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Sovereign Debt Reform and the Best Interest of Creditors

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I. INTRODUCTION

This Article is about boilerplate language located at the back of contracts drafted by the world's largest law firms. The clauses in question are process provisions that regulate the amendment of sovereign debt contracts. These paragraphs have been drafted and redrafted by generations of corporate lawyers, yet they have changed little in their broad outlines in more than a century of use. Now they take center stage in the global financial arena, where they govern billions of dollars (and pounds, euros, and yen) of sovereign debt in default and billions more in imminent risk of default. Officials, academics, and even some of the lawyers who drafted the clauses now want the clauses removed because they make defaulted debt difficult to restructure.

How did this arcane preserve of the bond lawyer come to be the cutting edge in the evolution of international financial architecture? Whereas private debt defaults lead to bankruptcy, sovereign debt defaults lead to informal, often lengthy standstills. The creditors can wait out the period of distress, expecting eventual economic recovery to lead to a resumption of payments. But, for the most part, payment resumption requires that creditors come to the negotiating table to rewrite the defaulted debt contracts. Such a "composition" or "restructuring" scales down the sovereign's obligations and causes it to return to health quickly. In theory, this makes both the sovereign and its creditors better off.

There are practical barriers to be overcome before a composition can be concluded. These stem from information asymmetries, from coordination problems, or from complex bargaining dynamics. Sovereign compositions tend to be tripartite negotiations. In addition to the sovereign and the existing creditors, international financial institutions like the International Monetary Fund (IMF) come to the table holding out new loans. In theory, these loans are conditional, requiring the sovereign to reform its economic policies and the unpaid creditors to share the pain by cutting back their claims to induce lending that facilitates economic recovery. In practice, the IMF often acts precipitously, bailing out the sovereign so as to stabilize the international financial system or satisfy some other political goal of its major shareholders. The prospect of a bailout diminishes the creditors' incentive to come to the bargaining table to make concessions.

Assuming bargaining commences, the bond contracts contain boilerplate clauses, called "unanimous action clauses" (or "UACs"), that erect a barrier to success. These clauses, which condition

amendment of the bond contracts' key payment terms on unanimous bondholder consent, govern the majority of sovereign bonds outstanding. A minority of bond contracts contain "collective action clauses" (or "CACs"), which permit across-the-board amendments with a three-quarters majority. Whereas CACs facilitate restructuring of the defaulting sovereign's debt, UACs stand in the way. With thousands of bondholders dispersed around the globe, coordinating a unanimous vote is difficult, if not impossible. Further, a unanimous vote requirement invites free riding: Because the transaction makes the group as a whole better off, an opportunistic bondholder has an incentive to "hold out"—to withhold its essential vote in hopes of procuring a side payment from the transaction's proponents.

The cumulation of frictions has led to calls for the institution of a sovereign bankruptcy regime. This would resemble corporate bankruptcy reorganization, albeit tailored for sovereign debt. The IMF has proposed a minimal bankruptcy architecture, one that would trump UACs and facilitate restructuring in a majority action framework. The United States Treasury agreed on the need for majority action, but has registered a contractarian objection to the IMF's plan for a new statutory scheme: Since UACs lie at the core of the problem and UACs are contract terms, the solution lies in persuading the market to rewrite sovereign bond contracts rather than in overriding them with an international mandate. Now that the official sector refuses to bail out every sovereign in distress, Argentina being the most prominent example, UACs constitute less of a strategic advantage. On the assumption that CACs are otherwise superior to UACs in terms of efficiency, the Treasury projects that sovereign bondholders will willingly exchange their UAC bonds for CAC bonds, ameliorating the coordination problems. Sovereign debt restructuring can then go forward in a framework of free contract.

Sovereign bondholders and sovereign borrowers at first rejected both proposals—the IMF's bankruptcy plan and the Treasury's spontaneous bond exchange suggestion. These real parties in interest preferred the status quo. But their motives were suspect. To the extent that the status quo makes unconditional IMF bailouts more likely, the sovereigns and their lenders have reason to oppose reform, whether mandatory or contractual.¹ Official sector pressure

1. For a recent overview of the "financial architecture debate," see Barry Eichengreen, *Restructuring Sovereign Debt: Analytical Issues and Policy Proposals*, J. ECON. PERSP. (forthcoming Fall 2004); Peter B. Kenen, *The International Financial Architecture: Old Issues and New Initiatives*, 5 INT'L FIN. 23, 26 (2002); Marcus Miller, *Postscript Sovereign Debt Restructuring: New Articles, New Contracts—Or No Change?*, in SOVEREIGN DEBT: ORIGINS,

has since broken the pattern of universal market opposition. A handful of sovereign issuers have successfully departed from market practice and include CACs in new bonds. The present question is whether this development heralds a market-wide shift to CACs as advocated by the Treasury.

This Article inquires into the causes of this multiparty dispute. It takes a new look at the economics of sovereign lending, identifying interests fundamental to the sovereign debtor-creditor relationship that have been obscured in a debate focused largely on opportunism occasioned by IMF bailout lending. This different focus leads us to identify unsound premises on both sides of the dispute between contract and mandate.

The contractarians propound a “free lunch” theory of sovereign lending. They assume that CACs are a first best improvement over UACs, and that a transition to CACs holds out a surplus for all parties to share. Unfortunately, no such twenty-dollar bill has been left lying on the table. In our view, sovereign lenders rationally could prefer UACs to CACs, and could do so even in a world without IMF bailout lending. It follows, on a worst-case scenario, that engrained resistance will prevent a voluntary, market-wide transition to CAC bonds, and that a majority action regime may be achieved only on a mandatory basis. On a best-case scenario, it follows that frictions will impede a market transition from UACs to CACs. If the international financial community wishes the incipient transition to become general and remain stable, it will have to pay for it. Yet it is unclear where the money would come from to pay UAC bondholders to trade their bonds for CAC bonds. In the alternative, the IMF will have to intervene aggressively, forcing model contract terms on sovereign borrowers by threatening penalties for those who borrow with UACs. The best-case scenario, thus characterized, is essentially mandatory intervention.

We accordingly agree with sovereign bankruptcy proponents who doubt that the markets will spontaneously and quickly shift from UACs to CACs once participants realize that bailouts are no longer readily available. But we also suggest that the bondholder community and the sovereign debtors have legitimate reasons for remaining suspicious of bankruptcy proposals. The IMF’s proposal rests on a triad of majority action, cost savings, and administrative convenience as it simultaneously attempts to address the need for a better framework for bailout lending and to rationalize the process of

sovereign debt composition. These elements do not import a persuasive normative grounding for a bankruptcy regime. The economics of sovereign lending suggest a stronger, contract-based norm—the best interest of creditors,² defined as whatever the unpaid lenders freely approve. Under the norm, only the creditors themselves should determine whether a given composition serves their best interests. It follows that a sovereign bankruptcy process should not attempt to replicate the transactional bias of American corporate reorganization, where the need to close the deal can override other concerns. In the sovereign context, the long-run interests of defaulting sovereigns and their creditors are more closely aligned than those of defaulting private borrowers and creditors. If sovereign creditors do not like the restructuring on offer, it must be allowed to fail.

Under this view, a sovereign bankruptcy regime need do little more than trump UACs with CACs and then leave the parties to renegotiate their contracts. With CACs in place (however imposed), the parties can be remitted to the law governing their contracts—the law of the State of New York in most cases—without needing the assistance of a bankruptcy infrastructure.

But one problem remains with this minimal approach, a problem stemming from the contractual jurisprudence of sovereign debt.³ Once a renegotiation framework is established, a given creditor's worst enemy may be neither the defaulting sovereign nor the IMF, but another creditor or group of creditors with conflicting interests. The contract law of New York is undeveloped on the question of whether sovereign creditors owe one another meaningful good faith duties. The law of private debtor-creditor relations, meanwhile, rejects the suggestion that creditors should owe duties to one another, leaving the job of constraining opportunistic behavior within the creditor group to the bankruptcy system.⁴ Over a century ago, however, in the period antedating the federal statutory reorganization regime, intercreditor duties did exist. As we see it, the

2. As distinguished from the “best interests of creditors” as used in the jurisprudence of corporate bankruptcy in the United States. See *infra* text accompanying note 123. Coming at the problem from a different angle, economist Andrei Shleifer has also recently argued for a norm of “the best interest of creditors.” See ANDREI SHLEIFER, WILL THE SOVEREIGN DEBT MARKET SURVIVE? (Nat'l Bureau of Econ. Research, Working Paper No. 9493, 2003).

3. The closest the economics literature gets to recognizing this point is Barry Eichengreen's observation that debtor-creditor negotiations have been quick to produce results when the parties have shown good faith. Barry Eichengreen, *Crisis Resolution: Why We Need a Krueger-Like Process to Obtain a Taylor-Like Result* 5 (Apr. 29, 2002), <http://emlab.berkeley.edu/users/eichengr/policy/iiekrueger.pdf>.

4. See *infra* text accompanying notes 207-227.

matter of intercreditor equity became cabined in the federal bankruptcy reorganization regime after that regime appeared in 1934. Thereafter, state case law on intercreditor equity atrophied, replaced by a regime of contractual self-protection. A viable framework for sovereign restructuring, whether contract based or encapsulated in a bankruptcy regime, needs an adjudicatory authority willing to impose good faith duties across groups of creditors.

The Article proceeds as follows. Part II draws on the economics and practice of sovereign lending to assert that sovereign bankruptcy proposals should not be driven exclusively by the bailout problem. Reform proposals need to address the fundamentals of sovereign debtor-creditor relationships that operate independently of IMF intervention. These fundamentals help to articulate a contract-based norm, the best interest of creditors.

Part III looks at the sovereign bankruptcy movement to show that the best interest norm already has influenced its participants, albeit implicitly. The most prominent proposal, that of the IMF, has evolved towards both minimalism and creditor involvement. Some of what the IMF proposes to provide, however, is either unnecessary or inimical to the creditors' best interests. Most importantly, it is unclear that the IMF's involvement in the administration of such a system adds anything of value to either the sovereigns or their creditors.

Part IV appraises the CAC versus UAC debate. Here we encounter a puzzle: the persistent use for more than a century of UACs in New York-based sovereign debt issues and CACs in London-based debt issues. A frequent explanation of this puzzle centers on the Trust Indenture Act of 1939,⁵ which embeds the UAC in publicly issued corporate bond contracts in the United States,⁶ therefore implying that a path dependency constrains the drafting of New York sovereign contracts. We reject this contract failure explanation and propose instead a multiple equilibrium explanation. Under this explanation, UACs and CACs are both rational solutions to an intractable problem. The choice between the two entails trade offs, and is a matter of lender preference under uncertainty rather than a function of an efficiency calculation. One factor leading lenders to favor UACs is the lack of a good faith backstop, which results in a need for self-protection. Holding out is the only weapon one has in a

5. 15 U.S.C. § 77aaa (2000).

6. For discussion, see Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250-51 (1987).

world in which creditors motivated by side deals can impose suboptimal compositions by majority rule.

Part V projects that such side deals and giveaways will occur if sovereign debt compositions are negotiated under CACs. Resolution of these disputes, therefore, requires a robust good faith principle. We draw on the history of corporate reorganization prior to the enactment of section 77B of the Bankruptcy Act of 1934⁷ to show that courts have grappled with these questions before, intervening on equitable principles.

II. RELATIONAL FUNDAMENTALS

Discussions of sovereign debt reform have focused primarily on what mechanisms can be borrowed from the corporate bankruptcy context. Little attention has been paid to the differences between the economics of the two contexts and these differences' implications for a sovereign bankruptcy regime. This part performs that task.⁸

A. Background

Today's sovereign default crisis follows from the growth of the market for emerging country debt in the 1990s. Between 1992 and 1997, credit flowed copiously into emerging markets, averaging \$154 billion a year.⁹ But risk perceptions in the emerging country debt market changed after a succession of financial crises—in Mexico in 1995 and then in East Asia and Russia in 1997 and 1998.¹⁰ Demand for emerging market securities dropped to \$50 billion per year in the period from 1998 to 2000.¹¹ A full-blown crisis ensued in 2001, when

7. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912 (repealed 1938).

8. INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS (2002) (performing an analogous function in the context of IMF policy and planning), <http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf>.

9. In hindsight, much of this investment looks to have been overoptimistic, based on inadequate information about emerging nations' economic, political, and institutional problems. See Guillermo A. Calvo, Globalization Hazard and Delayed Reform in Emerging Markets, LACEA Presidential Address (Oct. 18, 2001), <http://www.depeco.econo.unlp.edu.ar/jemi/2002/trabajo2.pdf>. Lenders may have underestimated the likelihood of liquidity crises and other economic distress. Alternatively, they may have assumed that troubled sovereigns would be bailed out by the IMF. See generally Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613 (2001) (arguing that international organization into nation-states causes continuing global vulnerability to financial crises), available at http://www.oup.co.uk/jielaw/hdb/Volume_4/Issue_04/pdf/040613.pdf.

10. JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 89-98, 119-27, 142-51 (2002).

11. John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at Institute for International Economics (Apr. 2, 2002), <http://www.ustreas.gov/press/releases/po2056.htm>.

Argentina, its economy in collapse, defaulted without the benefit of an emergency credit facility from the IMF.¹² The flow of debt to emerging market governments in 2002 slowed to under \$12 billion—a trickle compared to the flows of 1992-97.¹³ This sovereign debt crisis follows other emerging market (and particularly Latin American) defaults of the 1930s and 1980s.

Argentina's default changed the rules of the game in sovereign lending. In the mid 1990s, emergency credit provided by the IMF (and the United States Treasury) cured the liquidity crises of countries like Mexico and the East Asian tigers. Arguably, a two-sided moral hazard problem resulted. One defective incentive lay with the sovereigns. Rehabilitation was achieved on an accelerated timetable thanks to the IMF's financial backing. We suspect that the IMF made these investments less for the purpose of rehabilitation than for the purposes of preventing contagion from spreading through the international financial system and protecting its political interests. The moral hazard problem of insured credit resulted. If the IMF was going to come in with cash, prudent borrowing made no sense. The second defective incentive lay with the private lenders. Some of the IMF's emergency funding, provided to forestall further crises, went directly into the pockets of banks and bondholders. Until the IMF found a way out of this bailout trap, sovereign lending threatened to become a high interest-low risk free lunch.¹⁴

These incentive problems have been ameliorated in recent times. Defaults by Russia and Argentina terminated the expectation that all large economies would be bailed out. At the same time, the IMF has conditioned loans to Ukraine and Ecuador, both suffering liquidity crises, on bondholder concessions.¹⁵ "Constructive ambiguity" now describes the posture of the official sector, and private lenders now proceed at their own risk. But amelioration does not mean solution.¹⁶ The bailouts of Brazil, Uruguay, and Paraguay in 2002¹⁷

For more detailed data on capital flows to emerging market economies, see INST. OF INT'L FIN., INC., CAPITAL FLOWS TO EMERGING MARKET ECONOMIES (2002).

12. Arturo C. Porzecanski, *Dealing with Sovereign Debt: Trends and Implications*, in SOVEREIGN DEBT AT THE CROSSROADS 27-33 (Chris Jachnick & Fraser Preston eds., forthcoming 2004).

13. See *A Better Way to Go Bust*, ECONOMIST, Feb. 1, 2003, at 64, 64 (reporting the latest statistics out of the Institute of International Finance).

14. Tarullo, *supra* note 9, at 649-51, discusses these problems in detail.

15. *Id.* at 650.

16. For discussion, see *id.* at 631-32, 649-51.

mean that incentive problems persist. The IMF still has reason to seek a means by which to force bondholders to participate in emergency rehabilitations, scaling down their claims as a condition to the provision of emergency loans. A sovereign bankruptcy regime looms large as the means to this end.

What is good for the IMF also may be good economic policy: Bondholder free rides on IMF bail outs are distortionary; lenders to distressed sovereigns should do no better than they would have done in the absence of an emergency credit facility. But it does not follow that what is good for the IMF necessarily makes for good economic policy: A bankruptcy procedure suited to the IMF's institutional preferences could also be distortionary and costly if it made lenders to a distressed sovereign worse off than they would have been in its absence (and in the absence of IMF bailout lending).

Just as bankruptcy's superiority over contractual composition cannot be assumed, nor can the IMF's cost-benefit perspective be accorded automatic hegemony.¹⁸ The IMF's perspective dominates the discussion over bondholder objections because the bondholders are dismissed as opportunists, who are simply attempting to sustain the flow of rents from bailouts. This dismissal is precipitous. Consideration also must be given to a new regime's impact on the fundamentals of the sovereign debtor-creditor relationship, viewed independently of the moral hazard problem stemming from the IMF's interventions.

This Part assays the incentive structure of sovereign lending. If law reform is to create value, it cannot model sovereign lenders only as economic opportunists. They also must be viewed as lenders who can take capital elsewhere if reform fails to address their concerns. We describe this zone of concern as "the best interest of creditors."

B. Corporate and Sovereign Borrowing Compared

Borrowers and lenders are natural enemies, more likely to conform to economic predictions of self-interest than human beings in most other relationships. Before the loan is made, the vulnerabilities lie on the borrower's side. The borrower needs the credit that the lender remains free to refuse. Once the loan closes, however, the vulnerabilities shift. The borrower walks away with the lender's

17. For a discussion of these crises and the private and official sector responses, see William R. Cline, "Private Sector Involvement": Definition, Measurement, and Implementation (Aug. 2002), <http://www.bankofengland.co.uk/conferences/conf0207/cline.pdf>.

18. See STIGLITZ, *supra* note 10, at 195-213.

funds. Nine-tenths of the borrower's contractual expectations are fulfilled. Meanwhile, the lender begins a contractual journey fraught with exposure to economic risk and human opportunism. For protection, the private lender relies on the legal regime that enforces the promise to pay.

Sovereign debt is different. It presents a puzzle, for the sovereign lender has no recourse to a reliable enforcement authority.¹⁹ For the most part, sovereign obligations cannot be directly enforced in the sovereign obligor's own courts.²⁰ A century ago, gunboat diplomacy by creditor governments sometimes took the lawsuit's place.²¹ But the gunboats have been mothballed. Now the sovereign creditor's only direct recourse lies in the courts of countries like the United States and the United Kingdom, which by statute have relaxed the traditional sovereign immunity barrier.²² But an unpaid lender takes up this enforcement opportunity only in the exceptional case. Going to court in a G-7 (or similar) country is beneficial only if the lender identifies property of the defaulting sovereign in that jurisdiction (or in another jurisdiction willing to levy execution on the first jurisdiction's judgment). And defaulting sovereigns try their best not to leave valuables lying around.

Even if an avenue of direct enforcement opens up, the sovereign creditor is at a disadvantage relative to its corporate counterpart. Unlike a defaulting corporate borrower, a sovereign cannot be liquidated. Nor can a composition that scales down a sovereign's obligations to a manageable level be effected at the expense of an equity interest, as occurs in corporate reorganizations.

19. See, e.g., Charles Lipson, *The IMF, Commercial Banks, and Third World Debts*, in DEBT AND THE LESS DEVELOPED COUNTRIES 317, 322-23 (Joshua D. Aranson ed., 1979) (describing the central puzzle in sovereign debt as that of why "so many states, with such diverse political structures, continue to service debts in spite of the political and social costs").

20. See Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors*, 37 INT'L LAW. 103, 116-17 (2003).

21. See, e.g., Paul de Graue & Michael Fratianni, *The Political Economy of International Lending*, 4 CATO J. 147, 158 (1984). The assertion that gunboat diplomacy played a role in inducing countries to pay their debts has been challenged forcefully in a recent book by political scientist Mike Tomz, who says that the primary reason that countries repay debts is in order to maintain or improve their reputations. See Michael R. Tomz, *Sovereign Debt and International Cooperation: Reputational Reasons for Lending and Repayment* 12-48 (Oct. 2001) (unpublished manuscript, on file with authors). The fear of sanctions, according to Tomz, has never been a primary motivating factor for sovereign debt repayment. *Id.* at 49-79.

22. Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1330, 1332(a)(4), 1391(f), 1441(d), 1602-1611 (2000); State Immunities Act, 1978, 26 & 27 Eliz. 2, c. 33, *reprinted in* 17 I.L.M. 1123 (1978).

The sovereign's citizens are its equity interest and its debt deals do not contemplate their being "wiped out" for the benefit of creditors.²³

The lender's powerlessness leaves the sovereign borrower with a disincentive to pay, and the borrower will default whenever the expected value of future financing falls below its present debt servicing costs.²⁴ Even though the sovereign debt contract is drafted to address and facilitate the possibility of conventional enforcement, the contract does not come close to guaranteeing that a sovereign able to pay will perform its promise. Unlike corporate borrowers, sovereigns do not necessarily default because they cannot pay. Whereas corporate defaults follow from the exhaustion of resources, sovereign defaults can be acts of political will. Sovereign distress can ripen into default when actors in the national government decide that the tax burden and administrative costs of debt service are intolerable and that the burden of payment (political as well as economic) outweighs the costs of default.²⁵ For example, only one of the nations in default in the Latin American debt crisis of the 1980s owed as much as 1 percent of gross national product.²⁶

Why, then, do lenders extend credit to sovereigns? The answer is that sovereigns try hard to pay. As a practical matter, their defaults tend to presuppose economic reverses, whether due to mismanagement or bad luck. Sovereigns rarely repudiate their debt contracts in whole. Defaults are partial, leading to the rescheduling of obligations and, in some cases, their reduction.²⁷ Historically, defaults by sovereigns have been common even as sovereign loans overall have been profitable.²⁸ Consider Eichengreen and Portes' figures on sovereign issues of the 1920s. Coupons were 7 to 8 percent. Defaults lowered actual rates of return to 5 percent for London issues and 4.6 percent for New York issues. United States Treasury bonds yielded 4.1

23. See Jeremy Bulow, *Debt and Default: Corporate vs. Sovereign*, in NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 579 (Murray Milgate & John Eatwell eds., 1992) (setting forth the most striking differences between corporate and sovereign bankruptcy as being in terms of "collateral, control, and continuity").

24. John Maynard Keynes, *Foreign Investment and National Advantage*, NATION & ATHENEUM, Aug. 9, 1924, at 584, 585.

25. Jonathan Eaton, *Debt Relief and the International Enforcement of Loan Contracts*, 4 J. ECON. PERSP. 43, 48-49 (1990).

26. That country was Chile. See Jeremy Bulow & Kenneth Rogoff, *A Constant Recontracting Model of Sovereign Debt*, 97 J. POL. ECON. 155, 156 (1989).

27. See Lee C. Buchheit, *Of Creditors, Preferred and Otherwise*, INT'L FIN. L. REV., June 1991, at 12 (discussing sorting of creditors in the course of restructuring).

