALLENGES 46 (2006), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2006/01/pdf/chp1.pdf.

3. *See, e.g.*, NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS (2004).

too, has been done thoroughly by others.[4] As anyone who has been part of any complex policy initiative knows, however, those two categories—what the participants *ought* to have been doing, and what they actually *were* doing—are often not the entire story. There is the third question of what the parties *thought* they were doing, which differs surprisingly frequently from either what they should have done or actually did do, and can reveal motivations and incentives that would not otherwise be obvious. This contribution to this symposium is of the third kind: I want simply to describe some of the thinking of the officials in the U.S. Treasury as we pursued this initiative on collective action in sovereign debt. Our reasons might not necessarily have been the best reasons; our perceptions of events were certainly incomplete, perhaps sometimes mistaken. But here are some observations on what we thought we were doing.

II

DIFFERENT APPROACHES TO SOVEREIGN DEBT CRISES

The senior Treasury officials of the George W. Bush Administration arrived in 2001 with a number of goals, one of the clearest of which was in the area of sovereign finance: We intended to change the practice that had developed during the 1990s of increasingly large-ticket, heavily intrusive assistance to sovereign debtors in crisis involving the International Monetary Fund (IMF), the Group of Seven nations (G7), and sometimes an even broader group of sovereigns. Beginning with the Mexican debt crises of 1994 and through the end of the decade, there were roughly fifteen serious crises in Latin America, Asia, and Russia, with the size and frequency of the intervention packages increasing steadily.[5]

The policy arguments both for and against such intervention are familiar: on the one hand, the risk that if a sovereign defaulted on its obligations, the resulting financial contagion would destabilize emerging markets generally—even those that were quite sound—and, on the other, the moral hazard of increased sovereign risk-taking and diminished market discipline ensuing from the bailout. The Treasury team of the '90s believed that, in each particular crisis, the potential consequences of contagion outweighed the risk of moral hazard and so justified the particular intervention; this new team saw the steadily increasing size and volume of bailouts and put greater weight on the importance of limiting moral hazard and thus finding alternatives to large-scale intervention.

The difference in views on this issue between the two Treasury teams was driven, however, not simply by different weights given to contagion and moral hazard but even more fundamentally by different approaches to the process of decisionmaking itself. Robert Rubin, the Treasury Secretary during most of the

4. *See generally* Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006).

5. JOHN B. TAYLOR, GLOBAL FINANCIAL WARRIORS 100 (2007).

'90s, believed that good decisionmaking began by accepting that nothing critical to a decision was provably certain, so every good decision started with an assessment of probabilities. A good decider evaluated as much information as could be reasonably obtained about a particular situation, judged the odds of various outcomes and possible gains or losses associated with each, and acted accordingly.[6] Members of Secretary Rubin's Treasury team have said this decisionmaking process—as much as any particular policy view that may have resulted from it—was essential to how they approached the world.[7]

This is an appealingly pragmatic and commonsensical view, and the clear implication is that strict decision rules that limit the freedom of policymakers to act as required in complex situations are usually not desirable because the full range of facts can never be known in advance. A strict policy rule is not absolutely inconsistent with such an approach: among the probabilities to be evaluated, for example, could be the potential for the politics of a situation to force policymakers to act in a way contrary to their evaluation of the odds; the best decision in that case might be to adopt a rule that limits their discretion and their corresponding ability to be pressured. Nonetheless, such a rule emphasizes the importance of applying discretion intelligently to the specific facts of each situation.

The Treasury officials appointed in 2001, however, arrived with a general skepticism about the merits of discretionary intervention by government not just in sovereign financial crises, but across the range of government action. Although this resulted partly from the weight given moral-hazard concerns, it was driven just as much by a fundamental concern about the uncertainty that the exercise of discretion by governments creates throughout the financial and economic system. When governments have discretion, markets and citizens cannot be sure how the government will act, and that uncertainty results in inefficiency, delay, and politicization. Governments can limit both moral hazard *and* uncertainty by refraining from intervention when possible, and when action of some sort is inherent in the government's mandate (as in issuing debt or executing monetary policy), by developing and sticking to clear, predictable rules for action, thus putting boundaries on what decisions can result from a weighing of the pros and cons.