28. Kenneth M. Kletzer & Brian D. Wright, *Sovereign Debt as Intertemporal Barter*, 90 AM. ECON. REV. 621, 621 n.1 (2000) (citing study by Lindert and Morton of 1552 sovereign issues of ten governments from 1850 to 1983).

percent during the period. Although defaults were frequent, outright repudiations were rare, and payments in abeyance recommenced as distress passed.²⁹

The historical pattern implies that default causes negative consequences to sovereigns. Defaulting sovereigns eventually must return to the credit markets.³⁰ The need for continued access to credit imports an incentive to pay. At the same time, the enforcement threat, built into the debt contracts but rarely used in practice, imposes a residuum of costs.

Economic accounts of sovereign debt relationships formalize this description. Armed with their analysis, sovereign debt looks less paradoxical.

C. Theories of Sovereign Debt

The economics of sovereign debt builds on the following axiom: Unless default imposes costs on the debtor, not only will the debtor not pay the debt, the lender will not make the loan in the first place.³¹ As the cost of default decreases, so does the sovereign's borrowing capacity. Contrariwise, as the cost of default increases, it at some point becomes so high as to foreclose *strategic default*.³² Strategic default is an opportunistic breach stemming from the debtor's desire to siphon off the payment flow on the loan for another purpose. In contrast, *distress default* describes a default following an unanticipated shortage of resources due to an external shock or other misfortune. Distress defaults are more excusable than strategic defaults.³³ To the extent either is costly, default entails welfare losses for the debtor and its economy. Despite this, an increase in default costs can be efficient if it encourages lending by discouraging strategic defaults.³⁴

29. Barry Eichengreen & Richard Portes, *After the Deluge: Default, Negotiation, and Readjustment During the Interwar Years*, in THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE 12, 27-29 (Barry Eichengreen & Peter H. Lindert eds., 1989).

30. Herschel I. Grossman & John B. Van Huyck, *Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation*, 78 AM. ECON. REV. 1088, 1088 (1988).

31. Gabrielle Lipworth & Jens Nystedt, *Crisis Resolution and Private Sector Adaptation*, IMF STAFF PAPERS, SPECIAL ISSUE: IMF ANNUAL RES. CONF., Vol. 47, 2001 at 188, 192, 195.

32. *Id.* at 195.

33. The notion of excusable versus non-excusable defaults is modeled in Grossman & Van Huyck, *supra* note 30.

34. Contrariwise, if a decrease in the cost of default is welfare maximizing, default is too expensive. Lipworth & Nystedt, *supra* note 31, at 199.

Within this framework, economists debate two explanations of sovereign debt: a reputation theory and an enforcement theory. There is evidence to support both.

1. Reputation Theory

The dominant view is that the primary cost of default to the sovereign is exclusion from future borrowing. Assume that national economies are cyclical and that people prefer to consume evenly across the cycles. It makes sense for the state to borrow on the downward cycle to fund consumption and repay the loans with returns generated on the upward cycle. The cost of default on the upward cycle is the cost of being shut out of the credit markets and associated consumption constraints on the next downward cycle. If default means an embargo on future finance, the sovereign preferring smooth consumption pays its loan. The only state that repudiates its debt is the state that never plans to borrow again.³⁵

More generally, whether in strategic or distress default, the defaulting sovereign converts a gain to itself. Default triggers a lender embargo. The debtor ends the embargo by transferring the converted surplus to the lenders. So long as this recompense is made, the moratorium can be short.³⁶

If we assume that the debtor has a high-powered incentive to regain access to the credit market, then the lender's problem lies less with the default itself than with the possibility of opportunistic behavior on the part of other lenders. A lender with no exposure to the defaulted debt could break ranks with the unpaid lenders, ignore the moratorium, and make a new loan to the defaulting sovereign. To the extent a new source of credit is available, the sovereign's incentive to

35. Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 REV. ECON. STUD. 289, 289-90 (1981). More elaborate articulations of this reputational model open up the class of defaults to distinguish between strategic and distress situations and expand the lenders' behavior pattern to allow for the possibility of forgiveness. A strategic defaulter that turns out to need future credit is "myopic." When it sees its mistake, it becomes "nonmyopic." It signals its transformation by repaying the defaulted loans. Readmission to the credit markets follows. Harold L. Cole et al., *Default, Settlement, and Signalling: Lending Resumption in a Reputational Model of Sovereign Debt*, 36 INT'L ECON. REV. 365 (1995); see also Tomz, *supra* note 21, at 18-21 (describing how sovereign lenders who default can reenter the lending markets by incurring the high cost signal of repaying their earlier debts and showing themselves to no longer be "lemons").

36. Kletzer & Wright, *supra* note 28, at 621. The credit inflows to Latin America in the early 1990s in the wake of Brady restructurings provide a good example of this. CHARLES W. CALOMIRIS, HOW TO RESOLVE THE ARGENTINE SOVEREIGN DEBT CRISIS (Am. Enter. Inst. for Pub. Pol'y Research, Papers and Studies, 2001), at http://www.aei.org/publications/pubID.14869/pub_detail.asp.

reach a composition with its unpaid lenders diminishes. Ironically, the reputational mechanism returns to working order only if the original lenders persuade the sovereign borrower to cheat the interloping lender.³⁷ With the interloper thrown into the composition process with the other unpaid lenders, the stick of refusal-to-lend held by the lenders once more becomes a cost to the sovereign borrower.³⁸

2. Enforcement Theory

The contrasting model is built around indirect sanctions. The theory is that a sovereign might rationally repudiate its debts even though it still needs a future source of finance to smooth consumption in downward cycles. The model depicts a sovereign at the end of an upward cycle. It possesses a cache of capital with which to pay the debt incurred on the previous downward cycle. The model suggests that the solvent sovereign has a choice. It can either pay the debt or it can default and invest the capital in an insurance contract designed to protect it against the next downturn. When this investment opportunity is available, the rational sovereign will default because, in the long run, saving and investing has a higher return than borrowing and repaying. When saving and investment of the purloined capital accompany the default, the sovereign grows faster, increasing its consumption with every turn of the cycle.³⁹ It follows that sovereign debt cannot be sustained on pure reputational enforcement. The lender must have some additional means by which to inflict financial costs on the defaulter.⁴⁰

But is the enforcement model “robust to institutional detail?”⁴¹ Its authors admit that sovereigns in default leave no obvious assets in plain view abroad for fear of creditor attachment. They argue, however, that this exercise of international creditor evasion carries

37. Kletzer & Wright, *supra* note 28, at 622.

38. The importance of creditor coordination in order to discipline mavericks who were tempted to lend to the sovereign in default during the mid-19th century is described in two recent papers. See Mark L.J. Wright, *Reputations and Sovereign Debt* (Sept. 2002) (unpublished manuscript, on file with authors); Mark L.J. Wright, *Sovereign Risk and Creditor Coordination* (May 2001) (unpublished manuscript, on file with authors).

39. William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840s*, 86 AM. ECON. REV. 259, 267 (1996). If the debtor has no place in which to invest, the reputational concern causes it to honor the debt. Harold L. Cole & Patrick J. Kehoe, *The Role of Institutions in Reputation Models of Sovereign Debt*, 33 J. MONETARY ECON. 45, 47 (1995).

40. Bulow & Rogoff, *supra* note 26, at 158; Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?* 79 AM. ECON. REV. 43, 46-47 (1989).

41. Bulow & Rogoff, *supra* note 40, at 43.

indirect costs. With the sovereign in default, foreign trade must be conducted in roundabout ways. For example, the sovereign loses access to short-term trade credits like bankers' acceptances, and when the sovereign places an asset abroad, a costly dummy entity must be used. Even if the costs of evasion are small in relation to GNP, the costs still loom large enough in comparison to the defaulted interest to make repudiation inconvenient: According to the model's proponents, even if the costs of default do not exceed 5 percent of total trade, few countries show a net gain on debt repudiation.⁴² Opponents, however, argue recent debt crises have yielded little evidence of lender interference with the trade of defaulters.⁴³ Moreover, it is not clear why the lenders would want to interfere with the trade of defaulting debtors, especially in distress defaults. Choking the debtor's trade only prolongs the distress and further delays the payment stream. Historians have found evidence to support both theses.⁴⁴

3. Implications for Sovereign Debt Restructuring

There is enough evidence in favor of each model to suggest that both figure into the real world dynamics of sovereign debt. Indeed, the situation is dynamic and recent litigation developments could create new opportunities for bondholder enforcement.⁴⁵ Below, we note some differences in the normative implications of the two models.⁴⁶

On a reputational model, the law has a limited contribution to make in solving sovereign debt crises. The defaulting sovereign has an incentive to present a plan of composition and lobby creditors for approval. Creditors themselves define the "best interest of creditors" as they approve or reject the sovereign's offer. The cost of default derives from the sovereign's long-term interest in credit market

42. Bulow & Rogoff, *supra* note 26, at 158-59, 167, 174-75.

43. Kletzer & Wright, *supra* note 28, at 622; *see also* Tomz, *supra* note 21.

44. Compare English, *supra* note 39 (arguing that defaults of American states during the 1840s support the reputational model), with James Conklin, *The Theory of Sovereign Debt and Spain Under Philip II*, 106 J. POL. ECON. 483 (1998) (arguing that the history of the 16th century relationship between the Genoese bankers and the Spanish crown supports the enforcement model).

45. *See infra* notes 109, 111.

46. Rogoff and Zettelmeyer note a difference in the models' bearing on the current crisis in KENNETH ROGOFF & JEROMIN ZETTELMEYER, EARLY IDEAS ON SOVEREIGN BANKRUPTCY REORGANIZATION: A SURVEY (Int'l Monetary Fund, Working Paper No. 02/57, 2002). They assert that under a reputational model the introduction of a bankruptcy regime will only have the minor effect of causing some loss of reputation to the sovereign choosing to invoke it. Under an enforcement model, in contrast, it is clear that the structure of the bankruptcy process matters a great deal.

access, not from a legally established enforcement structure. Legal intervention thus must be justified by reference to frictions, such as coordination problems, that create barriers to otherwise beneficial compositions

On an enforcement model, in contrast, the cost of default varies with the enforcement device's effectiveness. Costs of default could be too high (greater debtor welfare loss than needed for the given measure of creditor protection) or too low (default cost insufficient to import an incentive to perform). Coordination problems figure here too, but in a more complicated way. There is again a concern about transaction costs standing in the way of agreement. But these transaction costs can play a beneficial role as well. Assume that the costs of default stemming from a trade disruption or a credit moratorium are too low, and that additional costs would have the effect of deterring strategic defaults. On this scenario, a creditor coordination problem that delays composition and extends the period of economic punishment could be efficiency enhancing.

We note a point of ambiguity. Some economists assert that although strategic defaults are a theoretical possibility, sovereigns as a practical matter only default under identifiably bad economic conditions.⁴⁷ If true, it follows that the costs of default, whether due to reputation or enforcement, are sufficient to import incentives to perform. Indeed, defaults might cost too much.⁴⁸ Other economists assume that either strategic default or distress default is an active possibility.⁴⁹ If strategic defaults are possible, then the costs of default arguably are too low. The choice between the two descriptions is further complicated by the fact that no bright line test lets us assign real world defaults to the strategic and distress categories.⁵⁰ Recall that even in a situation of manifest distress due to an external shock, the ratio of debt to GNP can remain low enough to leave the sovereign with the ability to pay. What looks like a "distress default" may therefore follow from a political choice among costly courses of action. So long as the sovereign has a choice as to whether or not to default, strategy inheres in the fact pattern.⁵¹

47. Grossman & Van Huyck, *supra* note 30, at 1088.

48. For an expansion on this point of view, see INT'L MONETARY FUND, *supra* note 8, ¶ 8.

49. See, e.g., Lipworth & Nystedt, *supra* note 31, at 193.

50. This difficulty has concrete policy implications. IMF planners, for example, are having difficulty outlining terms for the activation of its sovereign bankruptcy procedure. See INT'L MONETARY FUND, *supra* note 8, ¶¶ 84-92.

51. The foregoing analysis implies a debt ceiling for each sovereign. The greater the borrowed amount the greater the benefit of default and the more likely default is signaled by the borrower's cost-benefit analysis. The total debt load should not approach that level. Eaton &

D. The Composition Bargain

Whatever a default's etiology, and whether our account focuses on reputation, enforcement, or both, a question arises: Why do unpaid creditors agree to take less than they were promised, instead of waiting out the distress and insisting that the renewed debtor make them whole?

For a simple scenario in which the debtor plausibly can negotiate for a reduction in the interest rate or the principal amount (a "haircut"), assume an enforcement model. Assume also that the lenders have a costly punishment available. Deployment of the punishment is cost effective for the lenders but the expected yield is less than the principal and interest owed. The borrower can come to the table with an offer of compensation in exchange for the withholding of the sanction. So long as the borrower offers more than the creditors' expected return from the sanction, they will settle for less than originally promised.⁵² Further, the creditors cannot credibly commit in advance to refuse to renegotiate.⁵³

Now switch to a reputational model. The sovereign's overhang of unpaid loans could discourage new investment. If the forgiveness of some of the debt restores the incentive to invest, it can be in the incumbent creditors' interest to make a concession. The new investment benefits the sovereign's economy, while also making the debt worth more than it would have been worth without the concessions and the new investment.⁵⁴ This is called "the debt Laffer Curve," because forgiving part of the debt increases the prospects for repayment of the remaining obligation.⁵⁵

Compositions can occur prior to default as well as in the wake of default. When a debtor with a current payment record experiences liquidity problems, a composition can be the means to avert default. The objective will be to delay near term maturities, stretching out the

Gersovitz, *supra* note 35, at 289. The debt ceiling will rise, however, as the creditors' enforcement devices make default more costly for the debtor.

52. Jonathan Eaton, *Debt Relief and the International Enforcement of Loan Contracts*, 4 J. ECON. PERSP. 43, 50-51 (1990).

53. Conklin, *supra* note 44, at 493-94. A proposed program of IMF funding conditioned on creditor concessions would work similarly.

54. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 405-06 (1981).

55. Kenneth Rogoff, *Symposium on New Institutions for Developing Country Debt*, 4 J. ECON. PERSP. 3, 5 (1990). Some question this explanation: with this free lunch sitting on the table, one can ask why debt crises take so long to resolve. Creditor coordination problems may be the reason. For an argument against the Laffer Curve in respect to Latin American borrowers in the 1980s, see Eaton, *supra* note 52, at 46-48.

payment schedule and reducing the near term interest burden. There will be a basis for trade with the creditors if, due to the liquidity crisis, the debt is trading at a substantial discount on expectations that payment in full will not be forthcoming. The composition relieves the near-term payment burden and averts the risk of default. This creates value because default carries collateral costs for both the creditors and debtor.⁵⁶ Pakistan, Ecuador and Ukraine all successfully negotiated exchanges along these lines in the late 1990s. In the latter two cases, the price of their bonds went up 20 to 30 percent.⁵⁷ Argentina and Turkey followed the same model in 2001.⁵⁸

Ideally, a distressed sovereign restructures prior to default. Avoiding default enhances the sovereign's reputation in the credit markets and economizes on enforcement costs. Unfortunately, liquidity crises often move more quickly than the adjustment processes and default proves unavoidable.

Multiple factors come to bear on the composition bargain, whether concluded before or after default. Clearly, adequate information respecting the debtor's economy, financial condition, and future prospects are necessary for the creditors to effectively appraise an offer on the table. The debtor comes to the table with some bargaining power. Because money has a time value and the future state of the debtor's economy remains uncertain, a deal promising the resumption of payments after default can be attractive. Institutional concerns also can incline creditors toward acceptance. On the other hand, waiting has an option value. Any offer simply holding out an increase in the price of bonds will not necessarily garner support. Sweeteners may have to be added; for example, an increased interest rate on the restructured debt to compensate for a repayment deferral.⁵⁹ And even with a sweetener added, creditor coordination problems can sour the deal.

56. Among other things, the debtor that defaults on one issue will suffer an inability to borrow, cross defaults on all of its bonds, loss of control of the process of restructuring, capital outflows, and a general loss of confidence in its economy. All of this negatively impacts the price of the bonds as well. Lipworth & Nystedt, *supra* note 31, at 200.

57. *Id.* Such dramatic increases may not occur again. The market, worried about hold outs, was skeptical about the possibility that the exchange offers could succeed. Henceforth, prices of bonds of sovereigns in impending distress will reflect the possibility of successful composition prior to the exhaustion of liquidity. *Id.* at 206.

58. See, e.g., Barry Eichengreen, *Financial Crises and What To Do About Them* 55, 63-64 (2001) (unpublished manuscript, on file with authors).

59. *Id.* at 57.

E. Coordination Problems and Coercive Behavior

Creditor coordination problems erect barriers to successful compositions. To describe them, we take up the particulars of today's sovereign debt crisis.

Today's crisis holds out coordination problems more daunting than those encountered during the 1980s. In the 1980s crisis, unanimous assent to compositions at least was feasible because money center banks held the bulk of the debt outstanding. Bank lenders are repeat players, constrained to cooperate with one another.⁶⁰ But the cast of characters changed in the 1990s. The banks sustained significant losses in the Latin American crises of the 1980s, and withdrew from a dominant role in sovereign lending. The sovereigns, returning to the borrowing practices of the nineteenth and early twentieth centuries, turned to the bond markets. The shift meant larger numbers of creditors holding smaller claims. In mid-1999, for example, Argentina had \$111.8 billion of foreign issued bonds outstanding and \$29.6 billion of bank loans.⁶¹ The bondholders were spread all over the world. Many were institutional investors, but there also were also large numbers of small, individual investors—purchasers of bonds in retail “cookie jar” offerings in Germany and Japan.⁶² Such a heterogeneous group of creditors inevitably can be expected to hold heterogeneous views about the debtor's ability to pay.⁶³

Obtaining the consent of a multitude of creditors is partly a matter of incurring costs (and retaining an underwriter and a proxy solicitor). But there also is a barrier in the contracts themselves. Of Argentina's \$111.8 billion of foreign bonds, 89 percent were issued

60. For a description of the workouts of the 1980s, see Jessica W. Miller, Comment, *Solving the Latin American Sovereign Debt Crisis*, 22 U. PA. J. INT'L ECON. L. 677, 679-89 (2001).

61. Pablo E. Guidotti, *On Debt Management and Collective Action Clauses*, in REFORMING THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM 265, 271 tbl.1 (Peter B. Kenen & Alexander K. Swoboda eds., 1999), available at <http://www.utdt.edu/~pguidotti/on.debt.management.and.collective.action.clauses.pdf>.

62. The shift in emerging market sovereign debt towards bonds is detailed in Mark L. J. Wright, *Sovereign Risk and Creditor Coordination* (May 2001) (unpublished manuscript, on file with authors). See also Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701 (1996).

63. For this reason, it makes no sense for a debtor to take the cash it has reserved for principal payments on defaulted debt and repurchase the debt on the market at deeply discounted prices. Once the market sees the buying activity, the price will rise to the reservation of price of the creditor with the highest valuation. Ishac Diwan & Dani Rodrik, *External Debt, Adjustment, and Burden Sharing: A Unified Framework*, PRINCETON STUD. INT'L FIN. NO. 73, at 35-36 (1992).

pursuant to debt contracts containing unanimous action clauses.⁶⁴ These UACs are customary in bonds issued in the United States, Germany, and Japan.⁶⁵ The remaining 11 percent of Argentina's bonds were issued in London, where the drafting practice includes collective action clauses. UACs invite free riding: Because the transaction makes the group as a whole better off, an opportunistic bondholder has an incentive to "hold out"—to withhold her vote in hopes of procuring a side payment.⁶⁶

UACs do not present an absolute bar to debt restructuring, however. A composition can be effected by indirection. Instead of being asked to vote on an amendment to their bond contracts, the bondholders are asked to exchange their bonds for substitute bonds that contain modified terms more favorable to the debtor. The proponent of the substitute bonds neither expects nor requests universal participation. Even so, the exchange offer does not close unless it garners supermajority acceptance. Holdouts remain a problem, however, because a free riding strategy remains available to the bondholder opportunist even if no side payments are forthcoming. To say no to an exchange offer is to hold on to your bond. You thereby retain the debtor's original promise to pay and all other contract rights, even as the exchanging majority makes concessions. If the offer succeeds, you benefit from the economic recovery, like the creditors who exchanged their bonds, without having made any concessions. Institutional bondholders known as "vulture funds" specialize in such strategic behavior. They typically purchase their bonds on the

64. Guidotti, *supra* note 61, at 271 & tbl.1.

65. The majority of sovereign bonds choose New York law; these include both bonds issued in New York and Eurobond issues. *See, e.g.*, Peter Petas & Rashique Rahman, *Sovereign Bonds—Legal Aspects that Affect Default and Recovery*, GLOBAL EMERGING MARKETS, May 1999, at 59, 60 (finding that over 70 percent of sovereign Eurobonds are issued under New York law).

66. These UACs can also be described as IACs, or Individual Action Clauses, because they grant bondholders individual rights. *See generally* Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040 (2002).

secondary market after the onset of distress at a deep discount,⁶⁷ looking for short-term returns of up to 30 percent.⁶⁸

If only a few creditors hold out, the exchange offer still succeeds. Unfortunately, if enough creditors hold out, the exchange offer will fail. More particularly, if the subsidy to the holdouts is greater than the increase in value to the exchanging creditors, every one of them is better off by refusing to exchange.⁶⁹ The failure of the offer then makes everybody worse off. Generally, in corporate exchange offers, it takes supermajority participation in the exchange offer—something more than 90 percent—to minimize the siphoning of value to the holdouts and therefore permit the offer to succeed.⁷⁰

The process can be manipulated for the borrower's benefit as well. Suppose a debtor owes \$100 and claims to have the resources to support a payment of only \$50. Assume it makes a take-it-or-leave-it exchange offer—a substitute debt contract with a face amount 50 percent lower than the original contract. The creditors believe the debtor can pay \$70 and refuse to exchange, so the debtor tries again, this time making the new debt offer senior to the debt in default. On an enforcement model of sovereign debt, the creditors now accept the offer, because failing to do so leaves them with a claim for \$100 against an asset base that certainly will be less than \$50.⁷¹ Alternatively, the sovereign could have the new debt secured by a payment stream at its disposal. The addition of seniority or security in the new issue imports an element of coercion.

Note that if the debtor makes a coercive offer considered too low by substantial number of creditors, the holdout possibility benefits the group as whole.⁷² On the other hand, covenants in standard

67. The term “vulture” refers to the fact that these hedge funds typically purchase the debt of companies and countries that are in financial distress and, therefore, have debt that is trading at a deep discount. Although even the Institute of International Finance—the global association of financial institutions—has publicly called for a targeted legal strategy to counter the supposedly disruptive activities of vulture funds in the context of sovereign restructurings, these funds are not without their supporters. See *Vulture Hunt*, FIN. TIMES, May 7, 2002, at 20 (arguing that vulture funds serve to provide much needed liquidity in the markets for distressed sovereign debt), 2002 WL 20298184; John Dizard, *A Bankrupt Solution to Sovereign Debt*, FIN. TIMES, Jan. 18, 2002, at 24 (arguing that there is nothing problematic about a vulture fund that purchases sovereign debt at a deep discount and then sues to be paid in full), 2002 WL 3303702.

68. John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1214 (1991).

69. Roe, *supra* note 6, at 236.

70. Coffee & Klein, *supra* note 68, at 1207-14.

71. Calvo, *supra* note 9, at 13.

72. Coffee & Klein, *supra* note 68, at 1223.

sovereign debt contracts (“negative pledge” and “*pari passu*” clauses) can be read to make the foregoing ploys ineffective by giving the non-exchanging creditors a pro rata right to the payment stream of the new bonds.⁷³ If the creditors can sustain this interpretation, they can attach the payments on the new bonds, and the coercive exchange does not proceed.

Finally, sovereign debt contracts hand the borrower a weapon to use against holdouts: the “exit consent.” The exchange offer is combined with amendment of terms in the bond contract that protect the bondholders but are subject to majority amendment. Under the New York practice, payment terms are subject to UACs while ancillary promises and process terms that protect the bondholders are subject to CACs. As they exit, the cooperative, exchanging bondholders approve an amendment that lifts the contract protections of the holdouts. This leaves the holdouts with their original principal and interest terms intact, but subject to manipulative action by the debtor. For example, the *pari passu* and negative pledge clauses described above may disappear through the exit consent process. For the holdouts, the possibility of ever receiving full payment diminishes with the loss of these protective provisions.⁷⁴ Within the past few years, exit consents have been used successfully by both Ecuador and Uruguay.⁷⁵

F. *The Best Interest of Sovereign Creditors*

Summarizing the foregoing economics and contracting practice, we now describe the best interest of creditors.

73. The use of *pari passu* and negative pledge provisions in this context—that is, where the sovereign attempts to grant a new borrower senior rank or security in the form of an earmarking of a specific payment stream for it—is very different than a vulture creditor trying to block payments to others of equivalent rank who have proceeded with a restructuring. That latter tactic, which appeared for the first time in the Elliott suit against Peru in Brussels in 2000, depends on a questionable interpretation of the *pari passu* clause that most commentators consider to be incorrect. See *infra* note 102. The legal validity of that interpretation is beyond the scope of this article.

74. On the use of exit consents to engineer a sovereign restructuring, see Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 70-82 (2000). See also Michael M. Chamberlin, *At the Frontier of Exit Consents*, Remarks at the Bear Stearns and EMCA Sovereign Creditors Rights Conference (Nov. 8, 2001), <http://www.emta.org/ndevelop/exitcons.pdf>.

75. See Felix Salmon, *Calm After the Storm*, EUROMONEY, May 2003, at 100, 103; Felix Salmon & Jorge Gallargo, *The Buy Side Starts to Bite Back*, EUROMONEY, Apr. 2001, at 46, 58-59; *Uruguay: Exchange Could Ease Liquidity Problem, but Fiscal Adjustments Remain Key to Restoring Solvency*, EMERGING MARKETS RES. NEWSL. (J.P. Morgan, New York, N.Y.), Apr. 30, 2003, at 1.

On a reputation model, default amounts to a standstill that endures until the sovereign (a) emerges from distress, and (b) determines that the benefits of renewed access to credit outweigh the costs of making payments on the old debt. Agreement on a composition can hasten reentry because scaling down the amount of old debt increases the sovereign's borrowing capacity. When the sovereign has a source of new borrowing to use in restoring its economic health, the incumbent creditors have an additional reason to agree to take less. But the floor on concessions is determined by the payoffs. If a debtor demanded deep concessions but the creditors projected an anemic economic recovery, then the creditors would likely reject the debtor's demands.

In contrast, when the market value of the debt after the composition is greater than the market value prior, the debtor and creditor will bargain over a surplus. The allocation of the surplus between the debtor and the creditors depends on a number of variables, including information asymmetries and economic volatility. But, at the bottom line, the sovereign must cater to the creditors, since it pays them only for the purpose of returning to their good graces.

Now shift to an enforcement model of sovereign debt. This changes the variables but delivers us to the same negotiating table. The borrower comes to the table because the default imposes costs on foreign trade; costs that make it harder to get out of distress. These costs of default do not redound to the creditors' immediate benefit, however, even as they have to invest in enforcement initiatives. Their unpaid bonds trade at discounts as a result. The double negative—costs on both the borrower and lender sides—creates room for trade.

These descriptions reveal a lot about the best interest of creditors without suggesting that a bankruptcy regime would enhance creditor welfare. This is because the models are populated by rational actors and outcomes follow from the presence or absence of a surplus. Given a surplus, the parties figure out a way to divide it, but given no surplus, there is no deal and the creditors are better off waiting.

Within this framework, a bankruptcy system can be justified three ways. First, it may help bring a surplus into existence. This would be the case where unilateral creditor enforcement actions prevented sovereign recovery without benefiting the creditors as a whole. This also would be the case if the IMF and other official sector actors decided that bankruptcy advanced their own purposes and made submission to the constraints of a bankruptcy system a condition to financial relief programs. Relief in the form of new lending can contribute to the creation of a surplus, justifying the

bankruptcy regime. Second, a bankruptcy regime may prevent a surplus from being dissipated. This would be the case if enforcement actions by creditors occurred frequently, causing costs of disruption to outweigh the benefits to the creditors as a whole. Third, a bankruptcy regime may overcome process frictions. Coordination problems could make it hard for sovereigns to get the composition proposal a full hearing. Even if compositions could be concluded without a formal bankruptcy regime, a legally constituted and protected space for renegotiation could, in theory, facilitate a debtor-creditor accord. By helping the creditors cheaply determine their best interest, it could make everyone better off. Alternatively, the dispersed creditors could have a collective action problem. The sovereign might exploit this by making a short duration take-it-or-leave-it exchange offer designed to allocate the majority of the surplus to itself. Finally, given debt contracts containing UACs (and perhaps even with CAC contracts), creditor opportunism in the form of holding out could prevent an otherwise advantageous composition from garnering sufficient assent.

There is a distinction among the three justifications for sovereign bankruptcy. The first and second justifications address the maximization of a surplus, in both cases triggered by value-depressive enforcement opportunities. Under a reputational model, neither justification is available. The third justification, with its focus on process and coercion, applies to both models of sovereign debt. To the extent that the reputational model has the greater resonance in real world practice, as we think has been the case up to now, the third justification should shape the bankruptcy regime. On this theory, sovereign bankruptcy should focus on solving creditor coordination problems and protecting against debtor overreaching in the division of the surplus rather than on containing creditor enforcement.

The best interest of creditors will vary with the circumstances. Where the sovereign is poised to recover, the best interest is a contractual arrangement that both restores the flow of payments and restores the sovereign to good standing as a borrower. Other compositions look toward rehabilitation at a future date. Here the best interest lies in a composition that divides the surplus in a satisfactory way, assuming the creditors deem the surplus to be adequate. Whatever the situation, the composition that realizes the best interest of creditors will follow from creditor assent. The goal of any sovereign restructuring mechanism, therefore, should be to enable freely given creditor assent.

III. TOWARD MINIMAL BANKRUPTCY

A. The Possible Regimes and the State of the Policy Debate

In Part III, we use the economic principles explained in Part II to explain why the first of the two major reform proposals, that of the IMF, has failed to win support from either the creditors or sovereign borrowers. We begin by setting out the range of proposals and the current state of the debate.

Sovereign bankruptcy discussions contemplate four alternative states of the world:

(1) *Full Bankruptcy*. This regime would be modeled on Chapter 11 of the United States Bankruptcy Code, but adjusted for the differences between the private and sovereign debt contexts.⁷⁶ Such a regime would have four basic features. It would: (a) stay enforcement proceedings by creditors; (b) accord priority status to new debt financing extended during the bankruptcy proceeding; (c) provide for approval of a composition by a supermajority of creditors, trumping contracts with UACs; and (d) empower a judicial authority to cram down a composition on dissenting creditors and classes, provided the composition met a substantive standard, in cases in which the supermajority approval was not met but a lower approval threshold was satisfied.⁷⁷

(2) *Minimal Bankruptcy*. This regime would eliminate any or all of three elements of full bankruptcy: the stay, the priority for new credit, and the cram down.⁷⁸ Approval of the composition would

76. For a summary of the differences between them, see Tarullo, *supra* note 9, at 633-35. For an expanded comparative perspective, see Patrick Bolton, *Towards a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World* (Oct. 2002) (unpublished manuscript, on file with authors).

77. For full bankruptcy proposals, see Benjamin J. Cohen, *Developing-Country Debt: A Middle Way*, ESSAYS INT'L FIN. NO. 173 (1989). See generally Kunibert Raffer, *Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face*, 18 WORLD DEV. 301 (1990) (drawing insights from Chapter 9, the United States bankruptcy system for municipalities).

78. For an academic proposal in the minimal bankruptcy mode, see Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 980-1010 (2000). For variations on the theme in policy briefs, see Anne Krueger, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Speech at the Institute for International Economics Conference on "Sovereign Debt Workouts: Hopes and Hazards" (Apr. 1, 2002), <http://www.imf.org/external/np/speeches/2002/040102.htm>; INT'L MONETARY FUND, *supra* note 8, ¶¶ 6-14. See also Christopher G. Oechsli, *Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305 (1981); Jeffrey Sachs, *Do We Need an International Lender of the Last Right?*

proceed under statutory rules, UACs would be superseded, and dissenters would be bound. There would be little incentive to hold out, unless a creditor had enough votes to block a majority.

(3) *Universal Collective Action Clauses*. All sovereign bonds would have CACs. No international bankruptcy regime would come into existence.⁷⁹

(4) *Status Quo*. Market actors would continue to exercise unfettered discretion in their contract drafting.⁸⁰

The cutting edge of the policy debate lies between regimes (2) and (3) above. Meanwhile, sovereign issuers and bondholders reject regime (2) and frequently express a preference for regime (4), but have taken steps towards regime (3).⁸¹

The case for a bankruptcy mandate took a step forward when Anne Krueger, First Deputy Managing Director of the IMF, endorsed the idea in November 2001.⁸² Her proposal was criticized by sovereigns and their bondholders alike for giving the IMF too much control over future compositions. The IMF then went back to the drawing board, reemerging on April 1, 2002, when Krueger laid out a more detailed proposal. The IMF made an emphatic move towards minimalism, offering a scheme featuring more creditor involvement and less IMF control.⁸³

The IMF's proposal has become the salient statement of the minimal bankruptcy idea. Krueger argues that an international bankruptcy regime needs to perform five functions: The procedure must provide (1) for confirmation by a supermajority vote of creditors, voting as one class across the range of the sovereign's debt instruments; (2) for a stay of enforcement proceedings against the debtor; (3) for priority status (and exclusion from the stay) for credit extended to the debtor after commencement; (4) for a standstill of debtor payments to creditors other than those extending new credit;

Graham Lecture at Princeton University (Apr. 20, 1995) (on file with authors). For a review of the literature, see ROGOFF & ZETTELMEYER, *supra* note 46.

79. See Taylor, *supra* note 11.

80. In the economist's ideal world version of the status quo, there would be no more bail outs and, therefore, no moral hazard problems.

81. Anna Gelpern, *How Collective Action Is Changing Sovereign Debt*, INT'L FIN. L. REV., May 2003, at 19, 20-21; *Dealing with Default*, ECONOMIST, May 10, 2003, at 63, 64.

82. Anne Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*, Address at the National Economists Club Annual Members Dinner (Nov. 26, 2001), <http://www.imf.org/external/np/speeches/2001/112601.htm> [hereinafter Krueger, IFA: A New Approach]; see also ANNE KRUEGER, INT'L MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 1 (2002), <http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf> [hereinafter KRUEGER, A NEW APPROACH].

83. See Krueger, *supra* note 78.

and (5) for reform of the debtor's economic policies.⁸⁴ The procedure would vest gatekeeper authority in the IMF. A distressed sovereign debtor would apply to the IMF for a standstill. The IMF would grant the standstill only if the debtor is acting in "good faith" and is committed to adjusting its debts.⁸⁵ Negotiation between the debtor, the preexisting creditors, and the IMF would then proceed inside the bankruptcy framework. A limited adjudicatory authority would be created that would not pass judgment on the substance of the plan, but would resolve disputes within the group of creditors.

The contract versus mandate debate was joined on April 2, 2002, when John Taylor, Undersecretary to the United States Treasury, refused to endorse the IMF proposal, asserting that contract reform remained the preferred mode for addressing the problem of sovereign default.⁸⁶ If UACs were a problem, then the bondholders themselves ought to be willing to trade in their old bonds for substitutes containing CACs. With the exchanges effected, debt could be restructured without the need for a bankruptcy process.⁸⁷

The bankruptcy movement has paused while actors variously appraise the IMF proposal and the viability of the contractual alternative. The IMF itself professes to be considering the contractual alternative.⁸⁸ Indeed, internal IMF discussions respecting the design of a sovereign bankruptcy regime have been gravitating away from mandate and in the direction of creditor consent.⁸⁹ On another front, actors working under G-10 auspices have devised new CACs adequate to the task assigned by the Treasury.⁹⁰ Success for the contractual solution, however, depends on the voluntary participation of sovereign borrowers and lenders, and a significant segment of that community is skeptical.⁹¹ The Treasury, apparently annoyed by the bondholders'

84. See KRUEGER, A NEW APPROACH, *supra* note 82.

85. Eichengreen, *supra* note 58, at 11; Krueger, IFA: A New Approach, *supra* note 82.

86. See Taylor, *supra* note 11.

87. *Id.*

88. Press Release, Int'l Monetary Fund, IMF Board Discusses Possible Features at a Sovereign Debt Restructuring Mechanism (Jan. 7, 2003), <http://www.imf.org/external/np/sec/pn/2003/pn0306.htm>.

89. See generally INT'L MONETARY FUND, *supra* note 8.

90. See GROUP OF TEN, REPORT OF THE G-10 WORKING GROUP ON CONTRACTUAL CLAUSES, annex 1 (2002), <http://www.bis.org/publ/gten08.pdf>.

91. For early reports on the wariness of market participants about the various reform proposals, see Alan Beattie, *Financial Groupings Want New Debt Rules*, FIN. TIMES, June 12, 2002, at 12, 12 (reporting agreement among buyers and sellers on the sovereign bond markets over unattractiveness of the IMF's statutory reform proposal); James Tyson, *European Nations Plan to Issue Sovereign Bonds with New Clauses*, BLOOMBERG NEWS, Sept. 9, 2002 (reporting that while Germany, France, and thirteen other European countries are willing to introduce

failure to embrace its contractarian accommodation of their interests, responded with a public tilt in the direction of the IMF proposal.⁹² This leaves the Treasury and the IMF occupying common ground, simultaneously (and ambiguously) entertaining the possibility of both approaches. Even so, the Treasury's message to the bondholders seems clear enough: Get with our contractarian program or face something you will like even less. These informal pressure tactics have yielded dividends, as Mexico, Brazil, Uruguay, South Africa, and a half dozen other countries have begun experiments with CACs in their New York bonds.⁹³

We appraise the IMF proposal here, deferring our appraisal of the Treasury's proposal to Part IV. Section B argues that the IMF proposal is not minimal enough. This discussion draws on Part II's presentation of the incentive structure of sovereign lending relationships to assert that three of the proposal's features—the stay of enforcement, the grant of priority status for new loans, and the payment standstill—add little to the posture of a sovereign default under the status quo. The value that the IMF proposal adds, therefore, differs little from the contractual proposal. Both seek majoritarian voting with the goal of facilitating bargaining and rehabilitation. The difference lies in the means to the end—where the Treasury would contract into CACs, the IMF would mandate them.

Section C expands on our argument for minimal bankruptcy by explaining why the IMF proposal appropriately omits two central features of the United States bankruptcy system—judicial fairness review of the reorganization plan and judicial cram down.

CACs, the Group of 24—including India and Egypt—have rejected the idea of CACs). The initial news on the proposals was not all bad though. Gradually, a critical mass of market actors came to support the inclusion of CACs in new issues. Whitney Debevoise, *The Debt Crisis Debate*, LATIN FIN., Nov. 2002, at 52-54, <http://www.emta.org/keyper/partingshotfinal1.pdf>; see *New Option Arises for Future Bond Launch*, GERTA MERCANTIL ONLINE, Sept. 18, 2002 (reporting Brazil's announced willingness to introduce CACs).

92. See, e.g., R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Address at IMF Conference on Sovereign Debt Restructuring Mechanisms (Jan. 22, 2003) (Chairman of Council of Economic Advisers espousing contractarian approach while simultaneously endorsing the benefits of an organized restructuring process).

93. John Barham, *Cooking Up a New Solution*, LATIN FIN., June 2003, at 10. As of the date of this writing, the list also included Canada, Turkey, Belize, Guatemala, Panama, Venezuela, and Korea. The exception to this trend was Israel, which used UACs in its New York law registration. For a recent report on this front, see INT'L MONETARY FUND, *PROGRESS REPORT TO THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE ON CRISIS RESOLUTION* (2003), <http://www.imf.org/External/NP/pdr/cr/2003/eng/090503.pdf>.

B. Not Minimal Enough

Krueger describes the IMF proposal in terms of the creditors' best interests. She professes three objectives: (1) providing incentives for more orderly and timely restructuring; (2) protecting asset values and creditors' rights; and (3) reducing the costs of disorderly workouts.⁹⁴ Many third parties, we suspect, read the proposal as an attempt to cure the problems that the IMF encountered in the bailouts of the mid-1990s. On this view, the best interest of creditors takes a back seat to the IMF's immediate objectives—preventing contagion in the international credit markets and transferring the burden of restructuring to private creditors.⁹⁵

1. The Standstill and the Bail In

The third-party view better describes the proposal's intended scope of operation. Consider the functions played by three of the proposal's components—the stay of enforcement proceedings, the standstill respecting payments, and the provision of priority for new loans. This trio is supposed to come into operation as distress ripens to default, encasing and ordering the process of emergency financing. The objective is to transform the bail out into a “bail in.” Here is the scenario. First, the sovereign with a liquidity crisis goes to the IMF, which plays a gatekeeping role, distinguishing between applicants genuinely in crisis and applicants able to pay and seeking to use the bankruptcy safe space opportunistically.⁹⁶ Once the gate is opened and the sovereign enters the safe space, the liquidity crisis is eased. Since a standstill is in effect, no default occurs and everyone stays calm. With no payments due immediately, an emergency loan from the IMF need not take first place on the agenda; instead, the preexisting creditors must come to the table and agree to give-ups. Capital controls also may be needed at this early point, the theory being that capital controls imposed with IMF sanction and for a short period of time will have no perverse effects. Once the preexisting creditors take their haircut, the IMF makes its loan from a priority position.

94. Krueger, *supra* note 78.

95. Lipworth & Nystedt, *supra* note 31, at 190, ascribe a trio of objectives to the IMF: (1) see private creditors share the burden of restructuring; (2) confine the damage of distress, protecting the world economy; and (3) see that the international credit markets run smoothly.

96. See Krueger, *supra* note 78.

Liquidity restored, the short-term bankruptcy ends. Combining the loan and the haircut, the debtor is creditworthy once more.⁹⁷

This sounds reasonable, but questions arise about credibility and perverse effects. The standstill is supposed to obviate the need to avoid default with new borrowing, but, in substance, standstill and default are the same thing. The literature points to only one point of difference. Standstill imports a freeze on interest accruals⁹⁸ where interest continues to accrue during the period of default under the debt contracts as written. This distinction does not impress us. That the interest meter stops clicking due to a statutory mandate does not make a default any less of a default. Nor does it change the final payment outcome. In the present system, the sovereign ready to return to the credit markets negotiates a payment schedule for less than the full amount. Interest accruals during the default appear primarily as numbers in the page of rights to be scaled down. Their existence is unlikely to make a difference in the negotiation's outcome.

The standstill provision speaks more to liquid capital nervously poised to exit the distressed jurisdiction than to the unpaid creditors. Here the bankruptcy regime blesses the default with a legal sanction. But it is not clear why, as between the status quo and the hypothesized new regime, a different behavior pattern follows for nervous capital that readily can be transferred to other national venues. Capital controls aside, the aspect of the program most likely to maintain calm in fluid capital markets is the prospect of an IMF emergency credit facility.⁹⁹ But the incentive structure implicit in the proposal does not hold out an *ex ante* IMF commitment. Instead, the preexisting creditors must make their give-ups under a threat that IMF credit will be withheld. Any doubt on this score would be resolved by capital flight, necessitating capital controls. It is hard to see how a standstill declaration makes a difference.

Nor is it clear that preexisting creditors will agree to a quick haircut. In the past, creditors have been incidental beneficiaries of IMF emergency credit. If the IMF is going to make the loans anyway, whether for political reasons or due to concerns about the international financial system, then bondholders are better off holding

97. The closest analogue in practice is the prepackaged bankruptcy, an out-of-court composition closed through Chapter 11 in order to take advantage of the Chapter's majority voting scheme. Section 1126(b) of the Bankruptcy Code, 11 U.S.C. § 1126(b) (2000), permits an issuer to conduct a binding vote on a plan of reorganization prior to filing for bankruptcy. In addition, 11 U.S.C. § 1121(a) allows a debtor to file a plan with its chapter 11 petition.

98. See Eichengreen, *supra* note 58, at 11.

99. *Id.* at 80-83.

out as a group. On the other hand, in cases like those of Ecuador and Ukraine, where default carries no negative systemic threat and emergency credit has been withheld, the IMF has a credible bargaining position. But the IMF has that bargaining position whether or not the negotiation is encased in a formal bankruptcy proceeding. Of course, the standstill stops the payment stream and pressures the lenders, but an old fashioned default does that as well. Moreover, the longer the standstill stays in place, the emergency proceeding designed to avert a liquidity crisis looks more like a conventional, drawn out sovereign default. As such, it hardly would have the effect of restoring confidence and preventing contagion.

The IMF's transmogrification of a "default" into "standstill," therefore, seems unlikely to persuade either nervous capitalists or the lending community that financial distress is not financial distress. Capital, not recharacterization, cures distress, leaving the IMF in more or less the same position with or without a bankruptcy process.