The best and most influential example of this mindset among the new Treasury team was that of John Taylor, the incoming Under Secretary for International Affairs. Taylor was a highly respected economist from Stanford who had done much work on the relative desirability of policy rules as opposed to discretion in government action. In fact, perhaps the most famous example of a policy rule of this sort was a rule Taylor had developed to guide monetary policy, which has become known as the "Taylor Rule." Based on a clear and simple relationship between inflation, unemployment, and the gap between

6. ROBERT E. RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD, at x–xii (2003).

7. *See generally id.*

actual and potential economic output, the Taylor Rule has come to be used by central banks throughout the world as a key input in their decisions.[8]

Although the Taylor Rule was the most well-known example of the mindset that the Bush Treasury team would bring to decisionmaking, the roots of this approach reach back much further: I have always believed that many of the new Treasury officials took much from their earlier association with George Shultz. Paul O'Neill (the new Treasury Secretary) and Ken Dam (the new Deputy Secretary) had worked closely with Shultz in the Nixon and Ford Administrations. Dam had also been Shultz's Deputy Secretary of State in the Reagan Administration, and John Taylor had been a close colleague of Shultz's at Stanford, where they were both fellows of the Hoover Institution. All these individuals referred to George Shultz as a key mentor, and they arranged for him to speak to the senior Treasury staff on the difficulties of policymaking early in the new Administration.

George Shultz has famously told the story of his first major challenge as Secretary of Labor in the late '60s.[9] In that era, significant labor disputes were almost always protracted conflicts that were never solved without extensive and athletic mediation from the federal government. In his academic work, however, Shultz had been an early proponent of the view that

> private collective bargaining . . . was being subverted by too much government involvement; that potential crises from strikes tended to be overrated and overdramatized; that high officials should refuse to become involved and certainly should not attempt to force the parties to settle their disputes; and that the clear willingness of high administration officials to become involved resulted in their exploitation by labor or management in a process where "supply created its own demand."[10]

As Shultz put it, "[I]f the president hangs out his shingle, of course he'll get all the business."[11]

When Shultz took office in 1969, there was enormous pressure on the new Secretary to intervene in a crippling longshoremen's strike on the East Coast that had already been underway for a month. Shultz resisted this pressure, maintaining that discretionary government intervention exacerbated problems over the long run and that government's role was to set transparent, predictable rules for private activity and then to stick with them.[12]

And the result? When the parties saw they could not draw the federal government into their conflict, they realized they would have to solve it on their own and turned to doing that. The public came to realize that government intervention in labor disputes, and the opportunities for political pressure,

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8. *See generally* John B. Taylor, *Discretion Versus Policy Rules in Practice*, 39 CARNEGIE–ROCHESTER CONF. SERIES ON PUB. POL'Y 195 (1993).

9. *See* GEORGE P. SHULTZ & KENNETH W. DAM, ECONOMIC POLICY BEYOND THE HEADLINES 1–2 (2d ed. 1998) (describing Shultz's handling of a strike by East Coast longshoremen).

10. *Id.* at 1.

11. *Id.*

12. *Id.* at 2.

gamesmanship, and further negotiation that intervention created, was unlikely to be forthcoming. And when President Ford handed over the reins to President Carter in 1977, not only were there no emergency boards or mediation processes in operation, there were no strikes underway or in the offing across the whole of the country.[13]

Without wanting to make too much of this analogy, I have thought of this contrast between the two Treasury teams as the difference between a "common law" and a "statutory" approach to government decisionmaking. For the '90s Treasury team, each sovereign crisis was like a case at common law: it was to be resolved in the way most appropriate to the facts of that case with a solution designed to relieve immediate, significant distress; it was modeled on the way similarly situated cases had been handled in the past; and it took into account all the factors that rendered each new case unique. Our approach, by contrast, was to be driven by a rule—analogous to a statute—that would impose a strict limit on where the logic of a particular case could take us. We wanted to live by a hard constraint on the system's ability to bail out private parties or to construct complicated, opaque arrangements, even when those options might seem to make sense given a particular set of facts. This "statutory" approach was rooted in our concern about the longer-term implications—much in the way that statutes, sentencing guidelines, and other limits on judges' discretion have been devised to increase deterrence and reduce uncertainty in the criminal law.

And it is fair to say that, in many ways, the differences in decisionmaking of these two Treasury teams extended over time the views of two different individuals who were not merely significant actors at a particular time in the past, but mentors to colleagues who would carry these approaches forward over a much longer period. President Obama's economic team, for example, is composed of many people who served under Rubin during the '90s, and they appear to have brought to the 2008–2009 financial crisis the same approach to decisionmaking and policy development. One of the chief critics of the interventionist response to the domestic financial crisis has been John Taylor. George Shultz and Bob Rubin have cast very long shadows.

III

SOVEREIGN DEBT CRISES UNDER THE BUSH ADMINISTRATION

Having come into office determined to change the practice of intervention in sovereign crises, the Bush Administration was presented with its first challenge in August of 2001 when an accelerating sovereign debt crisis in Argentina triggered a destabilizing slow run on the banking system and raised the prospect of imminent default. Our team tried to encourage a market-based restructuring that would have avoided default without the need for IMF or G7 intervention. But as the month of August progressed, it became clear that the various possibilities for restructuring were stymied by some basic provisions in

13. *Id.*

the bond contracts—principally the negative-pledge clause, which prevented the borrower from giving secured collateral to a subsequent lender.

Negative-pledge clauses are nearly universal in unsecured debt contracts: few lenders would be willing to become unsecured creditors if a borrower could impair its financial condition by taking on substantial additional debt while giving later lenders priority claims on the assets available to pay the debt. In normal circumstances, these negative-pledge clauses play a valuable role in encouraging market discipline and preventing the development of unstable debt structures. But once a crisis has developed, it could be in everyone's interest—including the unsecured bondholders—for a borrower to be able to attract additional funds by giving some appropriate priority to the new bondholders. Most of the restructuring ideas being considered for Argentina in the summer of 2001 depended, at least to some degree, on Argentina's giving new lenders a security interest in future revenues. This could not be done without permission from the beneficiaries of the negative pledge, but the bond contracts had no mechanism for that permission to be given short of a unanimous vote of the affected bondholders, which was impossible to obtain as a practical matter.

Many of our counterparts at the IMF and in other G7 finance ministries had considerable doubt about the merits of the financial engineering that underlay these various restructuring ideas. In hindsight, it is not clear that any of the particular approaches we had under consideration in August of 2001 would have improved Argentina's position beyond delaying, and perhaps worsening, the inevitable. But at the time it was extremely frustrating not to be able to consider them as options. The officials who were not lawyers and thus not as familiar with the positive aspects of negative-pledge provisions were particularly annoyed. Secretary O'Neill asked us in one internal discussion to consider a legislative project to prohibit negative-pledge clauses in sovereign debt entirely. Eventually, we persuaded him that the problem was not with the negative-pledge clause itself, which served a useful role in the ordinary course of events, but with Argentina's practical inability under its bond contracts to negotiate a waiver of the negative-pledge clause in times of distress, even when such a waiver would be in the collective interests of the bondholders as well as the borrower. In the end, we agreed in late August to a moderate $8 billion increase in IMF lending to Argentina—a "last chance," as it were. This was not our preferred outcome, but we felt we had been forced into it given our limited options. And in the minds of many of the Treasury's senior officials, including the Treasury Secretary, the principal obstacle to expanding our options was the negative-pledge clause.

It was in this context that Secretary O'Neill, John Taylor, and I met for breakfast in September with Horst Kohler, the Managing Director of the IMF, and Anne Krueger, his chief deputy and the senior American at the IMF. These breakfasts with the senior officials at the IMF and the senior international staffers at the Treasury occur frequently on a Treasury Secretary's schedule—every month or so—and this was the first to occur after the events of August.

Argentina was still in a precarious position even after the advance of additional funds from the IMF. Much of the discussion at this breakfast involved the obstacles to restructuring created by the terms of the bonds, including the negative-pledge clause. Secretary O'Neill had accepted the arguments against entirely prohibiting the negative-pledge clause, but he had continued to give thought to the problem and surprised us all by strongly encouraging the IMF to develop an international sovereign bankruptcy process. Just as in a domestic bankruptcy, such a process would allow a tribunal to override the terms of debt contracts—including negative-pledge clauses—in order to allow a restructuring of the debt when that was in the overall interest of claimants on the borrower. And given the stresses we were expecting in the international area, speed was important; at that breakfast, O'Neill said he thought the process should be in place by December of that year.