2. Priority Lending

At present, the IMF effectively receives priority treatment from its members-borrowers. Unlike private sovereign lenders, the IMF does not consent to reductions of its payment rights. And, unlike private lenders, it almost always gets paid.¹⁰⁰ The IMF's priority proposal,¹⁰¹ then, merely formalizes and sanctions the present practice, much like its standstill proposal, and would make a difference only if used to facilitate new financing with private credit in a manner similar to debtor-in-possession financing in corporate bankruptcies. This use, however, creates an appearance of conflict with one of the basic tenets of the reputation theory of sovereign debt. Recall that once the default occurs and the lenders are waiting for recovery, the sovereign retains a repayment incentive only to the extent that no third party lender appears on the scene holding out a new credit line. The IMF priority lending proposal effectuates just that result.¹⁰²

In other words, the extant creditors will not always want the distressed sovereign to have access to fresh priority lending. It follows that the incumbent creditors will want to decide on new priority loans

100. STIGLITZ, *supra* note 10, at 226.

101. See also INT'L MONETARY FUND, *supra* note 8, ¶ 72.

102. The priority lending proposal, like the CAC proposal, requires a mandate that overrides existing sovereign debt contracts. The contracts contain "*pari passu*" clauses which make priorities ineffective. See *supra* note 73 and accompanying text.

themselves. In many cases, one would expect such consent to be forthcoming readily, as all the creditors benefit when new financing helps bring the sovereign's economy out of distress.¹⁰³ So long as the debtor retains a good faith commitment to resuming debt service at the earliest opportunity, a priority emergency credit function should not prove deleterious to the interests of the creditors as a whole. But one should not expect approval in all cases. New priority loans hold out risks to preexisting creditors. If the loan proceeds are badly managed and the new capital does not assist the recovery process, but instead, say, flows out of the country, then a priority credit facility worsens the position of preexisting creditors. ■

We question whether IMF assumption of authority to decide on new priority private lending should be included in a sovereign bankruptcy regime. It does not serve the purpose of solving a collective action problem. Of course, new financing could hasten the sovereign's economic recovery. But the IMF's proposal merely shifts authority from the creditors: Bond contracts already allow for the preexisting creditors to permit fresh priority lending with a vote of either a simple majority or two-thirds majority of the bonds.¹⁰⁴ Since the IMF's agenda often diverges from that of the creditors, this shift of authority respecting priority private credit to the IMF would not be in the best interest of the creditors.¹⁰⁵

3. The Stay

The IMF, still following the corporate template, includes a stay of enforcement in its sovereign bankruptcy proposal.¹⁰⁶ In the private context, the stay is essential. Direct creditor enforcement against going concern assets tends to be value destructive, and the whole purpose of corporate reorganization is the enhancement of going concern value. It is less clear what benefits redound from a stay in the sovereign context. At least one commentary suggests that it should be dispensed with.¹⁰⁷ We agree, even as we note that the matter remains arguable.

103. For a statement of the importance of new priority financing in respect of sovereign recovery, see Bolton, *supra* note 76.

104. For an explication, see Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1345-46 (2002).

105. This position recently has garnered support within the IMF. See INT'L MONETARY FUND, *supra* note 8, ¶¶ 169-77 (proposing that new priority private loans require approval of 75 percent of the preexisting creditors).

106. Krueger, IFA: A New Approach, *supra* note 82.

107. Schwarcz, *supra* note 78, at 984-85.

Direct enforcement of sovereign debt is the exception and not the rule. Even the enforcement model of sovereign debt claims only that creditors use indirect means to inflict costs on defaulting sovereigns. We suspect the stay has found its way into the IMF proposal in order to address a residual threat of enforcement by vulture funds. This came to the attention of the international financial community as the result of an incident in June 2000.¹⁰⁸ Peru was in the process of executing a payment promise made pursuant to a composition reached with its creditors. Funds intended for holders of European issues were dispatched in banking channels. A hedge fund that had been a holdout from the composition managed to identify, in Belgium, monies headed to Frankfurt. The fund procured an attachment from a Belgian judge, ruling *ex parte*. The legal theory was that the payment violated a covenant of the original bond contract, which still governed the bonds belonging to the holdout. Whether or not the theory would have held up in a more knowledgeable court,¹⁰⁹ the ploy worked. Peru caved in and paid the vultures in full rather than have a settlement already reached with the vast majority of its creditors disrupted by a drawn out legal proceeding.

Since then, the threat of disruptive enforcement actions by holdout creditors has been repeatedly offered to justify both a sovereign bankruptcy regime and UAC reform.¹¹⁰ Although the threat has been utilized effectively in at least two other instances,¹¹¹ its

108. For a fuller description of the incident, see G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 635-36 (2001). See also Eric Lindenbaum & Alicia Duran, *Debt Restructuring: Legal Considerations*, EMERGING MARKETS RES. (Merrill Lynch & Co. Global Securities Research & Economics Group, New York, N.Y.), Oct. 30, 2000, at 1-3.

109. See Gulati & Klee, *supra* note 108, at 636-37, 651 (arguing that the argument was infirm); Letter from Charles H. Dallara, Managing Director, Institute of International Finance, to the Honorable Gordon Brown, Chairman of the International Monetary and Financial Committee (Apr. 9, 2002) (stating that the consensus of legal experts is that the interpretation of the *pari passu* clause in *Elliott v. Peru* (Elliott Assocs., L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000)) was incorrect and suggesting a strategy for reversing that interpretation), <http://www.iif.com/data/public/icdc0402.pdf>.

110. Most prominently, the actions of Elliott featured in Anne Krueger's speech on November 26, 2001 at the National Economists' Club, where she discussed the IMF's statutory proposal. See Krueger, IFA: A New Approach, *supra* note 82.

111. See Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructuring*, 54 EMORY L.J. (forthcoming 2004) (discussing both the *pari passu* cases) (unpublished manuscript, on file with authors). The attempt to utilize the *pari passu* argument has also failed in one instance. See *Kensington Int'l, Ltd. v. Republic of Congo*, 2002 No. 1088 (Commercial Court, Apr. 16, 2003), *aff'd*, 2003 WL 1935493 (C.A. May 13, 2003). As of this writing, the most recent case, against Nicaragua, has yielded an initial decision for the vulture creditors and has an appeal pending. See Angela Pruitt, *Nicaragua Creditor Suit Muddles Sovereign Restructuring*, DOW JONES CAP. MARKETS REP., Sept. 29, 2003.

gravity is questionable. Peru was jumped unawares in Belgium. It seems unlikely that many nations making payments in respect of a composition (or otherwise in a state of default) will be taken unawares in the future. Payment channels can be structured so that neither the sovereign nor its agents is the titleholder to any monies passing through unsafe territory, to the extent that passage through unsafe territory is necessary at all.¹¹² Consider this in regard to actions by Argentina in 2001, at a time of imminent default. Argentina and the IMF worried about creditor enforcement actions in the United States, where the Argentine government's bank reserves were sited. The expedient was simple. The monies were transferred to the Bank for International Settlements in Basle,¹¹³ apparently a safe space. The implication is that with advance planning, direct judicial enforcement against sovereigns has limited utility. No easy sovereign analog exists to the private law race to the courthouse.

On the contrary side, the enforcement model of sovereign debt can be drawn on to support a stay. As enforcement proceeds indirectly under the model, the sovereign incurs the costs of husbanding its assets so as to frustrate direct enforcement.¹¹⁴ It follows that a stay could assist the rehabilitation process, even if attachments are few and far between.¹¹⁵ The stay frees up the sovereign to engage in cross border transactions without incurring the costs of subterfuge. To the extent the enforcement model identifies costs, a stay imports benefits to the sovereign.

Whether an appropriate balance of enforcement costs and performance incentives would result from a stay is a more difficult question: Would the IMF's proposal make sovereign default overly attractive? The IMF in its gatekeeper role says "trust us." But it is not clear that the IMF, in its stabilizing role, would manage the gate in a way that maximizes the sovereign's incentives to pay its debts.

A final point that might cause suspicion towards the IMF proposal is that, to a considerable extent, creditors already have

112. Had Peru paid at home, in Peru, its bondholders would have been transferring amongst themselves in unsafe banking channels.

113. Eichengreen, *supra* note 58, at 89.

114. *See supra* text accompanying notes 39-44.

115. The latest reports are that numerous bondholder suits have been filed against Argentina, at least some of them hoping to use the arguments made by Elliott against Peru. *See* Pamela Druckerman, *Frustrated Argentine Bondholders Try Suing—Ambition Is To Seize Assets or at Least Gain Leverage; Why Managers Wait*, WALL ST. J., Aug. 23, 2002, at A6, 2002 WL-WSJ 3404256; *see also* Aaron Luchetti & Jonathan Karp, *Billionaire's Award May Snag Progress on Argentine Debt*, WALL ST. J., Sept. 22, 2003, at C1 (reporting on a \$700 million judgment awarded to Kenneth Dart in his suit against Argentina), 2003 WL-WSJ 3980356.

collective control over maverick creditor lawsuits. Maverick lawsuits with the highest potential to cause a sovereign meaningful pain are those for accelerated amounts (as opposed to those for an individual creditor's missed coupon payment). An acceleration, however, typically needs to be authorized by 25 percent of the creditors. And once authorized, it can be reversed by a simple majority vote.¹¹⁶

We doubt creditors believe that this segment of the IMF's plan will solve either coordination or hold out problems. It merely shifts authority from the creditors to the IMF; authority the creditors would rather retain. These points appear to be getting through to the IMF, as demonstrated in recent internal discussions. It is considering removing itself from the gatekeeper role. Members in distress would instead activate the bankruptcy process by representing that their debt had become unsustainable.¹¹⁷ The IMF also is considering dispensing with the automatic stay in favor of a requirement for a three-quarters majority creditor vote.¹¹⁸

C. Majority Voting, Cramdown, and Fairness Review

Even though we question many provisions of the IMF bankruptcy proposal, we believe it takes a step forward when it leaves the determination of the fairness of the composition (the "plan" in United States bankruptcy terminology) to the creditors, relegating any adjudicatory authority within the system to a secondary role. Any "cram down" of a restructuring plan thus would follow from the action of a majority of the bondholders' peers rather than from a judge.¹¹⁹

The omission of the judicial cram down will come as a jolt to observers steeped in United States bankruptcy practice. Chapters 9 and 11 of the United States Bankruptcy Code both provide for substantive review of the composition for fairness by a federal judge as a precondition to giving it binding effect on dissenting creditors.¹²⁰

116. For an explication, see Buchheit & Gulati, *supra* note 104, at 1330-31.

117. This creates a problem respecting the case of a member with sustainable debt that triggers the process opportunistically. Various alternative approaches are under consideration. See INT'L MONETARY FUND, *supra* note 8, ¶¶ 84-92.

118. *Id.* ¶¶ 124-38, 167. Any creditor receiving proceeds of an enforcement action would have its bankruptcy payout proportionately reduced. *Id.* ¶ 133.

119. See Schwarcz, *supra* note 78, at 1003-09. Schwarcz stops just short of leaving out the judge, suggesting that judicial cram down be held in reserve to be added to the system in case the creditors fail to agree to compositions. Krueger, *supra* note 78, takes the additional step, separating the judge from the approval process, and limiting the judge to intercreditor dispute resolution.

120. 11 U.S.C. §§ 943(b), 1129(a) (2000).

How could dispensing with judicial review enhance the attractiveness of the process to the creditors? The exercise of working through the answers to this question reveals the strengths of the IMF's minimal bankruptcy scheme, even as it identifies some additional weaknesses.

1. The Best Interest of Creditors as a Judicial Standard

The IMF could articulate a fairness standard. Under this Article's analysis, the "best interest of creditors" suggests itself as a suitable standard for both simplicity and economic sensitivity. The standard is easily stated: A composition realizes the best interest of creditors when the creditors freely assent to it, induced by the fair division of an adequate surplus. Applying the standard presents more difficulties. This determination lies in classic "business judgment" territory. It is the creditors who know what rehabilitates the borrower as creditworthy. It is the creditors who have the handle on the magnitude of the surplus under negotiation. It is the creditors who best know the difference between fairness and greed when the surplus is divided at the negotiating table. Given this, vesting the decision in the hands of an adjudicator suggests an ulterior, distributive motive.

Even if the subject matter was more justiciable, it is hard to envision an actor who could determine the best interest of creditors and impose that judgment on classes of dissenting creditors without the risk of losing the confidence of actors in the credit markets. The distributive, and hence political, consequences of this decision may be of too great a magnitude for technocratic treatment. Even the selection of the decision maker would present a public choice problem. The IMF, the *prima facie* candidate, has, among other problems, disqualifying financial stakes in the subject matter. Experts could be recruited, but would the context import sufficient reputational constraints to prevent their falling prey to influence activities?¹²¹

The creditors justifiably fear a tilted playing field—a bankruptcy process that serves the purposes of the IMF and the debtor, siphoning surplus to rehabilitation and repaying the IMF rather than paying the creditors. The IMF appropriately alleviates these suspicions by vesting decision-making authority in the creditors themselves.

121. Significantly, the IMF's proposal envisions an adjudicatory authority only for process questions, claim validation, and intercreditor dispute resolution. INT'L MONETARY FUND, *supra* note 8, ¶¶ 227-73.

2. United States Bankruptcy Compared

In the United States bankruptcy context, fairness standards protect the creditors. In theory, the judge reviews the plan to prevent wealth transfers in the debtor's direction. For example, consider the "best interest of creditors" standard of Chapter 9, which governs municipal bankruptcy.¹²² With municipal reorganization, as with sovereign default,¹²³ liquidation is not an option and local politics create a prima facie possibility of strategic default. In addition, the taxpayers are parties in interest; thus, Chapter 9 gives them a special right to appear and object to the plan.¹²⁴ The Chapter 9 process protects taxpayer interests in other ways as well: The creditors are not accorded the right to demand that municipal services be cut back so as to return the debtor to solvency; municipal officials retain some discretion to determine the effects of additional tax on community welfare.¹²⁵ This does not, at first blush, seem creditor protective. But creditor concessions respecting the tax burden are as unavoidable in the municipal context as they are in sovereign context.¹²⁶ Citizens of a city are mobile, at least when compared to citizens of sovereign nations. If the municipal tax burden becomes excessive, the citizens most able to pay the taxes will move someplace else.¹²⁷ Although a city cannot be liquidated, an excessive tax burden imposed for the benefit of creditors can destroy the city.¹²⁸ As a result, even though the defaulting city conceivably could pay the creditors in full in the long run (just like a defaulting sovereign), the Chapter 9 fairness standard contemplates that the creditors may be asked to scale back their rights. Accordingly, the municipal "best interest of creditors" standard does not contemplate payment in full. Just how much the

122. 11 U.S.C. § 943(b)(7) (2000).

123. Raffer, *supra* note 77, at 305-10, works through the analogy in detail.

124. 11 U.S.C. § 943(a) (2000).

125. See Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 466-67 (1993); see also *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 144 F.2d 654, 678-79 (9th Cir. 1940) (ruling plan to be fair when providing for payments "that could reasonably be expected in all the circumstances").

126. See *supra* text accompanying notes 52-53.

127. See Tarullo, *supra* note 9, at 637-38.

128. Chapter 9 is nonetheless quite protective of the creditors' interest. The high possibility of strategic default makes it relatively hard for a city to invoke its protection. Under 11 U.S.C. § 109(c), a filing municipality must be insolvent, it must desire to effect a plan, and it must have either (1) obtained the agreement of creditors holding at least a majority in amount of the claims of each class, (2) have attempted to negotiate with its creditors unsuccessfully, (3) be able to show that negotiation was impracticable, or (4) reasonably believe that a creditor was attempting to gain a preference.

creditors may be required to give up is left to negotiation, subject to the best interest standard and the requirement that the plan be feasible.¹²⁹ At this point, creditor protection comes to the fore. The best interest of creditors and feasibility standards collapse into a unitary inquiry. As applied, the standards look to the city's ability to pay: Its revenues and expenditures are compared, with the court taking into account the city's taxing power and the possibility of tax increases.¹³⁰ The bondholders are paid all that could reasonably be expected in the circumstances.¹³¹

Significantly, the Chapter 9 fairness standard applies even though a majority of creditors already has approved the plan after being presented a disclosure document vetted by the court.¹³² The fairness test is in addition to the vote. The drafter of Chapter 9, in the tradition of the United States law of corporate reorganization, assumes that creditors' collective action problems make them vulnerable to bad deals. On this scenario, insiders with private agendas, whether agents of the defaulting municipality or agents of financial intermediaries, can skew the deal to the creditors' detriment. The creditors, deprived by the stay of cash flows for an extended length of time, approve any deal that releases cash, even if an arms length negotiator would have rejected the deal out of hand. The fairness standard brings in a judge at the final stage to double check the bargaining result from the creditors' point of view.

The assumptions underlying this story of creditor vulnerability have come into question. Institutions have replaced individuals as the leading bondholders.¹³³ In the corporate distress context, they have been shown to be capable of surmounting collective action problems and saying "no" to an unsatisfactory offer from a distressed debtor.¹³⁴

129. *Id.* § 943(b)(7).

130. *See* *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415, 419-22 (1943).

131. *See* *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 114 F.2d 654, 678 (9th Cir. 1940). For further discussion, see *McConnell & Picker*, *supra* note 125, at 464-67.

132. *See* § 1124.

133. Kahan, *supra* note 66, at 1060-62 n.104, drawing on the last reported data on United States corporate bond ownership (from 1995), reports that households own only 15 percent of outstanding corporate bonds, while holding 41 percent of outstanding equities. He also reports that institutional bond owners are considerably more concentrated than institutional stockholders. *Id.* at 1061-62. The five largest holders often own 25 percent of an outstanding issue and a majority can be made up of the largest twenty to fifty holders. *Id.*

134. Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?*, 66 J. BUS. 499, 512 (1993); *see also* Lewis S. Peterson, Note, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505, 513 (1993) (arguing that creditors, by organizing and making credible

The same generally should be the case in the international context.¹³⁵ One might argue, therefore, that fairness review can be jettisoned in the sovereign context.

But there remains an argument for retaining fairness review in the United States bankruptcy context. The United States reorganization rules, under both Chapter 9 and the corporate section, Chapter 11,¹³⁶ never actually require approval by a majority of the creditors, whether simple, absolute, or super. In both Chapter 9 and Chapter 11, creditors divide themselves into multiple classes in accordance with their priorities and other contract rights. No particular class structure is imposed. The general creditors, for example, could be organized in one class, or divided into a series of classes of general creditors with particular affinities, such as trade creditors, bondholders, short term noteholders, and subordinated debentureholders.¹³⁷ When the debtor presents a plan of reorganization, approval is done on a class-by-class basis by majority vote (a vote of two-thirds of the creditors in the class by number, one-half of the total dollar amount of claims). The plan proceeds to a judge for substantive review, provided that a single class has approved it by majority vote. There is no requirement that the approving class hold any particular minimum percentage of aggregate claims much less a majority of claims. The result is that a plan can pass the voting stage with the approval of only a small minority of creditors. Gerrymandering in class formation therefore emerges as an important strategic skill in bankruptcy proceedings.¹³⁸

Given the infirmities in the operative mode of democratic decision making, it follows that a plan under Chapter 9 or 11 must satisfy a list of substantive criteria. Under Chapter 9, the best interest of creditors is the test.¹³⁹ The Chapter 11 criteria include a three-part fairness test. One part of the test keys into contracted-for priorities.

commitments to reject tender and exchange offers can prevent firms from making coercive offers).

135. That Argentina had a large number of retail bondholders (particularly in Japan and Germany), however, suggests that the story about institutional holders is not universally true.

136. Schwarcz, *supra* note 78, at 971-1010, provides a more extensive treatment of Chapter 11's pertinence to international bankruptcy. Our discussion has a limited purpose.

137. See 11 U.S.C. § 1102(b).

138. The most famous examples are "new value" cases involving single purpose real estate corporations. The debtor allied itself with a separate class of unsecured creditors owed a small amount to attempt to cram down a plan of reorganization on dissenting secured creditor with a claim greater than the value of the real estate asset. The definitive case rejecting the ploy is *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 437, 454-58 (1999).

139. 11 U.S.C. § 943(b)(7) (2000).

Another part of the test sets a minimum recovery floor.¹⁴⁰ The third part of the test is a bar against unfair discrimination.¹⁴¹ This holds out the possibility that an objecting creditor could stop a plan departing from the norm of *pari passu* treatment of creditors of equal priority,¹⁴² with a result of horizontal equity trumping majority or even supermajority rule. A plan with majority support can still be unfair to a particular dissenter, whether due to collusion between the debtor and a creditor coalition or to self-interested terms inserted by a creditor coalition acting unilaterally.

3. Implications for Sovereign Bankruptcy

This exposition of fairness review under Chapters 9 and 11 has implications for sovereign bankruptcy. If majority-approved compositions are imposed on dissenting minorities without a fairness check, then the voting process rises to paramount importance in the proceeding's allocational politics. The IMF proposal reflects an understanding of this when it suggests that all claimants be grouped in a single class to approve the plan by a single supermajority vote.¹⁴³ This bypasses the United States practice of voting by classes. Presumably, the number of votes per claimant will vary with the amount of the claim. For voting purposes, other distinctions among the creditors would be stripped away, including distinctions that loom large in private bankruptcies, such as secured versus unsecured and senior versus subordinated status. This should not present a problem

140. The first part applies to dissenting classes. § 1129(a)(8). The second part applies to dissenting creditors individually. *Id.* § 1129(a)(7). Each part addresses the value received by the dissenters under the plan. When a class as a whole rejects the plan, the plan fails the test if (a) the dissenting class receives anything less than the full value of its claim and (b) any class junior to the dissenting class receives any proceeds under the plan. *Id.* § 1129(b)(2). This is the absolute priority rule. It is applied by reference to the going concern value of the reorganizing firm: If the firm's value exceeds the amount necessary to pay the dissenting class in full, there will be room to allow junior creditors to get some payment on their claims.

Under the second part, dissent by an individual creditor defeats the plan if the plan provides the creditor anything less than the amount the creditor would receive if the firm were liquidated. *Id.* § 1129(a)(7).

141. *Id.* § 1129(b)(1).

142. Note that the case law does not require strict *pari passu* treatment. See *In re Aztec Co.*, 107 B.R. 585, 589-90 (Bankr. M.D. Tenn. 1989) (setting out a four part test).

143. See Krueger, *supra* note 78; see also INT'L MONETARY FUND, *supra* note 8, ¶¶ 165-75. The IMF proposal would combine the aggregate voting approach, on a three quarters majority vote of all claims, together with a class organization structure for purposes of negotiation of the terms of the reorganization bargain. In the authors' contemplation, a plan could treat different classes differently so long as it garnered the requisite aggregate vote.

in the sovereign context. Secured and subordinated lending are rare; only official sector creditors like the IMF claim priority status.¹⁴⁴

The question, which we take up later, is whether material intercreditor conflicts of interest, washed out at the voting stage, nevertheless could influence the terms of the composition. Note that the IMF proposal does contemplate an adjudicatory authority that addresses *intercreditor* disputes.¹⁴⁵ But the problems the IMF specifies for adjudication concern only *ex ante* contract rights—matters like preferential payments, the prohibition of which are fundamental to bankruptcy jurisprudence. Our question, instead, goes to *ex post* relationships rather than *ex ante* rights.¹⁴⁶ Conflicts of interest can arise within groups of creditors, leading to differing views about the best interest of the group. Creditors that are nationals of the sovereign (whether individuals or firms) may see things differently than foreign creditors. Similarly, creditors with continuing lending relationships with the sovereign may view plan terms differently from creditors intending to exit. Majority rule addresses the problem only by reference to the numbers. If conflicts taint only small numbers of creditors, the plan's integrity should not be affected. But if special interests encompass a majority or near majority, problems of discrimination could arise. The IMF's present proposal holds out no means to address this problem.