I was skeptical that something as complicated and controversial as an international sovereign bankruptcy process could ever be negotiated, certainly not within three months. Even if it could ever be put in place, I thought the ability to avoid politicization of such a tribunal's decisions was slim. An international sovereign bankruptcy tribunal would never be as rule-bound and interference-free as a domestic bankruptcy court in the United States, so the benefit of additional restructuring flexibility in distress would be bought at too high a cost in increased uncertainty about the outcomes of the insolvency process.

I also knew, however, that Secretary O'Neill's fundamental goal was not the creation of a bankruptcy regime, but the expansion of restructuring options in the face of otherwise intractable bond covenants—and I believed this could be achieved in a different way. Among the legal work I had done over the years was advising financial institutions on structuring derivative contracts. (One of my principal clients had been J.P. Morgan, which was one of the most active participants in the development of new and complex derivatives.) Derivative contracts were often intended to combine certain attributes of one type of security with certain attributes of an entirely different type of security, but this hybridization often meant that the resulting instrument "fell between two stools" as far as the law was concerned, so the rights of its holders might not be governed by standard provisions of law. As a result, those rights often had to be spelled out explicitly in the derivative contracts themselves. I had grown used to assuming that the legal regime one preferred to govern the rights of parties to any contract could be specified by agreement between the parties to the contract, even when that regime might not apply automatically under the law itself. With that mindset, providing a mechanism in the debt contracts themselves for modifying the terms of the foreign bonds when that was in the best interests of both bondholders and borrower seemed the most straightforward and practical way to meet that objective and to carry out Secretary O'Neill's wish to expand restructuring options. This mechanism would be a better alternative than creating an external, supranational legal regime that would override the terms of those contracts.

This idea was very much in tune with our team's general approach to government intervention and decisionmaking, and was thus strongly endorsed by John Taylor. It did not rely on government or IMF intervention to achieve future debt restructuring (thus limiting moral hazard), and the process was more predictable because it was less subject to politicization than a supranational tribunal would have been. We also discovered that it could build on much consensus-building work that had been done some years earlier in the international community on so-called collective-action clauses, which would increase the likelihood that the project could move quickly.[14]

One obstacle to moving quickly that surprised me was the initial, strong resistance that the proposal to include collective-action clauses in sovereign bond contracts received from some active buyers of sovereign bonds themselves, especially the Emerging Market Traders Association. What we were proposing was simply that bondholders would decide among themselves when it would be appropriate to modify the terms of a contract, and that such modification could happen only when a super-majority of bondholders agreed it was in the bondholders' interest. So I had expected that bondholders would be relatively quick to support—or at least not oppose—the adoption of such provisions.

This view was reinforced by what I—rightly or wrongly—understood the history of collective action in the restructuring of bonded indebtedness in the United States to have been. The law firm at which I had spent my career, Davis Polk & Wardwell, had built much of its original prominence on advising the railroad reorganizations of the late nineteenth century. Although this was somewhat before my time, I had been interested in the history of that era, and as a young associate had spent hours late at night after my day's work was done studying the files of those transactions, which were still in the firm's warehouse. The United States had no corporate bankruptcy law during this period, so these reorganizations had to be accomplished through negotiated, contractual agreement—similar to what we were proposing for sovereign debt. Clauses that allowed a majority of creditors to bind all creditors allowed this system to work outside of formal bankruptcy.

Such clauses were not only accepted but strongly desired by bondholders, and understandably so, since without them, holdouts and free riders could insist on being paid the full amount of their claims even if a majority of bondholders accepted a restructuring in order to maximize the prospect of recovery. Even after the United States adopted a modern corporate reorganization statute in

14. Secretary O'Neill supported the collective-action clause approach to his problem, but since his fundamental aim was enhancing the restructuring options for distressed sovereign debt, he did not want to suspend work on a sovereign bankruptcy process until it was clear that the collective-action clauses would work. Accordingly, we encouraged a "dual-track" process—with the Treasury encouraging work on collective-action clauses and the IMF developing a sovereign bankruptcy regime called the "Sovereign Distress Resolution Mechanism"—until the clauses actually began to be adopted in debt contracts seventeen months later.

the 1930s, there was still a strong impetus to use these collective-action clauses to restructure outside of the new statutory reorganization procedure. This impetus was so strong that the New Deal authors of the new bankruptcy procedure—who wanted to expand the role of government oversight in the process and had a personal and political aversion to the Wall Street firms that traditionally conducted these restructurings—eventually included a provision in the Trust Indenture Act of 1939 that explicitly forbade collective-action provisions in the debt of public companies.[15] This was expressly intended to force all reorganizations to proceed under the supervision of a bankruptcy court, since only there could the necessary modification of bond terms be accomplished.[16]

This history also led me to a hypothesis as to how the practice of forbidding collective action in sovereign debt contracts governed by New York law had begun in the first place—when it did not seem to make sense given the incentives of the parties and when such rigidity had never been the practice in competing jurisdictions, especially England. Given the way large law firms work, it seemed very likely that decades ago, a young lawyer in one of the large New York law firms charged with drafting a sovereign bond contract had taken a domestic bond contract as a model, which—because of the Trust Indenture Act—would have required unanimous agreement of the bondholders for any modification of the bond's terms. That contract then became a precedent for the next one, and so on, and soon enough an iron-clad market practice had developed. What is more, it all looked quite normal because New York lawyers had grown used to such a provision in their domestic bond indentures. But this provision was designed to force reorganization proceedings into the statutory bankruptcy process and made sense only in the context of such a process. When there was a bankruptcy court, contractual collective action was unnecessary because the court provided an alternative mechanism for making the necessary modifications to the terms of the bonds that would allow a reorganization to take place. Without a bankruptcy court, however, collective-action clauses were in everyone's interest and had thus been a long-standing prior practice.

Given all the above, I felt that if the participants in the emerging-market bond process thought clearly about their real interests and realized the logical flaw underlying the provisions they had been living with throughout their careers, the vehement and somewhat unreasoning resistance to these clauses would subside. In time, this is exactly what happened, but initially the most vocal representatives of the market were strongly opposed. They did not, however, represent the largest purchasers of emerging-market debt, who waited until it seemed as if this project had real prospects of success before engaging seriously with the policy question. Eventually, Mohammed El-Erian, who was

15. 15 U.S.C. § 77 (2006).

16. David A. Skeel Jr. provides an interesting and comprehensive review of this history that largely reinforces the view I had developed as a young man poring through the Davis Polk warehouse files. *See generally* DAVID A. SKEEL, JR., DEBT'S DOMINION (2001).

the principal emerging-market investor at Pacific Investment Management Company, the largest buyer of sovereign debt, and Paul Denoon at Alliance Capital, another large investor, sat down with us separately at the Treasury. Both agreed with the points we were making about the bondholder benefits of collective action and agreed to signal to the issuers of such debt that they would continue to be buyers of bonds that included such provisions. It was only a matter of weeks after those discussions that Mexico issued bonds containing such covenants for the first time. The speed with which the prior market practice changed—so that now the inclusion of such provisions in sovereign debt under New York law is almost as common as their exclusion was earlier—is, I think, evidence that these provisions do further all parties' interests. In addition, the "domino effect" of the Mexican precedent provides at least some indirect support for my belief about how the original practice had developed in the first place, given how easy it is for a prominent precedent to become the unquestioned market standard.

IV

CONCLUSION

These reflections represent at least one participant's views about what the U.S. Treasury thought it was doing in pursuing the collective-action project in 2001 and 2002. The collective-action-clause project followed quite naturally from the decisionmaking philosophy, policy inclinations, specific experiences, and immediate problems faced by the Treasury team in 2001. And although collective-action clauses—as an international policy project—are behind us, it is interesting to note that the conflict in policymaking approaches between the "common law" and "statutory" models of government decisionmaking continues to reverberate in the policy debate over the proper government response to the 2007–2009 financial crisis, and in many cases it is argued by the same players. Rubin and Shultz have retired, but their influence will continue to be felt at the Treasury for a long time yet to come.