D. Summary

The IMF proposal appears to follow from deductive reasoning. At the starting point lies the cluster of incentive problems the IMF encountered in its 1990s bailouts. These problems are then taken to the corporate bankruptcy template. There the IMF planner selects instruments that might help. The problem is that the creditors would rather keep many of these instruments for themselves. In addition,

144. See Gelpert, *supra* note 111, at 11-19 (describing sovereign debt contracting practice, including the informal nature of prioritization). But significant distinctions remain. Different issues of debt have different interest rates and durations, factors impacting significantly on their market values. But these intercreditor differences are ignored in United States bankruptcy practice.

145. Krueger, *supra* note 78.

146. The subsequent discussion in INT'L MONETARY FUND, *supra* note 8, ¶¶ 155-64, mentions intercreditor disputes without clearly specifying a source of authority for their determination. Both creditors committees and the system's adjudicatory authority are mentioned. The Report is also unclear on the question of what law would apply. See *id.* ¶ 264 (mandating application of "relevant national law" to substantive disputes and the dispute resolution forum's "own law" for procedural issues).

these grants of authority to the IMF do not themselves solve creditor collective action problems.

What happens when the hypothesized scenario fails to play out and the standstill imports no rapid relief? One suspects that the process would be deployed to pressure creditors to facilitate relief by making extraordinary give ups. In other words, there is the danger that the IMF will use the tools of the bankruptcy scheme to effectuate its agenda and not that of the creditors. In light of that possibility, a rational creditor might prefer the status quo, where relief is not rapid, but patience and an upturn in the business cycle can return the sovereign to health. Thus rehabilitated in the fullness of time, the sovereign returns to its creditors to make a more favorable deal. The IMF's omission of judicial cram down becomes all the more important on this extended distress scenario. The creditors must be left free to say "no" and wait it out.¹⁴⁷

IV. THE UNANIMOUS ACTION/COLLECTIVE ACTION PUZZLE

All sides came into the crises of the 1990s sharing the assumption that the shift from bank lending to bond issuance implicated intractable coordination problems. This assumption followed from experiences in the debt crises of the 1980s, when restructuring procedures were disorderly, even with long-term players at the table and norms of cooperation in play. Hundreds of creditors with disparate views had to be brought into line, and UACs complicated this task.¹⁴⁸ Composition was achieved only with official sector intervention and years of negotiation. The small amount of bonded debt was put off to one side, and allowed to escape from restructuring on the theory that bondholder coordination was too hard to procure.¹⁴⁹ The assumption that bondholders with UACs could not be brought to agreement on compositions benefited the bondholders in the bailouts, as they stood to one side collecting the proceeds of emergency loans.

These assumptions changed after 1999 when Pakistan, Ecuador, and Ukraine successfully concluded compositions with

147. A term the proposal omits also looms large on this scenario—the supermajority approval percentage. The creditors will want a number above three-quarters majority used in British contracts; the proposal's promoters will want a number below it.

148. See Michael M. Chamberlin, *Revisiting the IMF's Sovereign Bankruptcy Proposal and the Quest for More Orderly Sovereign Work-Outs*, Remarks at the Institute for International Economics Conference "Sovereign Debt Workouts: Hopes and Hazards" (Apr. 2, 2002), <http://www.emta.org/ndevelop/rid7mac.pdf>.

149. See Lipworth & Nystedt, *supra* note 31, at 190.

dispersed bondholder participation. These compositions were of the preemptive variety,¹⁵⁰ mooted as exchange offers, and successfully closed before liquidity problems became serious. Vulture investors did not disturb the proceedings. There was value on offer in the compositions and the vultures accepted it instead of holding out for more.¹⁵¹ The success of these initiatives surprised the bond market: In response to the closing of the Pakistan composition, borrowing costs of other countries (countries with no significant economic connections to Pakistan) increased by twenty-five to ninety-five basis points.¹⁵²

Now that the era of bondholder immunity from restructuring is over, the IMF argues that bondholders need a fair and predictable process in which to bargain over compositions. The IMF points out that exchange offers exploit bondholder coordination problems, skewing the field of contract in the debtor's favor. The debtor, seeking to maximize its bargaining power, presents the compositions on a take-it-or-leave-it basis, after brief consultation with only a handful of large bondholders.¹⁵³ For the most part, no "collaborative dialogue" occurs.¹⁵⁴ A bankruptcy regime would offer a committee structure that would make such negotiations feasible.

The United States Treasury rejected these arguments and took the lead in advocating a contractual alternative (and for a time even blocked attempts by other members of the G-7 to issue stronger words of support for the IMF plan).¹⁵⁵ Like the bankruptcy proponents, the contractarians recognize a need for concerted action within the international financial community, but they focus on the need for a

150. See Punam Chuham & Federico Sturzenegger, *Default Episodes in the 1990s: What Have We Learned?* 26-27, <http://www.utdt.edu/~fsturzen/chuhanfinal.pdf> (Nov. 24, 2003); *supra* text accompanying note 57.

151. Argentina also closed a large preemptive exchange in 2001. This was a voluntary operation, eschewing the coercive device of the exit consent. Approximately one third of Argentina's debt was exchanged, amounting to one half of eligible bonds. Ninety percent of Argentina's retail European investors exchanged. ADAM LERRICK & ALLAN H. MELTZER, CARNEGIE MELLON GAILLIOT CTR. FOR PUB. POLICY, *SOVEREIGN DEFAULT: THE PRIVATE SECTOR CAN RESOLVE BANKRUPTCY WITHOUT A FORMAL COURT* 4 (Apr. 2002), http://www.emcreditors.com/pdf/n_JEC%20Sov%20Bankruptcy%20Study%20.pdf

152. Matthew R. McBrady & Mark S. Seasholes, *Bailing-In* 4 (Dec. 20, 2000) (unpublished manuscript, on file with authors).

153. INT'L MONETARY FUND, *INVOLVING THE PRIVATE SECTOR IN THE RESOLUTION OF FINANCIAL CRISES—RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS* 14-16 (2001).

154. See Krueger, *supra* note 78.

155. See Taylor, *supra* note 11. Although Taylor's position in April 2002 appeared to be an outright rejection of the IMF's statutory proposal, the Treasury's stance appears to have softened to one of considering both proposals (while still favoring the contractual approach). See Michael M. Phillips, *Support Builds for Plan to Ease Debt Loads of Developing Nations*, WALL ST. J., Sept. 17, 2002, at A16.

transition from UACs to CACs. As we have seen, UACs make it hard to garner creditor assent to a composition. Bankruptcy proponents argue that this strengthens the case for mandatory intervention. Contractarians reverse this argument, drawing on two assumptions: First, compositions in theory create value; and second, UACs in theory benefit only opportunists who hold up rational creditors who seek access to the value created. Given both assumptions, the bondholders should be willing to exchange their UAC bonds for CAC bonds. All one need do is make a public offer of the new CAC bonds and let the market price them.¹⁵⁶ The price will, in any event, exceed that of the UAC bonds, inducing across-the-board exchanges by the old bondholders,¹⁵⁷ even the vultures.¹⁵⁸

Experts are drafting new model provisions for sovereign debt contracts. These include:¹⁵⁹

156. Presumably, the stronger the IMF policy against bailouts, the lower the price.

157. See Lerrick & Meltzer, *supra* note 151, at 3-4.

158. Any additional value-creating features of the proposed sovereign bankruptcy regime can be included in the new bond contracts. For example, if a standstill declared by the IMF creates value, the new bond contracts can channel enforcement through an indenture trustee whose enforcement powers yield to the standstill. Taylor, *supra* note 11. If subordination to new loans made after a default makes the bondholders better off, the *pari passu* clauses in the bonds can open up an exception. See Lerrick & Meltzer, *supra* note 151, at 3-4. If creditors need to delegate bargaining authority to representatives, that too can be done in advance in the contracts. See Taylor, *supra* note 11, ¶ 13.

There is a rich literature advocating contractually authorized bankruptcy. See, e.g., Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1820-39 (1998); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100-21 (1992).

159. See GROUP OF TEN, *supra* note 90. See also Miller, *supra* note 1, at 183-97, for an overview. See also G-7 FIN. MINISTERS & CENT. BANK GOVERNORS, DECLARATION ¶¶ 4-9 (1998) (examining and suggesting reforms to the international financial system), at <http://www.imf.org/external/np/g7/103098dc.htm>; G-7 FIN. MINISTERS & CENT. BANK GOVERNORS, STRENGTHENING THE INTERNATIONAL FINANCIAL SYSTEM AND THE MULTILATERAL DEVELOPMENT BANKS ¶¶ 11-13 (2001), at <http://www.g8.utoronto.ca/finance/fm010707.htm>; GROUP OF TEN, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES ¶¶ 4-10 (1996) (considering means to deal with future sovereign liquidity crises), available at <http://www.bis.org/publ/gten03.htm>; INT'L MONETARY & FIN. COMM., BD. OF GOVERNORS, IMF, COMMUNIQUÉ ¶ 11 (2001) (looking forward to exploration of increased private sector involvement in crisis prevention and management), at <http://www.imf.org/external/np/cm/2001/010429b.htm>; see also, e.g., BARRY EICHENGREEN, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE: A PRACTICAL POST-ASIA AGENDA 9-18 (1999) (offering "pragmatic" proposals for reform); BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 28-54 (1995) (discussing options and offering an agenda for reform); Lee C. Buchheit, *A Lawyer's Perspective on the New Financial Architecture*, 14 J. INT'L BANKING L. 225 (1999), reprinted in *THE REFORM OF THE INTERNATIONAL FINANCE ARCHITECTURE* 235 (Rosa M. Lastra ed., 2001); Lee C. Buchheit, *The Collective Representation Clause*, INT'L FIN. L. REV., Sept. 1998, at 9, 9-11 (considering possible changes to bond documentation); Lee C. Buchheit, *Majority Action Clauses May Help Resolve Debt Crises*, INT'L FIN. L. REV., July 1998, at 13, 13-14; Lee C.

(1) Provisions aggregating all the issuer's bonds into one class for purposes of approving a composition. The CACs would permit the modification of payment terms by a majority fraction of the bonds that is significantly less than the current 100 percent requirement.

(2) Clauses restricting individual bondholder enforcement power. These enforcement constraints could include:

(i) Majority action enforcement clauses. These require permission from a significant fraction of the bondholders before an individual bondholder can bring suit. This clause, taken together with a CAC respecting contract amendment, makes restructuring easier by relaxing the unanimity requirement and makes it harder for maverick creditors, in search of preferential payments, to bring disruptive litigation.

(ii) Super Trustee provisions. Trustees under current New York-issued sovereign bond contracts perform largely ministerial tasks.¹⁶⁰ Super Trustee provisions would grant the trustees significantly more authority. The Super Trustee would be able to make substantive decisions for the bondholders on matters such as whether to bring suit for unpaid amounts and whether to accept a restructuring offer. A Super Trustee would act for the benefit of the creditor class as a whole, solving collective action problems while eliminating the problem of maverick litigation.

(iii) Sharing clauses. A sharing clause obliges any bondholder who sues to share the recovery ratably with the other bondholders.¹⁶¹ As a practical matter, the sharing clause removes the incentive for individual bondholders to sue unilaterally in the hope of receiving an earlier and larger payment than that received by other members of the group.

Designing new clauses is easy. The hard part is getting the debtors and creditors to accept them.¹⁶² The parties are far apart:

Buchheit, *Changing Bond Documentation: The Sharing Clause*, INT'L FIN. L. REV., Aug. 1998, at 17, 17-19 (exploring the use of contractual provisions in sovereign bonds).

160. This is a far cry from the world of common stock, where shareholders of large public companies delegate almost all authority for important decisions to the Board of Directors.

161. Under the interpretation of the *pari passu* clause in *Elliott v. Peru*, Elliott Assocs., L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000), this is what the *pari passu* clause would operate to do. That particular interpretation, however, has come under some challenge. See *supra* note 109.

162. Krueger, for the IMF, responds that the UAC-CAC swap will not work. Krueger, *supra* note 78. The same creditor coordination problems that necessitate a mandatory bankruptcy will get in the swap's way. *Id.* Opportunistic bondholders will hold out, with the result that

While those on the drafting project talk about a two-thirds or three-quarters majority rule, the Emerging Market Creditors Association suggest something between 90 and 95 percent as an appropriate majority rule.¹⁶³ Many sovereign debtors match the creditors in their lack of enthusiasm for the contractual initiative. Presumably, they fear that CACs could raise borrowing costs and retard the flow of credit. But the market has begun taking baby steps towards CACs despite these fears. We have seen offerings in New York using both a 75 percent and an 85 percent threshold. Although the 75 percent threshold appears to be winning, it is still too early to predict where the market will settle, or whether it will settle on CACs at all.¹⁶⁴

A full scale and rapid transition to CAC bonds in new financings seems likely only if the IMF credibly conditions the availability of credit on use of the new debt contract provisions.¹⁶⁵ But even if such a stick proved effective, it would take years before a full transition to CACs could take place. At the end of 2001, \$354 billion of sovereign debt was outstanding. Of this amount, 70 percent was issued in the United States and Germany under UACs, while most of the remaining 30 percent was issued in Britain and Luxembourg under CACs.¹⁶⁶ If all bonds issued from 2002 onward contain CACs but none of the existing UACs are amended, 80 percent of bonds would be governed by CACs by 2010 and 90 percent by 2019.¹⁶⁷

A near term contractual solution to the creditor coordination problem, however, calls for a more heroic effort: All (or nearly all) outstanding UAC bonds would have to be exchanged for CAC bonds. If the contractual approach's basic assumption—that CACs create value

significant numbers of UAC bonds will remain in circulation. *Id.* Nor, absent a mandate, can there be any guarantee that CACs will be universal in future bond issues. *Id.* Finally, absent a neutral supervising authority, there will be no guarantee of a clean vote. *Id.*

163. See Michael M. Chamberlin, Executive Director EMTA, *Sovereign Debt Contracts: What Do We Need to Change* 3 (2002) (reporting on the view of the six emerging market debt trade associations), <http://www.emta.org/keyper/iif1017.pdf>.

164. See Barham, *supra* note 93, at 13 (asking whether Argentina will choose the 75 percent from Mexico and Uruguay or 85 percent from Brazil); Felix Salmon, *Brazil Goes Off on a CACs Tangent*, EUROMONEY, June 2003, at 156, 156.

165. For a discussion of the difficulties which might arise in connection with this, see INT'L MONETARY FUND, COLLECTIVE ACTION CLAUSES IN SOVEREIGN BOND CONTRACTS—ENCOURAGING GREATER USE 13, 15, 16-20 (2002).

Taylor suggests that the IMF could offer an interest rate reduction for sovereign borrowers whose private sector bonds contain CACs. See Taylor, *supra* note 11. Taylor also mentions a stick—the IMF would require any country using a credit facility to use CACs in its bonds. *Id.* The previous administration also took a position against interference with contract rights, even as it admitted that the contracts might be costly and inefficient. Tarullo, *supra* note 9, at 671.

166. INT'L MONETARY FUND, *supra* note 165, at 5 tbl.I.

167. *Id.* at 6.

by solving creditor coordination problems—is correct, then both debtors and creditors should be clamoring for these CAC exchanges. But there has been no such demand. So it appears that a carrot will be needed in the form of additional consideration. Alternatively, a stick could be wielded through the exit consent device, but these devices are disliked in the creditor community.¹⁶⁸ Plus, some exchanges will be hard to effectuate, even with exit consents, because the issuers are already in trouble.¹⁶⁹ If CACs do create value, why this resistance?

The discussion that follows shows that the CAC value story is contestable. In the imperfect world we live in, a rational bondholder may prefer the UAC.

■

A. Empirical Studies

A number of empirical studies seek to sustain (or falsify) the claim that CACs create value. If the CAC value story is accurate, CAC bonds should sell at lower yields than UAC bonds. But setting up a pair of comparison bonds is difficult. Ideally, one would want thickly traded bonds from the same issuer, with identical contract terms (other than, of course, the amendment clauses).¹⁷⁰ No such bonds exist; therefore, the studies proceed on a rougher basis.

One set of studies finds that CACs reduce borrowing costs for the most creditworthy issuers, and increase them for less creditworthy issuers. The inference is that good credits benefit from the prospect of coordination and lower default costs, while bad credits do not benefit because the cost advantages of the CAC are outweighed by moral hazard and default risk.¹⁷¹ Other studies find no evidence that CACs affect borrowing costs.¹⁷² Here, the inference is that the cost benefits of easy restructuring are cancelled out by the attendant decrease in the costs of default and aggravation of the moral hazard problem.

168. *Id.* at 19.

169. *Id.*

170. *Id.*

171. Barry Eichengreen & Ashoka Mody. *Is Aggregation a Problem for Sovereign Debt Restructuring?*, 93 AM. ECON. REV. 80 (2003) (PAPERS & PROCEEDINGS); see also Barry Eichengreen et al., *Crisis Resolution: Next Steps*, BROOKINGS PAPERS ON ECON. ACTIVITY (forthcoming 2003) (reporting on recent empirical research on the topic), <http://papers.nber.org/papers/w10095.pdf>.

172. See TORBJORN BECKER ET AL., BOND RESTRUCTURING AND MORAL HAZARD: ARE COLLECTIVE ACTION CLAUSES COSTLY? 25-26 (Int'l Monetary Fund, Working Paper No. 01/92, 2001); see also Anthony Richards, *The Usage and Pricing of Collective Action Clauses in International Bond Issues* (May 26, 2003) (unpublished manuscript, on file with authors). Still more studies find that CAC issuers pay a small premium. Contrariwise, some report a small discount for UK issuance. INT'L MONETARY FUND, *supra* note 165, at 12.

We question whether any study in the present context can yield a measure of the relative value of CACs and UACs. Even if a pair of comparison bonds existed and the market perceived an advantage in holding the CAC bond, it is not clear that bond prices would reflect the market's perception. Hypothesize an issuer having CAC bonds and UAC bonds outstanding simultaneously. If the issuer goes into distress, a bondholder coordination problem arises respecting the UAC bonds. If the UAC bondholders cannot be induced to agree to a composition, then any composition tentatively reached with the CAC bondholders presumably fails as well. The final effectiveness of the CAC issue composition (if properly drafted) would be conditioned on the closing of the compositions of all other issues of bonds. Otherwise, the CAC issue would end up surrendering value while the UAC issue withheld consent, causing a transfer of value from the CAC issue to the UAC issue.

Extending this line of analysis, hypothesize an issuer having only CAC bonds outstanding. Would that country's debt have a lower coupon than debt of the same maturity of another country of equal creditworthiness whose bonds contained UACs? We doubt it. Nothing would guarantee that, in the event of distress at some future time, all of the first country's issues still would be governed by CACs. This is because nothing prevents a CAC borrower from negotiating a new debt issue in New York using UACs, or, alternatively, from refunding an existing CAC borrowing in New York under a UAC. The low coupon CAC borrower, thus, could at any time turn itself into a borrower with a potential creditor coordination problem.¹⁷³ Given this inherent flexibility of status, it is difficult to see how a market yield comparison could demonstrate the value differential between CACs and UACs.¹⁷⁴

The result is that the value creation story remains a theoretical assertion. If the assertion is correct, however, we must account for the market resistance to CACs by reference to frictions, behavioral biases,

173. The problem could be solved in the CACs themselves. The CACs would condition the availability of majority amendment on majority amendment's availability in all of the issuer's bonds. We are unaware of any real world use of such a provision.

174. Compare the study of the effect of projected restructuring costs due to aggregation problems—that is, coordination costs stemming from a large number of bond issues outstanding, each one of which separately would have to assent in a restructuring. By hypothesis, the larger the number of bond issues outstanding, the greater the potential cost. Barry Eichengreen and Ashoka Mody show that distributing the same principal amount of debt across different bond issues raises the cost of debt on the tenth issue by about 8 basis points. Eichengreen & Mody, *supra* note 171. The impact is greater when the issuer has a low credit rating. Interestingly, they find that the presence or absence of CACs does not significantly effect the perceived costs of aggregation. *Id.*

path dependencies, and other imperfections. Alternatively, we can question the value assertion itself. Perhaps CACs do not hold out a first best equilibrium solution for sovereign debt contracting. If CACs are not first best, then a rational creditor in a second best world might choose a UAC.

B. Frictions and Imperfections

1. Ignorance and Myopia

The first wave of articles and reports on CACs, produced in the mid and late 1990s, had an explanatory tone. The writers assumed that sovereign debtors and creditors needed to learn about the clauses' benefits. Once the market heard the word, it would pick up the value on the table.¹⁷⁵ Yet, after a plethora of articles, numerous conferences, and repeated official sector pronouncements, most new bond issues done prior to 2003 still contained UACs. Given the bombardment of material since the mid-1990s, no one can argue that the reason this move did not begin prior to 2003 was that no one knew about the CACs.

Continued attachment to UACs suggests myopia on the parties' part, particularly amongst creditors. If creditors have a strong, albeit irrational, preference for UACs, borrowers will cater to this preference in order to avoid an increase in borrowing costs. This leaves open the problem of explaining the creditors' irrational preference.

2. Drafting Inertia

Some research suggests that contracting parties are biased in favor of using established, standard terms in their contracts. This is referred to as the "status quo" bias.¹⁷⁶ Perhaps we have such a pattern of bias here, especially considering that the respective drafting

175. For example, take the articles by Lee Buchheit. *See supra* note 159. One sees a similar tone in the early official sector reports exhorting the use of CACs, such as the 1996 Rey Report that recommended the adoption of CACs as a measure to facilitate debt restructuring. GROUP OF TEN, *supra* note 159. For a chronology of events, see Press Release, Dep't of Fin., Canada, Reforming the Global Financial Architecture: A Chronology, available at <http://www.fin.gc.ca/news02/02-034e.html#Reforming>.

176. *See generally* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) (arguing that parties to a contract view default terms as the status quo and that parties prefer the status quo to other alternatives).

practices of New York and London can be traced back to Victorian times.¹⁷⁷

A status quo bias is not an immovable block, however. It is only a bias. Even as people attach themselves to the contract terms that they begin with or inherit, they still should be willing to switch in order to capture significant benefits. The benefits claimed for CACs seem significant enough to have induced a switch by now, if those benefits actually exist.

3. Moral Hazard

Under the moral hazard story, creditors and defaulting sovereigns both want bailouts.¹⁷⁸ If their contracts have CACs, the official sector—the rich countries and the international financial institutions they control—will order the debtors to work out any problems with their creditors. UACs, in contrast, let the distressed debtors and creditors point to an insurmountable barrier to restructuring. The official sector then has no option but to provide a subsidy. The preference for UACs thus follows from opportunism.

But this story is incomplete. First, it only accounts for the preference for UACs beginning in the mid-1990s. It does not explain why UACs proliferated in the first place or why lenders in the private sector often prefer them.¹⁷⁹ Second, not every distressed sovereign gets bailed out, as the world saw with Argentina. It follows that a bond issued by a country with a low likelihood of getting a bailout could be more valuable with a CAC. But we see no such pattern. Third, bailouts are not free. They come with conditions that further the political interests of the IMF and its primary sponsors.¹⁸⁰ There

177. De Forest Billyou, *Corporate Mortgage Bonds and Majority Clauses*, 57 YALE L.J. 595, 595-96 (1948). The “innovation externalities” identified by Kahan, *supra* note 66, at 1079, in respect of the improvement of corporate trust indentures, do not obtain in respect of CACs and UACs. An innovation externality deters contractual improvement because, absent patent protection, the improvement is shared among the entire class of users. The sharing denudes the innovating lawyers of an incentive to invest in improvements. *Id.* Here, in contrast, the competing contract forms already are on the table. For the same reason, we see no network externality deterrent here. Standard forms are available if the market wants to shift to CACs.

178. See *supra* text accompanying note 14.

179. See *infra* note 184.

180. For example, it is rumored that recent disbursements of funds to Pakistan and Turkey were impliedly conditioned on supporting the anti-terrorism coalition and clamping down on Islamic militants within their borders. Brazil provides a more explicit recent case. At the time of its bailout, a pending election both contributed to the distress and gave rise to policy concerns in the official sector. Leftist candidates who were leading in the polls were required to make public guarantees that they would continue to support the current government’s free market economic policies—a step at least partially inconsistent with their political platforms. Further, it is

may be some countries that are simply too big or too nuclear to be allowed to fail. For the rest, it is not clear that strategic contracting makes sense.

4. Signaling

Asymmetric information can explain the failure to adopt CACs. The story is that creditors do not have full information about debtors, and thus worry about unobservable downside factors. When a debtor asks for a CAC, the creditor infers that the debtor expects to default. No debtor wants to signal itself as being at a high risk of defaulting; therefore, no debtor asks for CACs.

Of course, if CACs create value in excess of the cost to the debtor of the negative signal, then we should expect the debtors to introduce them despite the signal. A first mover problem may explain why this does not happen. Given inertia in the market, the first issuers to change their contracts disrupt market expectations and, as a result, incur special costs. Those costs would be compounded in the case of a change from UACs to CACs because the benefits stemming from the clauses accrue on a very long term.¹⁸¹ It follows that the costs may outweigh the benefits for the first mover, even though the benefits far outweigh the costs for debtors as a whole.

There are three problems, however, with this explanation. First, it looks only at the debtor's stake in the contract's amendment terms. Thus, even if the explanation is correct, we still have to explain why the creditors do not request CACs. Second, the story fails to confront historic market practice. An issuer seeking a CAC always has the option of taking its loan transaction to London. In so doing it runs little chance of sending a negative signal respecting creditworthiness, as New York does not take the good credits and London the bad. Countries finance in London for a long list of reasons, like interest rates, transaction costs, customers, and relationships with intermediaries; all factors more important at closing than the choice of a CAC over a UAC. Third, recent market developments rebut the story. The first moves have taken place (we suspect with pressure

difficult for many countries to know, *ex ante*, whether they will qualify for a bailout in the event of a future economic crisis. A couple of years ago, Pakistan was grouped with Ecuador and Ukraine as a country unlikely to receive a bailout. The geopolitical shifts of 2001 brought it to the front of the queue.

181. INT'L MONETARY FUND, *supra* note 165, at 11. For a fuller discussion of frictions that inhibit the improvement of standard form contracts, see Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 353-65 (1996).

from the Treasury), but to our knowledge there have been no subsequent exchange offers to move from UACs to CACs.

5. Path Dependence

The practice divergence between New York and London can be explained in part by legislative intervention and legal precedent. In the United States, Section 316(a) of the Trust Indenture Act of 1939 requires that contracts governing publicly issued bonds contain UACs.¹⁸² Contrariwise, it has been suggested that the United Kingdom requires inclusion of CACs in bonds under its law.¹⁸³ Neither regulation extends to sovereign bonds, but such regulations could have “locked in” the drafting practice in the two financial centers. Departure from the forms disrupts expectations and causes costs to be incurred. Other things being equal, could not the intermediaries be sticking mindlessly to the inherited forms, which have been influenced by regulation?

The problem is that other things are not equal under the CAC superiority story. Given value on the table, New York underwriters would request redrafting of the standard forms, and the lawyers would do what they were told despite their practice traditions and any associated cognitive biases.¹⁸⁴

182. Trust Indenture Act of 1939 § 316(a), 15 U.S.C. § 77ppp (2000). The purpose of the section was to discourage out-of-court compositions so as to force the parties into the then new Chapter X bankruptcy procedure, where strong judicial supervision was provided for. Roe, *supra* note 6, at 234. Roe argues, correctly, that subsequent changes in bankruptcy law and practice remove the need for the mandate. *Id.* at 316. Our point is that removal of the mandate would bring no change in the actual provisions of bonds, which would continue to include UACs.

183. INT’L MONETARY FUND, REPORT OF THE ACTING MANAGING DIRECTOR TO THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE ON PROGRESS IN REFORMING THE IMF AND STRENGTHENING THE ARCHITECTURE OF THE INTERNATIONAL FINANCIAL SYSTEM ¶ 54 (Apr. 12, 2000), <http://www.imf.org/external/np/omd/2000/report.htm>, cited in Tarullo, *supra* note 9, at 671 n.196.

184. Plus, the continuing presence in United States law of a UAC mandate respecting publicly traded bonds does not dictate a UAC practice respecting many bonds and notes issued outside of the mandate’s parameters. These include privately placed notes, notes traded on the so-called 144A market, bank term loans, and sovereign bonds. Yet, despite the absence of regulations mandating the terms of any of these debt contracts, almost all use UACs in the United States. Howard J. Kashner, *Majority Clauses and Non-bankruptcy Corporate Reorganizations—Contractual and Statutory Alternatives*, 44 BUS. LAW. 123, 124-25 (1988). The UAC practice, by the way, also shows up with respect to bank term loans in the United Kingdom—that country’s dominant mode of debt finance. JOHN ARMOUR & SIMON DEAKIN, *NORMS IN PRIVATE INSOLVENCY: THE “LONDON APPROACH” TO THE RESOLUTION OF FINANCIAL DISTRESS* (Univ. of Pa. L. Sch., Inst. of L. & Econ., Working Paper No. 173, 2001).

CAC bonds appeared in American financial history in cognizable numbers in only one era. This was during the Depression, when new bonds issued in reorganizations of insolvent single purpose real estate corporations sometimes contained CACs. According to testimony by an SEC

6. Summary

The foregoing explanations, taken separately or as a group, fail to explain why CACs have failed to proliferate (assuming that the value story has merit). But they do suggest that frictions will retard the present contractual reform initiative. They also leave us with a question: Whether lenders for more than a century have been investing billions of dollars pursuant to manifestly irrational contracts?

C. The Persistent Preference for Unanimous Action

Why, despite the logic of majority action, do American lenders retain their preference for unanimity not only in sovereign bonds but in all types of lending? We have three suggestions. The first follows from enforcement theory: UACs deter default by making it more expensive. Our second suggestion follows from reputational theory: When a rehabilitating debtor makes a composition offer, the process context influences the division of the surplus; UACs force the debtor to make a higher offer. The third suggestion looks to intercreditor conflicts. Coalitions within the creditor group or amongst creditors and the debtor can use the majority action privilege to impose unequal outcomes. The rational creditor will require a defense against such exploitation. Absent a robust backstop of intercreditor good faith duties, only a right of individual dissent suffices.

1. The Cost of Default

The value of a CAC lies in cheaper creditor coordination and enhanced chances of composition. But there are costs. Whether by reducing out of pocket costs or by making compositions more accessible, CACs make default cheaper. To the extent default is cheaper, strategic default becomes a more viable alternative.

staffer at the Hearings on the Trust Indenture Act, CAC bonds constituted about 10 percent of the market. *Hearings on H.R. 5220*, 76th Cong. 284-85 (1939). Much like dealmakers at today's IMF, the dealmakers in those reorganizations operated in a world without a bankruptcy procedure that imposed majority rule (at least prior to 1934). Also, like actors at the IMF, they had become exasperated with coordination problems stemming from UACs. Billyou, *supra* note 177, at 595-96. Unfortunately for the CAC value story, however, those actors also were famously sleazy. The real estate bond firms, precursors of the junk bonds dealers of the 1970s and 1980s, had been hawking speculative paper to credulous retail investors for decades, promising high returns for no risk. See JAMES GRANT, *MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 157-72* (1992) (providing a history of early twentieth century real estate finance).

But do sovereign lenders really incur a cognizable risk of strategic default? A default makes sense for a sovereign if the savings from the composition exceed the costs of default. If we assume a debt structure with CACs, that result follows only if the debtor persuades a majority of creditors to vote for the restructuring. We think it likely that institutional lenders will vote against such a restructuring if they think that the country is acting opportunistically. If we project correctly, the advantage of UACs over CACs with respect to strategic default deterrence is negligible. UACs would have a more cognizable advantage if information asymmetries can prevent big lenders from distinguishing between a strategic and a distress default. But, if there were a real risk of that happening, one would have expected creditors to be more enthusiastic about the IMF bankruptcy proposal. The IMF makes itself the gatekeeper in the proposal, undertaking to analyze a country's true financial condition before commencement of a composition process. Now, even though the creditors had many reasons for opposing the IMF's proposal, with lack of trust in the IMF no doubt prime among them, we suspect that they saw no countervailing benefit in IMF gatekeeping. Our guess is that the creditors believe themselves and other market actors, such as credit rating agencies and investment banks, to be quite capable of distinguishing between strategic and distress defaults.

A complication remains. We also have seen that sovereign defaults have strategic overtones even in distress situations: Sometimes government actors decide to default, making a political decision that weighs the impact of tax hikes and other strains on the domestic economy against the cost of default.¹⁸⁵ If CACs influence these calculations so as to make default more likely, then it follows that the contractual initiative does not hold out a free lunch, at least to a private creditor.

Nobody knows where these costs and benefits net out. Recall the ambiguous implications of the empirical studies canvassed in the previous section. One study, finding no evidence that CACs lower borrowing costs,¹⁸⁶ reasonably inferred that the decrease in the cost of default and the attendant increase in the magnitude of the moral hazard problem caused by CACs could offset the benefits of easy restructuring. On this analysis, a creditor rationally could choose between a CAC and a UAC based on a coin flip. From this, an explanation for the century-long divergence in the drafting traditions

185. See *supra* text accompanying note 51.

186. See *supra* note 172 and accompanying text.

of New York and London follows. As between the two apparently equal choices, any small factor in the legal, economic, or cultural background can cause the practice to tip in favor of one approach over the other. The choice having been made, the conservative, repetitive dynamic of debt contracting assures that the choice becomes universal in the market and prevails for an indefinite period.

Recall that a contrasting study suggested that creditworthy borrowers might prefer CACs because cheaper creditor coordination would lower the creditors' default costs. Borrowers with bad credit would use UACs because, with default a more immediate prospect, the cost advantages of the CAC would be outweighed in the lenders' minds by moral hazard and default risk.¹⁸⁷ But this theory can support the opposite conclusion as well.¹⁸⁸ Bolton and Scharfstein hypothesize that a low-quality firm would find it optimal to maximize its liquidation value: A distress default being likely, it would want contracts carrying as little cost as possible in the event of default. The smaller the number of creditors and the lower the voting barrier, the cheaper the liquidation and the greater the value of the debt.¹⁸⁹ In contrast, with high credit borrowers, strategic default is the dominant problem. Factors increasing the cost of such a default—such as multiple creditors and tougher voting rules—enhance the value of the debt.¹⁹⁰

We emerge with opposing suggestions: CACs for good credits and UACs for bad credits, or alternatively, UACs for good credits and CACs for bad credits. This ambiguous economics fails to predict a logical dominance by either UACs or CACs.¹⁹¹

2. The Division of the Surplus

Bolton and Scharfstein explain that the greater the number of creditors and the higher the percentage of creditor votes needed to approve a renegotiation, the lower the debtor firm's surplus in the renegotiation.¹⁹² This point says something important about United States creditors' preference for UACs.

187. See *supra* note 171 and accompanying text.

188. Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 19-20 (1996).

189. *Id.* at 3.

190. *Id.*

191. Patrick Bolton notes an additional complicating factor. Bolton, *supra* note 76. A borrower's commitment to excessively high restructuring costs does more than build in a disincentive to default. *Id.* at 31. It also builds in an incentive to overborrow. *Id.* at 31-32.

192. Bolton & Scharfstein, *supra* note 188, at 18.

Consider the game posited below:

Exchange Offer Game

		Creditor B	
		Cooperate	Defect
Creditor A	Cooperate	<i>625, 625</i>	<i>550, 800</i>
	Defect	<i>800, 550</i>	<i>400, 400</i>

The set up assumes that a sovereign borrower in distress has offered its two creditors a composition of \$550. The offer is stingy: If the creditors surmount their collective action problem and negotiate with the borrower, they can get the offer increased to \$625. Holding out, “defecting” in the parlance of the prisoner’s dilemma, can mean an \$800 payoff. If both creditors hold out, the deal fails and the recovery is \$400 received after an extended default and a long lapse of time.

It is unclear what a creditor should do. The italicized outcomes in the chart show A’s optimal moves given the alternatives of cooperation and defection by B. If B accepts the offer, A is better off holding out and taking the \$800. But if B holds out, A is better off cooperating and taking the \$550, thereby avoiding the worst-case payoff of \$400. Since A does not know what B is going to do, it is not clear how A should play. A multiple equilibrium outcome results—the situation is unstable.

The posited payoffs lend insight into the divergence of views between the official sector and the creditors. Bankruptcy proponents focus on the avoidance of the \$400 payoff and the realization of the \$625 payoff, arguing that only a bankruptcy process offers the creditors a stable context in which to realize the \$625. The contractarians also focus on the avoidance of the \$400, positing that with CACs and a large group of creditors, the prospect of an \$800 recovery is eliminated, and with it the \$400 worst-case scenario. The question is how the dispersed creditors then surmount the negotiating barrier presented by the take-it-or-leave-it exchange offer of \$550, so as to benefit from a more equal division of the surplus. The magnitude of the resulting problem depends on the barrier’s height. Given institutional bond holding, the barrier may not present a substantial problem in the real world. Informal coordination is possible amongst a small group of lead institutions, making it possible for the group to

reject \$550 and bargain for \$625 as a group without the need for a bankruptcy process.

The UAC proponent sees things differently. If all the bonds have CACs, the take-it-or-leave-it offer is \$550. The question is whether the offer would be higher if all the bonds had UACs. We answer the question in the affirmative, and suspect that most creditors do too. Given information asymmetries, the creditors will have a range of upset prices respecting acceptance of the debtor's offer. If the debtor needs 100 percent or a supermajority, it will have to increase its offer to meet the reservation prices at the higher end of the range.¹⁹³ The UAC thus counteracts the disorganized creditors' tendency to cut and run to take a lowball offer.

Of course the UAC creates a hold out problem even as it causes the offer to rise. But a hard-nosed bondholder has a response: If the offer makes a generous split of the surplus, holdouts will not be so numerous as to threaten the deal. No one ever expects 100 percent participation in a composition under UACs. Yet such exchange offers close all the time on the basis of supermajority acceptance.¹⁹⁴ Meanwhile, neither the bankruptcy advocates nor the contractarians offer evidence that holdouts regularly cause exchange offers to fail.¹⁹⁵ When offers do fail, it may be that they are too low and, as a result, attract something much less than a supermajority of creditors.¹⁹⁶

193. This is nothing more than the law of downward sloping demand. It explains why bidders make tender offers for majority blocks with back end mergers, rather than attempt to purchase firms through open market purchases. See generally Richard Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1055 (1991) (arguing that the existence of downward sloping demand explains various market phenomena); Lynn Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1259-75 (1990).

194. The creditor associations are asserting that a 90 percent participation would be needed—a daunting figure. See GROUP OF TEN, *supra* note 90. But a look at the leading private case, *Katz v. Oak Industries, Inc.*, 508 A.2d 873 (Del. Ch. 1986), shows a complex exchange offer with an upset participation requirement of 85 percent or less. That upset calculation will change from situation to situation.

195. See Stewart Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161, 169-70 (1997) (showing that the holdout problem does not seem to be so severe as to prevent the accomplishment of restructurings respecting public debt, particularly given use of coercive devices like exit consents); see also Jean Helwege, *How Long Do Junk Bonds Spend in Default?*, 54 J. FIN. 341, 348-49 (1999).

196. We draw indirect support for this assertion from Marcel Kahan and Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?* 66 J. BUS. 499 (1993). This presents the results of a study of 58 consent solicitations in which an issuer of widely held debt requested the modification of existing covenants but did not request either interest deferral or principal forgiveness. *Id.* at 502-03. Since covenants tend to be absent from investment grade debt, nearly all of the issues surveyed were junk bonds. *Id.* at 503. The solicitations broke down as follows: 25 were simple consent solicitations in which receipt of an offered cash payment was conditioned on

A numerical example will help explain this. Assume that a sovereign is in default on debt with a face amount of \$100. These bonds are trading for \$65, a value that can be expected to fall further unless rehabilitation succeeds by means of a composition. The sovereign, now on the road to recovery, can afford to pay \$95. The surplus is \$95 minus \$65 or \$30. Assume that with a CAC providing for amendment by a two-thirds majority, the sovereign can get the requisite participation by offering a bond worth \$75—a two-thirds to one-third split of the surplus in the sovereign's favor. With a UAC, it will have to offer more. Assume that if it offers a bond worth \$85, it will get 90 percent participation under the UAC, leaving holdouts with face value claims of \$10. The value of the \$85 exchange offer is as follows:

$$\begin{aligned} \$85 \times .90 &= \$76.50 \text{ (consideration to participants)} \\ \$100 \times .10 &= \$10.00 \text{ (consideration to holdouts)} \\ \$86.50 &\text{ (total yield to bondholders)} \end{aligned}$$

This recovery reverses the percentage division of the surplus—now it is roughly two-thirds to the bondholders and one-third to the sovereign. The problem lies in the possibility that too many bondholders will hold out and defeat the offer, leaving the holders with bonds only worth \$65. Let us assume that composition failures due to holdouts are rare—a 20 percent possibility. The question is

consent to the amendment; 24 were accompanied by tender offers; 8 were accompanied by exchange offers; 1 was accompanied by a tender offer and an exchange offer. *Id.* A requirement of an exit consent or consent as a condition to payment was present in 44 of the 48 offers for which data could be found. *Id.* at 506-07. The issuers sought, inter alia, to make leveraged acquisitions (31 percent), make dividends or other stockholder payments (13.8 percent), conduct recapitalizations (10.3 percent), sell assets (8.6 percent), and issue more debt (6.9 percent). *Id.* at 504 tbl.1.

The average payment offered in those solicitations exchanging the consent for cash was \$20.51 per \$1,000 face value; the median cash payment was \$15 per \$1,000 face value; nine of the 23 cash offers were above \$20; the two largest were \$60 and \$95. *Id.* at 511. Evidence of the result of the solicitation was found for 52 of the cases, and in 83 percent of these the solicitation succeeded. *Id.* at 503. A statistical survey of the prices of the issues showed that 29 of 42 issues, or 69 percent had positive abnormal returns around the time of the announcement of the transaction: The average abnormal bond return was 2.34 percent, while the average abnormal return for the stock of the issuer was 9.5 percent. *Id.* at 510. Thus, the study showed that the solicitations increased the value of both the debt and the stock.

Kahan and Tuckman conclude that the issuers have not been exploiting the structural opportunity to coerce that the bond contracts create. *Id.* at 513. They hypothesize that the bondholders can, in practice, coordinate their response so as to insure an adequate level of payment. *Id.* As evidence, they cite the formation of bondholder groups in 12 cases; of these 12 solicitations, 11 either failed or had their terms modified before approval. *Id.* at 512. Overall, in 42 percent of the cases, the issuers modified the terms after an initial failure to obtain consents. *Id.*

whether that possibility makes the CAC offer more attractive. It does not:

$$86.50 \times .80 = 69.20$$

$$65.00 \times .20 = 13.00$$

$$\text{\$ } 82.20 > \text{\$ } 75$$

Now say the probabilities are 50-50:

$$86.50 \times .50 = 43.25$$

$$65.00 \times .50 = 32.50$$

$$\text{\$ } 75.75 > \text{\$ } 75$$

The expected value of the UAC exchange offer is still greater than that of the CAC offer. Only at under a 50-50 chance of success does the CAC create value for the creditors as a whole.

The above numbers are our invention, posed for the sake of argument. To the extent they strike the reader as plausible, it follows that UACs are not irrational, and CAC value is not a sure thing.

3. Exploiting Minority Creditors

Finally, CACs present a risk of opportunistic collusion between the debtor and a majority of creditors to exploit a minority of the creditors. The debtor makes a side payment to a majority of the creditors, inducing them to support a composition that reduces its overall debt burden by extracting value from the minority creditors. For example, the large creditors may be promised future business with the sovereign. This is not an unlikely eventuality in the sovereign context, where the sovereign's incentive to compromise arises largely from a desire to return to the credit markets. Thus, respecting a particular composition on offer, the interests of primary lenders and bondholders from the secondary market can diverge, with the primaries lumping returns from the composition together with returns from projected new deals with the sovereign, and the secondaries looking only to the composition. Alternatively, a sufficient fraction of the debt may be purchased at low prices by entities sympathetic to the sovereign. These sympathizers then validate a composition that exploits the minority creditors.¹⁹⁷

With a UAC, a minority creditor does not have to worry about majority opportunism. If it thinks the deal burdens its interest unduly, it can hold out.

197. See, e.g., Coffee & Klein, *supra* note 68.

D. Summary

The foregoing makes us dubious of the CAC value story. But we do not claim to have refuted it. After all, CAC bonds have been issued for more than a century in London without friction or objection. But we do claim to have refuted the charge that bondholder objections to CAC exchanges (and sovereign bankruptcy) stem only from opportunism related to IMF bailouts. This leads us to predict that there will be no spontaneous move for universal CACs. If the contractual strategy is to accomplish anything, the IMF, the United States Treasury, and the other G-7 nations will have to do more than simply induce an initial move. The question they need to ask is: What steps will make the move pervasive and stable?

V. COLLECTIVE ACTION AND GOOD FAITH

Movement to CACs began in 2003, evidenced by several New York bond issues and successful exchange offers.¹⁹⁸ Where then do we find ourselves? To the extent the CAC-UAC preference differential is narrow and historically grounded, these recent transactions could herald a preference shift. But, to the extent the preference differential is based on considerations from the core of the debtor-creditor incentive structure, the transactions could amount to only an isolated episode. One could then see movement back toward UACs in new bond issues (and in any exchange offers, as a sweetener).

Either way, the new equilibrium sought by CAC proponents could be destabilized if collusive behavior skews the results of restructurings for the benefit of majority creditor coalitions. This could happen when a majority of bondholders approves a restructuring that allocates most of the surplus to the sovereign in exchange for the sovereign's promise of future lending business. Alternatively, a one-sided deal could result when a large percentage of the debt is held by nationals of the sovereign (or other sympathetic entities). If such incidents occurred, it would not take long for the markets to move back to UACs, which provide an effective, if crude, mode of prevention. It follows that a stable contractual transition to CACs presupposes the control of side deals. This control could come from contract drafting or, alternatively, from the backstop regime of contract law (specifically, the good faith duty).

198. See Elmar B. Koch, *Collective Action Clauses—The Way Forward*, GEO. J. INT'L L. (forthcoming 2004).

In this Part we argue that judges interpreting and applying CAC bond contracts under New York law should take the initiative and sculpt a regime of intercreditor good faith duties adequate to police collusion and other opportunism on the part of bondholders of distressed sovereigns.

A. Contract Drafting Versus Judicial Intervention

We confront at the outset the argument that sovereigns and bondholders desiring to prohibit collusion will draft appropriate exclusions in their contracts' voting provisions. Under this view of contract law, the good faith duty operates as a gap filler that prevents opportunism that the parties would have contracted to prohibit had they thought of the contingency at the outset. Where, however, the contingency was well-known to the parties *ex ante*, and they made no provision preventing it, no constraint on self-interested conduct is imposed *ex post*. Since the parties know about the possibility, their silence implies consent. Even if consent cannot be implied on the facts of the case, the judge should still refrain from intervention in order to force parties to draft better contracts.¹⁹⁹

In the case of CAC bond contracts, the opportunistic action at issue—the debtor colluding with a majority of creditors to exploit the minority—would likely be envisioned at the outset by the parties. As we have seen, fear of such opportunistic behavior is a primary explanation for the century-long use of UACs. It arguably follows that if market actors omit a direct prohibition of collusion in connection with a considered move to CACs, they must not want one. Alternatively, since the presence or absence of a prohibition could bear on the contract price, the creditors must be unwilling to pay the price of the extra protective term. Finally, the creditors may be relying on reputational markets. Where markets impose reputational costs on misbehaving debtors—for example, by raising their costs of borrowing—and the court system is both expensive and error prone, creditors may rationally decide not to purchase the right to go to court.

We question this line of reasoning from start to finish, reciting our objections from finish to start.

The reference to reputational enforcement posits that creditors prefer reputational sanctions over court-based enforcement. Borrowers who misbehave towards their creditors do suffer reputationally. But,

199. See, e.g., Frank H. Easterbrook and Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426, 445 (1993); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 324-25, 329-30 (1992).

as we have seen, the sovereign debt market specializes in long-term forgiveness.²⁰⁰ More importantly, even if market reputational sanctions were significant and there were correspondingly high costs of litigation, it does not follow that creditors would avoid putting a protective term in the contract, if indeed a suitably drafted term were available. Sovereign creditors already contract for numerous enforcement provisions, despite the fact that direct enforcement opportunities rarely occur. Avoiding the costs of going to court does not seem to be a concern that determines the terms of sovereign debt contracts.

Moving to the implication of consent from knowledge, drawing inferences from contract silence about what the parties wanted at the drafting table is a risky business. The parties could make either of two provisions respecting good faith: They could specify that the contract is governed by a good faith duty, or, if the parties wanted no backstop protection, they could explicitly exclude good faith review. As a predictive matter, each alternative seems equally likely. Yet neither shows up in bond contracts, even though the current default position of the law is somewhat unclear in the sovereign context. It follows that the problem here cannot be solved as a matter of volition. What we have is instead a normative problem: The burden to draft explicitly must be allocated to one party or the other and this allocation stems from a normative choice on the part of the judge.

Finally, we reach the argument that refraining from intervention forces the parties to draft explicitly. This presupposes that a complete menu of contingent contract terms is available to the parties. The sovereign context, however, is full of unforeseeable contingencies, a matter made worse by problems of observability and verifiability.²⁰¹ Much of good faith and fiduciary law exists to provide ex post solutions respecting such non-contractable subject matter.

We suspect that this is also the case where the experts do not know how to draft explicit prohibitions.²⁰² Even though opportunistic

200. See *supra* text accompanying notes 36-39.

201. For contributions to the literature making this point, see Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988). See also Bengt Holmstrom & Paul R. Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991) (showing that contracts that tie an agent's compensation to verifiable measures can divert effort and attention from other more important but less easily measured aspects of performance).

202. That the creditor community is concerned about problems of opportunities arising as a result of CACs is evidenced by the recent attempts to draft a "code of conduct." See Angela Pruitt, *Conduct Code in Emerging Markets Bridges Difference*, DOW JONES CAP. MARKETS REP.,

collusion between the debtor and a majority of its creditors is a known possibility with CACs, it can show up in infinite guises.²⁰³ For example, the contract could provide that any bondholder with a commitment to lend to the bond issuer loses its vote. But a lender in discussions with the sovereign about a future deal would not be picked up by such a provision. Indeed, such conversations arguably should not come at the cost of the vote and are hard to observe in the bargain. Yet *ex post*, the conversation could occasion conduct viewed as bad faith. Specificity with respect to prohibited relationships, such as bond holding by entities controlled by the sovereign (who might later collude with the sovereign against external lenders), also creates a risk of overcoverage. What one era views as a suspect relationship can be deemed harmless by the next generation.²⁰⁴ Things like insider borrowing—for example, a sovereign selling bonds to state run entities—can be beneficial to the external creditors in cases where the insiders are the only ones willing to lend.

In sum, determining whether there has been opportunism that traverses the line of good faith involves a fact intensive, “you know it when you see it” analysis. The job of policing therefore requires an adjudicator.

B. Good Faith, Financial Contracts, and Sovereign Debt under CACs

But will the courts take responsibility and police sovereign debt restructurings? Presumably, the projected CAC bonds still will be governed by the law of New York. But there is precious little New York law either on intercreditor duties specifically or sovereign bond law more generally. It is likely, then, that a court confronted with the good faith case posited here would look at general corporate bond law and attempt to translate it to the sovereign context. Unfortunately, good faith duties have been found to be essentially nonexistent in the corporate bond context.

We argue that a successful contractual transition to CACs would justify a move backwards in time from today’s barren good faith

June 18, 2003. Perhaps more importantly, the one full scale move from UACs to CACs, that of Uruguay, has provisions in it that take a first step at protecting against debtor opportunism. See Felix Salmon, *Uruguay Closes a Loophole*, EUROMONEY, May 2003, at 101, 101.

203. See Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917, 926-28 (2002).

204. This happened with the Trust Indenture Act, which as originally drafted offered a long list of prohibited trustee relationships, all of which were deleted by the Congress in an amendment thirty years later. S. REP. NO. 101-155 (1989).

landscape to precedent from the late nineteenth and early twentieth centuries, when courts demonstrated more of a willingness to step in and block opportunistic behavior by creditors against each other.²⁰⁵ We propose a trade. For years, the official sector has been pleading for CACs. Under pressure, the markets have reluctantly taken initial steps towards them.²⁰⁶ We argue that there is a necessary “give back” to support further forward movement and import long term stability: Judicial policing of the opportunistic use of CACs in restructurings. The trade implies costs for the domestic public sector, in the form of additional work for certain courts. But that extra cost seems minimal in comparison to the benefits gained from process improvements in sovereign restructurings.²⁰⁷

1. The Negation of Good Faith

Recent generations of cases on bondholder rights teach that lending relationships are arm’s-length transactions among sophisticated parties and that, absent an explicit contract term, there are no constraints on borrower or intercreditor opportunism.²⁰⁸ The courts start with the premise that sophisticated parties enter into bond contracts; parties capable of negotiating for the terms they want.²⁰⁹ For a court to imply additional terms, *ex post*, would be to frustrate their intent and add uncertainty.

205. See *infra* notes 234-240 and accompanying text.

206. In 1998 there was a bond issue by Thailand that was done with CACs, but this may have been an aberration. See ELECTRICITY GENERATING AUTHORITY OF THAILAND, OFFERING CIRCULAR (Oct. 13, 1998) (on file with authors). The most recent move towards attempting CACs began with the filing of a shelf offering by Mexico (presumably under United States pressure) where the stated intent was to use 75 percent majority action provisions for payment terms. See John Authers, *Mexico Pioneers Plan to Ease Debt*, FIN. TIMES, Feb. 25, 2003, at 25, 2002 WL 14178460.

207. The analysis of good faith in the sovereign context in this Article, builds on a preliminary treatment in Buchheit & Gulati, *supra* note 104, at 1339-42.

208. There are a number of articles tackling the bondholder-stockholder conflict. See Caroline M. Gentile, *Allocating Risk and Control: The Role of Bond Covenants in Corporate Governance*, U.C. DAVIS L. REV. (forthcoming 2004) (reviewing the literature). In 2003, we have seen Mexico, Brazil, Uruguay, South Africa, Turkey, and Korea, among others, move to experimenting with CACs in their New York law bonds. Even prior to this, isolated issuances to countries like Lebanon and Qatar were not enough to garner attention, let alone produce any momentum for a market shift to CACs. On the prior issues, see MARK GUGIATTI & ANTHONY RICHARDS, DO COLLECTIVE ACTION CLAUSES INFLUENCE BOND YIELDS? NEW EVIDENCE FROM EMERGING MARKETS 5-8 (Reserve Bank of Austl., Research Discussion Paper No. RPD 2003-02, 2003), <http://www.rba.gov.au/rdp/RDP2003-02.pdf>.

209. See *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1049 (2d Cir. 1982); see also *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

Accordingly, interpretation proceeds within the four corners of the contract, even when a good faith breach is alleged.²¹⁰ The rule is that no fiduciary or good faith duties run from the debtor to the bondholders unless the opportunistic conduct violates an explicit clause of the contract. This rule has been articulated despite black letter law that all contracts are subject to an implied covenant of good faith and fair dealing. As articulated in the *Restatement (Second) of Contracts*, good faith is a backstop duty intended to protect parties who do not have specific contract provisions to protect them.²¹¹ In the majority of cases, to require a contract term first, as the rule for bonds does, is to say “no good faith duty.”²¹²

To make out a claim for a breach of the narrow good faith duty that applies to bond contracts, the bondholder plaintiff must demonstrate that it is clear from the “express terms” of the contract that a particular implied contract term would have been included in the contract if the parties had negotiated over it.²¹³ The result is that, to the extent a debtor takes an action pursuant to an express clause of the contract, the good faith argument is cut off.²¹⁴ The court will not step in when the debtor (or creditor) takes an action pursuant to the express terms of the agreement, even if it happens to substantially impair the realization of another party’s contractual expectations.

2. Narrow Good Faith and Intercreditor Relationships

The leading intercreditor case is *Aladdin Hotel Co. v. Bloom*,²¹⁵ decided by the Eighth Circuit in 1953. It concerned an issue of real

210. See William W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 120 n.123 (citing *Gardner & Florence Call Cowles Found. v. Empire, Inc.*, 589 F. Supp. 669, 673 (1994) (holding that an implied covenant of good faith derives substance directly from Indenture’s language and cannot give debenture holders any rights inconsistent with those set out in the Indentures) and *Katz*, 508 A.2d at 879 n.7 (holding that a corporation’s duty of good faith to bondholders differs from its duty to stockholders)).

211. RESTATEMENT (SECOND) OF CONTRACTS §§ 204 cmt.d, 205 cmt.a (1981).

212. See William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 933-34 (2002).

213. *Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998); *Katz*, 508 A.2d at 880; see also *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989) (holding that a covenant of good faith and fair dealing is implied only where the implied term is consistent with other mutually agreed upon terms in the contract).

214. See *Metro. Life Ins. Co.*, 716 F. Supp. at 1517 (“In contracts like bond indentures, ‘an implied covenant . . . derives its substance directly from the language of the Indenture and cannot give the holders of Debentures any rights inconsistent with those set out in the Indenture.’” (quoting *Gardner & Florence*, 589 F. Supp. at 673 (internal quotation marks omitted))).

215. 200 F.2d 627 (8th Cir. 1953).

estate bonds left over from a depression era composition. Interest was payable at 5 percent out of income only until maturity, which was after ten years.²¹⁶ Thereafter, if the bonds were not paid down, interest was an absolute 8 percent, a high coupon in those days.²¹⁷ Before the tenth anniversary, a group holding a majority of the stock of the issuer purchased a majority of the bonds.²¹⁸ Unfortunately for the bondholder minority, the bonds contained a CAC. The CAC gave the dual majority a simple expedient on the tenth anniversary: Amend the bonds to extend the maturity date another ten years.²¹⁹ The 5 percent out of income interest provision was thereby also extended.²²⁰ This, as a practical matter, assured that no proceeds of the enterprise ever entered the pockets of the minority bondholders—insiders easily can manipulate things so that no “income” ever will exist. Had the securities been common stock, majority to minority fiduciary duties would have been available to protect the minority on this “freeze out” fact pattern. But the Eighth Circuit slammed the door in the minority bondholders’ faces.²²¹

Aladdin Hotel was decided before the articulation of the contemporary contract law good faith duty. But the case’s spirit activates the later intercreditor cases. Most have arisen in the syndicated loan context. The courts proceed from the premise that the parties are sophisticated commercial actors who have entered into an arm’s-length contract. Given this premise, the courts will not imply good faith duties unless the parties expressly contract for them.²²² Hence, in *First National Bank Ass’n v. Canadian Imperial Bank of*

216. *Id.* at 628.

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* at 633.

222. *E.g.*, *First Citizens Fed. Sav. & Loan Ass’n v. Worthen Bank & Trust Co.*, 919 F.2d 510, 514 (9th Cir. 1990); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank*, 731 F.2d 112, 122 (2d Cir. 1984); *Banco Urquijo, S.A. v. Signet Bank*, 861 F. Supp. 1220, 1249 (M.D. Pa. 1994); *Banque Arabe Et Internationale D’Investissement v. Md. Nat’l Bank*, 819 F. Supp. 1282, 1296 (S.D.N.Y. 1993); *Banco Espanol de Credito v. Sec. Pac. Nat’l Bank*, 763 F. Supp. 36, 45 (S.D.N.Y. 1991).

There is one New York case that suggests that creditors in syndicated loan agreements have meaningful obligations in the context of pursuing legal action against the debt. *Credit Francais Int’l, S.A. v. Sociedad Financiera de Comercio, C.A.*, 490 N.Y.S.2d 670, 684 (N.Y. Sup. Ct. 1985). As the bulk of the case law cited demonstrates, however, this case has had little impact. For criticisms of the case, see Lee C. Buchheit, *Is Syndicated Lending a Joint Venture?*, INT’L FIN. L. REV., Aug. 1985, at 12; Lee C. Buchheit & Ralph Reiser, *The Effect of the Sovereign Debt Restructuring Process on Inter-creditor Relationships*, 1988 U. ILL. L. REV. 493, 502-04. See also Jeffery N. Brooks, *Participation and Syndicated Loans: Intercreditor Fiduciary Duties for Lead and Agent Banks Under U.S. Law*, BUTTERWORTH J. INT’L BANKING & FIN. L., June 1995, at 275.

Commerce, when a group of banks in a syndicate entered into a standstill agreement with the borrower following a missed interest payment, the court rejected a minority member's argument that the majority was obliged to declare a default.²²³ Similarly, in *New Bank of New England v. Toronto-Dominion Bank*, when a majority of the lenders did not vote to accelerate the debt, despite the occurrence of an event of default, the court refused a minority lender's complaint that the majority was obliged to vote to accelerate.²²⁴

The syndicated bank loan cases, although rejecting a mainstream good faith inquiry, can be read narrowly on their facts. Thus read, they stand for the proposition that when a majoritarian modification occurs in a distress situation, includes an equal payout to all the creditors, and involves no side deal between the majority and the debtor, no violation of duties to the minority occurs.²²⁵ *Aladdin Hotel* presents more of a problem. It specifically involves bonds and sustains a majoritarian amendment of the bond contract that effects a manifestly unfair transfer of wealth from the minority to the majority.

One recent case, however, that does protect a bondholder minority is *Federated Strategic Income Fund v. Mechala Group Jamaica, Ltd.*²²⁶ There, a federal district court in New York barred an Exit Amendment offer that looked unfair to minority holders.²²⁷ The amendments in question, effected under a CAC, would have essentially stripped the debtor corporation of all of its assets and left the dissenting creditors with only a shell against which to pursue their claims. A strict reading of the precedent on coercive exchange offers suggested that the debtor owed no significant good faith duty. The court, however, faced with the unfairness of the offer, had little trouble in deciding to block the transaction.²²⁸

223. No. 3-93-366, 1995 U.S. Dist LEXIS 12105, at *14 (D. Minn. June 9, 1995).

224. 768 F. Supp. 1017, 1021-22 (S.D.N.Y. 1991); see also *Yucyco, Ltd. v. Republic of Slov.*, 984 F. Supp. 209, 221 (S.D.N.Y. 1997) (rejecting minority creditor's claim that agent was obliged to declare an event of default and accelerate the debt—where the indenture required permission from the majority creditors to accelerate—even though the particular minority holder had been excluded from participating in the offer).

225. In any event, syndicated loan disputes do not translate easily to the context of a large sovereign bond issue because the relationships among creditors in a syndicated loan tend to be tighter and the creditors are likely to be more sophisticated (generally banks and other financial institutions) than in the bond context.

226. No. 99 CIV 10517 HB, 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999). For a discussion of the case, see Buchheit & Gulati, *supra* note 74, at 73.

227. *Federated Strategic*, 1999 WL 993648, at *7, 10.

228. *Id.* at *10. Similarly, in a later *Yucyco* case incarnation from the one discussed above, Judge Chin was faced with a somewhat harsh action by the majority creditors. *Yucyco, Ltd. v. Republic of Slov.*, 1999 WL 169530 (S.D.N.Y. Mar. 25, 1999). What the majority creditors did

The bottom line still is that the case law gives a majority of creditors wide rein in amending the terms of a bond contract pursuant to an express term. But *Mechala* at least suggests that the door could open for claims of bondholder majority to minority oppression. The case becomes stronger when reference is made to cases antedating *Aladdin Hotel*.

3. The Special Case of Sovereign Debt

Assume that the courts are not about to reconsider their rejection of good faith duties in the corporate bondholder context. There is nevertheless a case for an exception for sovereign bonds.

The contemporary rejection of intercreditor duties occurred in the shadow of Chapter 11 and its predecessors. Inside Chapter 11, a fiduciary regime including intercreditor duties comes to bear.²²⁹ This protective regime takes tentative steps in pre-bankruptcy distress situations,²³⁰ but self-protection by contract otherwise prevails outside of bankruptcy. The implicit judgment is that when they really need

was to consent to release the obligor banks from any and all claims under the prior debt agreement. *Id.* at *2. Yucyco had not been permitted to participate in the exchange agreement and yet had also lost its claims against the obligor banks. *Id.* As a formal matter, the court ruled that the action of the majority creditors violated a “no amendment” clause. *Id.* But a plausible argument was made by the defendants that this clause only applied to those items that had been carved out as exceptions to the majority Modification clause. *Id.* at *3. The court, however, went to something like a good faith rationale in saying: “A creditor would not have been likely to loan substantial sums under an agreement that would permit important rights—such as the ability to seek payment from certain obligors—to be extinguished by a simple vote of the majority of creditors.” *Id.*; see also Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1833 (1992) (“Even if the terms of the bond contract did not contain a term that expressly prohibited the debtor or its controlling stockholders from voting on amendments, it is hard to imagine any court today that would interpret a ‘majority consent’ provision to validate such a stripping of bondholders’ entitlements.” (footnote omitted)).

229. Under Bankruptcy Code section 1129(b), a reorganization plan may not “discriminate unfairly.” This is not a strict rule of pro rata treatment. Since the Code literally prohibits only “unfair” discrimination, by implication it allows for discriminatory departures from pro rata treatment so long as they are not “unfair.” The justification is that the plan allocates a “surplus” over liquidation value to which all creditors have not made a proportionate contribution. 7 COLLIER ON BANKRUPTCY ¶ 1129.04[3][b] (Resnick et al. eds., 15th ed. rev. 1996).

The leading case, *In re Aztec Co.*, 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989), offers a four-part test to determine whether discrimination is unfair: (1) whether the discrimination has a reasonable basis, (2) whether the debtor can confirm a plan that does not discriminate, (3) whether the discrimination is in good faith; and (4) how the plan treats the classes discriminated against. For a critical discussion, see Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998).

230. See WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 275-90 (5th ed. 2002) (describing application of fraudulent conveyance law and fiduciary duty to protect creditors in financial distress situations).

it—in severe distress situations—bondholders get protection. But, so long as the bond is paying, no solicitude need be extended.²³¹

Sovereign debt is different because no bankruptcy regime protects sovereign creditors. It follows that bond contract law that assumes bankruptcy's availability does not translate well to the context of a distressed sovereign.²³² The doctrine, in effect, has a gap. We would fill it by having a judge interpolate good faith intercreditor duties in distress situations, especially in cases of opportunistic behavior on the part of a bondholder group.

There is precedent with which to fill this gap. To find this case law we have to look to the period prior to the creation of the federal bankruptcy reorganization regime.²³³ During that era, distressed corporate bond issuers and bondholders struggled in an environment not dissimilar from that facing sovereign issuers and bondholders. Unsurprisingly, the case law on bonds and bond contracts was different.²³⁴

The early twentieth century commentary suggests that a majority of creditors seeking to impose a restructuring plan on a dissenting minority owed the minority fiduciary duties.²³⁵ The description of the duties as “fiduciary” may sound extreme today, but in those days the term also covered territory covered by today's good faith duty. Both commentators and judges from the period contemplated that a majority-driven debt restructuring, in which dissenting minorities were taking a haircut, would be subject to scrutiny.²³⁶ Leading cases such as the Second Circuit's decision in

231. See *Metro Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

232. Cf. Tarullo, *supra* note 9, at 633-40 (explaining how the differences between sovereigns and companies make it difficult to translate laws that govern companies to the sovereign context).

233. On the federalization of bankruptcy, see David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 490-512 (1994).

234. Bratton, *supra* note 210, at 118 n.114 (citing Francis Lynde Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts and Debenture Indentures*, in STETSON ET AL., SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 25-27 (1917) (justifying complexity of trust indentures, not on ground that no legal protection exists, but on ground that implied-in-law protection is too uncertain)).

235. See, e.g., Charles H. Haines, Jr., *Corporations—Modification Provisions of Corporate Mortgages and Trust Indentures*, 38 MICH. L. REV. 63, 67 (1939).

236. See Billyou, *supra* note 177, at 596-97 (describing the applicable law in England and Canada and noting that modifications in the United States were subject to similar restrictions in terms of court scrutiny); cf. Note, *The Rights and Remedies of the Bondholder Under Corporate Bonds and Indentures*, 27 COLUM. L. REV. 579, 584-86 (1927) (stating that the majority bondholders were assumed to be acting in the best interests of the bond class, but suggesting that the courts were especially concerned with collusive arrangement between the debtor and the majority creditors).

*Hackettstown National Bank v. D.G. Yuengling Brewing Co.*²³⁷ have never been explicitly overruled.²³⁸

The high water mark for discussions of majority-minority intercreditor duties was the period between 1890 and 1930. The cases and articles discussing them tended to involve the equity receivership. This was a judicial device used in the pre-bankruptcy reorganization era to assist firms, particularly railroads, whose distress implied economic jeopardy for the community as a whole. In those days, federal bankruptcy meant liquidation, which made no sense because the railroads were worth more as going concerns than as liquidated entities, and the economy depended on them in any event. The distressed railroads were interstate entities, so state insolvency receivership laws were inadequate to tackle their problems, and there was no federal corporate reorganization mechanism. Hence, with the urging and assistance of Wall Street lawyers, most prominently Paul Cravath, the federal courts stepped in to supervise restructurings.²³⁹ A creditor would go to a judge and ask for the appointment of a receiver to take control of the debtor's assets. Eventually a creditor majority would present a plan to the judge (a plan engineered by insider shareholders, and their lawyers and investment bankers). The judge would issue a decree that would enjoin creditors from enforcing their claims against the reorganized corporation by using means other than those provided for in the decree. Majority bondholders owed relatively strong obligations to behave fairly towards minorities.

The precise contours of the late nineteenth and early twentieth century theory of intercreditor rights are difficult to discern, given that the judicial opinions are context specific. Yet, we think it is clear

237. 74 F. 110 (2d Cir. 1896).

238. *Hackettstown* has language suggesting that creditors owe each other fiduciary duties. *Id.* at 112-14. For the most part, however, the modern day bond cases do not mention it (perhaps because the lawyers are not aware of it and do not raise it before the court). One recent case that did tackle *Hackettstown* was *CIBC Bank & Trust Co. (Cayman) v. Banco Central do Brasil*, 886 F. Supp. 1105, 1115 n.8 (S.D.N.Y. 1995). In *CIBC*, the plaintiffs were asking that the court rule in their favor against what looked to be a collusive arrangement between the debtor and a large debt holder (one of the debtor's instrumentalities) on the basis of the implied duties of good faith among creditors. *Id.* at 1114. The *CIBC* court ignored the broad language in *Hackettstown* that suggested fiduciary type duties existing among creditors and instead distinguished *Hackettstown* by pointing to the different factually situation there. *Id.* at 1115 n.8.

239. For a description of these equity receiverships that sets them in the context of a history of the developments in United States bankruptcy law, see DAVID SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001).

that the level of concern for creditor rights during this period was higher than it has been since World War II.²⁴⁰

4. English Intercreditor Duties

The commentators tell us that meaningful intercreditor duties also obtained in English law during the early portion of the last century.²⁴¹ That voice of English authority faded during the course of the twentieth century, however. But, unlike United States contract law, today's English law does not interpolate a line of cases that rejects the proposition of good faith scrutiny of bond contracts. Until recently, there simply were no cases. Meanwhile, British bond issues, domestic and sovereign, have employed CACs, while British bank loan contracts have tracked United States practice and combined UACs and CACs.²⁴²

The period of silence ended recently with the decision of *Redwood Master Fund Ltd. v. TD Bank Europe Ltd.* by the High Court in London.²⁴³ This intercreditor case suggests the possibility of good faith scrutiny. The case involved a syndicated loan arrangement under which the payment terms were covered by a UAC and the secondary terms by a CAC. The debtor was in distress. A default on one of its borrowings had triggered a cross default provision in the instruments—"tranche A"—upon which the plaintiffs had purchased exposure. The debtor had not yet drawn down the tranche A funds. Given the default, it had no right to do so, which was fine with the plaintiffs. The plaintiffs' problem was that other tranches had been drawn down and the majority of the lenders held interests in both the undrawn tranche A and the already-drawn tranches. A conflict of interest resulted: Those who had already loaned money (and had not been repaid) wanted to keep lending from tranche A because the loan proceeds would flow through to repay the obligations from the other

240. Indeed, in the Depression era, bondholder interests appear to have been the primary concern of the courts, legislatures, and policy makers. See William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 748 (2001); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1374-75 (1998).

241. See Billyou, *supra* note 177, at 596-97 (citing materials).

242. See ARMOUR & DEAKIN, *supra* note 184.

243. 2002 WL 31676297 (Ch. Dec. 11, 2002). Given the rarity of such cases, the case received considerable attention in the press (leading to articles with provocative titles such as "Bankers win court battle over the future of lending") and that brought it to our attention. *E.g.*, Rob Mannix, *Bankers Win Court Battle over the Future of Lending*, INT'L FIN. L. REV., Jan., 2003, at 4, 4-5; *Best Interests of Lenders Paramount*, TIMES (London), Jan. 30, 2003, 2003 WL 3100029; *Majority Banks: Authority*, PLC MAG., Jan. 1, 2003, 2003 WL 12877470.

tranches. Those who had not loaned, however, had no desire to see their money be put to use for that purpose by a distressed company. The clause governing a waiver of the default was a CAC. An 80 percent creditor majority used the CAC to waive the default.²⁴⁴ Plaintiffs challenged, arguing that the majority's action violated the majority's implied obligation to exercise its CAC power "in the best interests of the class as a whole."²⁴⁵

The court recognized that the majority had an obligation to exercise its amendment power in good faith, but it found the plaintiffs' reading of the good faith duty too expansive. The implied duty of good faith, said the court, protected against actions that were "dishonest abuses" of majority power and amounted to "fraud."²⁴⁶ Alternatively, plaintiffs could win if they were to demonstrate that the exercise of majority power had been "motivated by a malicious wish to damage or oppress the interests of the minority."²⁴⁷ The duty did not extend so far as to require that the majority make no changes that hurt one subgroup more than another. It was in order to enable effective decision making in such situations, the court explained, that the decision-making power had been delegated to the majority.²⁴⁸ The minority's good faith reading, in contrast, amounted to a minority veto right.²⁴⁹

The court stated that these cases have to be decided on their individual facts and scrutinized for bad faith or fraud.²⁵⁰ On the facts of the case, it found that the waiver was beneficial for the holders of tranche A as a whole and that there was no bad faith or manifest unfairness.²⁵¹ Taken together, this suggests that, despite the outcome, English courts will scrutinize the merits of cases where minorities challenge the majority's action on a CAC. It is less clear whether the case implies that good faith scrutiny was an active possibility in

244. *Id.* Subsequently, the consent of over 95 percent of the creditors in value was obtained. *Id.*

245. *Id.* In making their argument, plaintiffs pointed to the judgment in a 1927 dispute between majority and minority shareholders, *British America Nickel Corp., Ltd. v. M.J. O'Brien, Ltd.*, [1927] A.C. 369, 371 (P.C. 1927), where Viscount Haldane said: "[T]he Power given [under majority voting provisions] must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only." *Redwood Master Fund*, 2002 WL 31676297.

246. *Id.*

247. *Id.*

248. *Id.* Plus, the parties in a syndicated loan arrangement were sophisticated parties who knew what kind of arrangement they were getting into at the outset. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

England throughout the twentieth century, thereby helping to explain the persistence of CACs in London issue bonds. But some inferences can be drawn. The parties in *Redwood Fund* vigorously contested what the common law precedents dictated, suggesting that the historical practice did not predict a clear result. At the same time, the absence of recent case law, taken together with the serious reception accorded the plaintiff's argument, suggests a standing expectation of judicial scrutiny.²⁵²

5. The Contrary View

We fight a rear guard action in arguing for good faith. At first cut, the sovereign context looks much the same as the traditional corporate one. Sophisticated parties enter into detailed contracts. The sovereign debt cases from recent years suggest that courts view things this way.

252. A hint as to the historical understandings of intercreditor obligations is also contained in a recent review of a private bankruptcy settlement by the Supreme Court of Judicature. In reaching its decision that the private settlement was void, the court found that there was an implicit good faith duty among creditors. *Somji v. Cadbury Schweppes, PLC*, 2000 WL 1881249 (Ch. Dec. 20, 2000). The court, although explicit that it was not relying on cases prior to 1996, stated that

the deputy judge's impressive survey of old law [predating the Bankruptcy Act of 1996] shows that in relation to compositions and arrangement with creditors the court did impose a strict requirement of good faith as between competing unsecured creditors . . . [and although] there is no strong presumption that a similar presumption must be found in the new regime [created in 1996] . . . (to put it at its lowest) it would be no great surprise to find it in there in one form or another.

Id.

Although we articulated intercreditor duties as good faith obligations, an English court might also characterize them as either fiduciary or implied duties. English law appears to contemplate both possibilities. On fiduciary duties, English law appears to keep a fairly open definition of such duties and often adds fiduciary relationships as it sees fit. See J. Beatson, *ANSON'S LAW OF CONTRACT* 267-68 (28th ed. 2002). The three broad categories of fiduciary duties that already exist are as follows: relationships of trust and confidence; relationships of power/influence/discretion; and relationships of confidentiality. See P.J. Millett, *Equity's Place in the Law of Commerce*, 114 *LAW Q. REV.* 214, 219-21 (1998); see also Alexander F.H. Lokem, *Fiduciary Duties and Implied Duties of Good Faith in Contractual Joint Ventures*, *J.B.L.* at 550-56 (Nov. 1999). One could argue that intercreditor duties fit either of the first two categories. Moving to implied duties (and it is worth noting that the judge in *Redwood Masters* used the concepts of "good faith" and "implied duties" interchangeably at times), there appear to be three types of implied terms: (1) terms that the parties probably had in mind but did not bother to add in the contract, (2) terms that the parties, regardless if they had them in mind, would have agreed to if the issue was raised, and (3) terms that, regardless of whether they had them in mind, would have added to the contract if they had foreseen the difficulty. Glanville Williams, *Language and the Law*, 61 *LAW Q. REV.* 71, 401 (1945). Depending on context, intercreditor duties could fit into any one of the three categories.

In *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*, the borrower's lawyers argued that the court should use principles of comity to thwart an enforcement action by a holdout creditor.²⁵³ The Second Circuit said no. Writing for the panel, Judge Calabresi explained that the United States interest in allowing contract enforcement actions trumped the need for a smooth debt resolution process:

First, the United States encourages participation in, and advocates the success of, IMF foreign debt resolution procedures under the Brady Plan. Second, the United States has a strong interest in ensuring the enforceability of valid debts under the principles of contract law, and in particular, the continuing enforceability of foreign debts owed to United States lenders. The second interest limits the first so that, although the United States advocates negotiations to effect debt reduction and continued lending to defaulting foreign sovereigns, it maintains that creditor participation in such negotiations should be on a strictly voluntary basis. It also requires that debts remain enforceable throughout the negotiations.²⁵⁴

Similarly, in *Elliott Associates, L.P. v. Banco de la Nacion*,²⁵⁵ the same court rejected another sovereign plea. This time the request was that the court use principles of champerty to block the holdout creditor's actions.²⁵⁶ The court quoted Judge Calabresi's language from *Pravin Bankers* and explained that it was not going to take an action against the holdout creditor that in effect produced an involuntary "cram down."²⁵⁷ We point these cases out to flag two things. First, their tone is hostile to the notion of intercreditor obligations. Second, that hostility appears to follow from the courts' perception of United States interests. We discuss the importance of the second point later.

Finally, *CIBC Bank & Trust Co. (Cayman) v. Banco Central do Brasil*²⁵⁸ involved a sovereign debtor, an intercreditor dispute, and a discussion of intercreditor law from the turn of the twentieth century. *CIBC Bank* bears a factual resemblance to *Aladdin Hotel*. The plaintiffs were minority holders of Brazilian debt under a syndicated loan agreement.²⁵⁹ One of the other lenders in the syndicate was Banco do Brasil ("BdB"), an instrumentality of the state.²⁶⁰ Brazil had defaulted on its obligations and CIBC wished to accelerate the debt.²⁶¹

253. 109 F.3d 850, 853-54 (2d Cir. 1997).

254. *Id.* at 855 (citations omitted).

255. 194 F.3d 363 (2d Cir. 1999).

256. *Id.* at 369.

257. *Id.* at 380.

258. 886 F. Supp. 1105 (S.D.N.Y. 1995).

259. *Id.* at 1107.

260. *Id.*

261. *Id.*

Through the debt holdings of BdB, however, Brazil was able to block CIBC's attempt to accelerate because the contract required a vote of more than 50 percent of the creditors and BdB owned 51 percent.²⁶² Citing old intercreditor duty cases such as *Hackettstown*, the plaintiff argued that the collusive arrangement between Brazil and BdB violated the implied duties of good faith and fair dealing.²⁶³ The court, however, stated that the old case law was inapplicable because it involved "compositions," that is, restructuring agreements that the parties make when the debtor is insolvent.²⁶⁴ This case, it explained, was about a contract dispute, and the plaintiff knew fully well at the time of contracting with Brazil that BdB was a lender.²⁶⁵ Hence, had the lenders wanted a clause that restricted BdB from having its votes counted, they should have asked for it at the outset.²⁶⁶

The case repeats the hard line that no implied duties obtain in respect of action explicitly authorized by the contract.²⁶⁷ That said, the court failed to confront the old cases and commentaries. First, it is not clear that intercreditor duties existed only in the context of a composition or insolvency. As discussed, the language about intercreditor duties from that period appears stronger.²⁶⁸ Second, Brazil was indeed going through a composition; Brazil had defaulted on its debt and had to renegotiate. The plaintiff was a minority creditor suing under the old debt instruments because it did not want to go along with the new plan Brazil had proposed.

C. Summary

The *CIBC* court should have scrutinized the deal. Whether it would have found anything is another question. Similarly, a bond market shift from UACs to CACs should be viewed as a material

262. *Id.*

263. The *Hackettstown* decision was pointed out to the court by the plaintiffs in a supplemental letter to the briefs. *See id.* at 1115 n.8; *see also* Letter from Martin London, Attorney, Paul Weiss Rifkind & Wharton, to Judge Loretta A. Preska, U.S. District Judge (May 1, 1995) (on file with authors).

264. *CIBC Bank & Trust Co.*, 886 F. Supp. at 1115.

265. *Id.* at 1116-17.

266. *Id.* at 1117.

267. Judge Preska quotes the following language from *Metropolitan Life Insurance Co. v. RJR Nabisco*, 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989), one of the standard cases in modern debtor-creditor law: "In contracts like bond indentures, an implied covenant derives its substance directly from the language of the Indenture, and cannot give the holders of Debentures any rights inconsistent with those set out in the Indenture." *CBIC Bank & Trust Co.*, 886 F. Supp. at 1116.

268. *See supra* notes 234-240.

change in circumstances justifying a shift to good faith scrutiny. For endorsement of this assertion, we look to no less an authority than the United States Treasury.

We think the Treasury, having promoted CACs, has a responsibility to intervene in subsequent litigation to explain the new regime and its implications for the judicial role. There is precedent for such intervention. In *Allied Bank International v. Banco Credito Agricola de Cartago*, Costa Rican banks had defaulted on their obligations as the result of their government's decision to restrict outflows of foreign exchange.²⁶⁹ 170 out of 171 creditors agreed to a composition.²⁷⁰ The one holdout accelerated its debt.²⁷¹ The Second Circuit, in its first hearing of the case, and consistent with what it perceived to be the creditors' interest in an orderly restructuring of the debt, blocked the acceleration.²⁷² On rehearing en banc, however, the Justice Department informed the court that the government's policy, while favorably disposed to orderly restructurings, primarily favored allowing the creditors to enforce their contracts.²⁷³ In other words, private ordering (and holdouts) were to trump the policy rationale that had guided the court's first decision. The resulting en banc decision of the Second Circuit reversed the court's earlier position.²⁷⁴ This policy position was later echoed in Judge Calabresi's opinion in *Pravin Banker*²⁷⁵ and then again in *Banco de la Nacion*.²⁷⁶

If the government were to make a similar appearance today, it presumably would state the opposite position.²⁷⁷ From the public's

269. 757 F.2d 516, 519 (2d Cir. 1985). The *Allied Bank* decision and creditors' coordination problem in the absence of sovereign bankruptcy were much discussed issues in the mid-1980s. See, e.g., Stephen Bainbridge, *Comity and Sovereign Debt Litigation: A Bankruptcy Analogy*, 10 MD. J. INT'L L. & TRADE 1, 29 (1986); Andrew C. Quale, Jr., *Allied Banks' Effect on International Lending*, INT'L FIN. L. REV., Aug. 1985, at 26; Ruben Sklar, *Renegotiation of External Debt: The Allied Bank Cases and the Chapter 11 Analogy*, 17 U. MIAMI INTER-AM. L. REV. 59 (1984); Roger M. Zaitzeff & C. Thomas Kunz, *The Act of State Doctrine and the Allied Bank Case*, 40 BUS. LAW. 449 (1985).

270. Bainbridge, *supra* note 269, at 29.

271. *Id.*

272. *Allied Bank*, 757 F.2d at 519-20.

273. *Id.*

274. *Id.* at 523. On *Allied Bank*, see Tarullo, *supra* note 9, at 676 and more generally, Bainbridge, *supra* note 269.

275. 109 F.3d 850 (2d Cir. 1997).

276. 194 F.3d 363 (2d Cir. 1999).

277. See Tarullo, *supra* note 9, at 676 (pointing out that the Justice Department can inform a court that the government's policy had changed (while also suggesting that it is not clear a court would depart from the pattern of literal enforcement of debt contracts)). While the government policy in *Allied Bank* was to urge the court to allow the non cooperating creditors to sue, that position had softened by the time of the *CIBC* case, where the United States government amicus

perspective—one where the rich countries want to avoid bailouts and the poor countries want to avoid the pain presently suffered by Argentina—the goal should be to help CACs survive. If the courts fail to police opportunistic behavior, the markets likely will move back to UACs, as opposed to undertaking the daunting task of contracting for more explicit good faith duties. The government accordingly could tell the courts that public policy considerations point towards a default rule of meaningful good faith intercreditor duties.

In sum, we project that the courts could be persuaded to turn to the old equity receivership cases (especially if supported by an amicus brief from the United States government). Such scrutiny would not prevent a majority of creditors from taking actions to enable a restructuring of a distressed sovereign's debt. It would simply enable a displeased minority creditor to ask for review of the majority's modification plan. That heightened judicial scrutiny would bring with it heightened uncertainty and the possibility that the modification plan will be set aside. But that is not a bad thing if creditors are concerned about coercive modifications and the scrutiny lends comfort. In the long run, creditors who feel safer will be more willing to lend.

We are left with two sets of solutions at different ends of the spectrum. Under the prevailing weak good faith doctrine, the majority of creditors under a CAC can use modification terms to solve the holdout problem. The problem is the risk of oppressive majority action. The result is the bondholders' preference for UACs, which in turn creates the holdout problem. To persuade creditors to move to, and stay with, the use of CACs, they need a substitute for the protections that UACs otherwise provide them. Key among these protections are good faith duties.

One solution would be to include these gap-filling duties within a new statutory bankruptcy scheme for sovereigns. There are reasons for preferring a statutory scheme over contractual modification.²⁷⁸ But the only plausible statutory scheme on the table today is that of the IMF and neither the creditors, the debtors, nor the United States Treasury want anything to do with it.²⁷⁹ That means that the most

brief expressed concern about the actions of vulture creditors. See Charles D. Schmerler, *Litigating Defaults on Sovereign Debt Law, Policy Struggle to Defer to Foreign States While Honoring Lenders' Rights*, N.Y. L.J., Apr. 15, 2002, at S1.

278. See, e.g., David A. Skeel, Jr., *Can Majority Voting Provisions Do It All*, 52 EMORY L.J. 417 (2003).

279. See, e.g., Miller, *supra* note 1, at 184, 196-97 (describing the United States Treasury's views on CACs, where although the United States prefers CACs to the SDRM, it serves its purposes to keep the threat of the SDRM open so as to induce the markets to try CACs); *A Better*

likely solution will be a move to CACs under New York contract law.²⁸⁰ For that solution to remain stable, the courts interpreting these contracts need to read implied duties into the contracts.

VI. CONCLUSION

When a policymaker from Washington asks a bondholder to exchange her UAC bond for a new bond with a CAC, the bondholder will be suspicious. “Policy,” after all, often means a loss of value inflicted to advance someone else’s agenda. Recent debates in Washington do not allay such suspicions. The talk centers on ways to make sure that, when help is extended, none of it comes the bondholders’ way. At a time when the value of the bondholders’ investments has plummeted, institutions not known to make sacrifices themselves sternly lecture the bondholders on the need to take less. In such an atmosphere, it is not surprising that the bondholders resist reform.

If the policymakers expect the bondholders to exchange UACs for CACs, they will have to allay their fears. This accommodation could come in the form of money, but there is no money. We offer several second best solutions. First, the policymakers need to emphasize that sovereign bondholders reasonably can be asked to make give ups only as a means to the end of creating surpluses. Then the policymakers need to state that the fair division of those surpluses is their top policy priority. To make that statement credible, they need to confront the deficit in legal protection. When compared to their corporate counterparts, sovereign creditors already have fewer protections.²⁸¹ To delimit these protections without providing a credible substitute creates the risk that the creditors will take their money and play elsewhere.²⁸²

Way to Go Bust, *supra* note 13, at 64 (reporting that “most financiers, whether bankers or bondholders, loathe the SDRM”), *available at* 2003 WL 6244817.

280. See Miller, *supra* note 1, at 184, 196-97.

281. See SHLEIFER, *supra* note 2, at 5-10.

282. See *id.* at 4-5 (reviewing evidence showing that where creditor and shareholder rights receive more protection, investment levels are higher and markets are thicker).